Is This Company About to Revolutionize the Oil Sands?

Description

Recently, I wrote about **MEG Energy** (TSX:MEG), calling it Canada's cheapest oil company.

MEG's management team has done a nice job keeping operating costs under control, which means it can generate plenty of free cash flow, even with crude trading at today's still-depressed levels. The company has a market cap of $1.6 billion today; it's estimated to produce $445 million in free cash flow in 2019, assuming crude oil averages US$60/barrel. That gives us a free cash flow yield of 28%.

Or, to put it another way, MEG shares should generate enough free cash flow to buy the whole company in fewer than four years.

Some of Canada's other top oil producers also have attractive free cash flow yields, but they don't have the long-term reserve life that MEG offers. The company's heavy oil reserves in the south Athabasca region in Alberta should last another 40 years at current production levels. Better technology could mean access to more barrels, which means the reserve life would actually increase over time.

MEG could even be acquired by one of the major producers. Remember, **Husky** made an offer to acquire the company for $11 per share less than a year ago, a deal that ultimately failed. Shares trade at $5.52 each as I write this. A 100% return would be a nice short-term reward. Long-term investors could see $25 per share; that's what the stock traded at back in 2015.

The company isn't just a cheap oil producer play. It also has some interesting technology — something that could revolutionize how bitumen is transported from the oil sands.

A better way?

Oil sands crude is incredibly thick. It has little resemblance to the oil you put into your car or use to grease up your lawn mower.

Bitumen is too thick to flow through pipelines, so producers have a couple of options. They can either

invest in upgrading equipment that converts bitumen into something closely resembling light sweet crude. Or they can add diluent to the thick crude, enough that it flows nicely through the pipeline.

MEG has started a field project testing a third method. Its patented Hi-Q process is a three-step method to separate some of the heavier parts from bitumen, making it thin enough to flow through pipelines without diluent.

The process still uses diluent to transport bitumen from the field to the upgrading plant, but it can then be recycled for additional use. The heaviest parts of the bitumen are then removed. The resulting crude can flow through pipelines without needing to be thinned down.

The process has three distinct advantages. It's much more environmentally friendly compared to the traditional upgrading process. It would immediately free up gobs of much-needed pipeline space. Remember, bitumen needs to be diluted by 30% before it'll flow through pipelines. Finally, oil sands producers wouldn't need to acquire natural gas condensate to act as a diluent. Condensate has traditionally traded for close to the same price as light sweet crude. This means oil sands operators would see cost savings as well.

Convinced its technology works, MEG is now working with bankers to see if it can license the process to other oil sands operators. With oil sands production expected to grow to some four million barrels per day by 2030, it's easy to see a massive potential market for this process.

The bottom line

MEG Energy is already one of Canada's cheapest oil stocks. That alone makes the stock a buy today.

Hi-Q is just icing on the cake. Other oil sands producers might choose to copy the technology rather than pay to use it. Or they might be more comfortable continuing with the current system. Still, it's a very interesting part of an already enticing investment opportunity.

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