Are Natural Gas Stocks the Investment of the Century?

Description

Despite years of expected bounce-backs, natural gas has remained a losing bet for more than a decade. From 2001 to 2008, Henry Hub natural gas prices averaged roughly $8 while reaching highs of above $14 several times.

Following the financial crisis of 2008, prices went on a 10-year decline, falling close to the $2 market earlier this year.

Several recent events, however, have caused some analysts and big-time investors to turn bullish. The market remains skeptical, but if they're right, there could be 100% upside potential in nearly a dozen natural gas stocks.

Betting on the reversal of a decade-long downtrend is risky, but it's bets like these that produce spectacular results. Let's find out whether natural gas stocks are setting up to be the bet of the century.

Understand the past

If you don't understand why natural gas prices are depressed, you won't be able to take advantage of a reversal. That's because the current market dynamic betrays basic sensibilities about how markets work. Often, markets respond to demand.

If natural gas demand rises, prices will rise in suit. If natural gas demand falls, prices will likewise fall. While that's still true on a short-term basis, the long-run direction of pricing has followed *supply*, not demand.

In 1970, U.S. natural gas production—the biggest determinant of North American pricing—peaked at roughly 60 billion cubic feet per day. Over the next 35 years, production stagnated. By 2005, production was still around 60 billion cubic feet per day.

In 2005, the shale revolution kicked off, driven by fracking, horizontal drilling, and dramatically lower production costs. Notably, drillers weren't searching for natural gas.

Instead, they were drilling for higher-margin crude oil. The associated natural gas production was merely a byproduct.

From 2005 to 2019, natural gas production grew by more than 50%, even as prices tumbled lower and lower as natural gas pricing was decoupled from demand.

Energy companies were willing to sell their natural gas production at any price because the only thing they actually cared about was the associated oil production.

Investors keep calling a rebound, but as long as inexpensive crude oil exploration drives natural gas production, it will be difficult to forecast a pricing rebound. Consider **Peyto Exploration & Development Corp.** (TSX:PEY).

Shares have gone on runs of 100% or more multiple times in recent years due to a resurgence in optimism. Yet since 2011, the stock has lost 80% of its value.

Peyto has some of the cheapest production costs in the industry, but it's no help when natural gas prices have the ability to fall lower than the entire industry cost curve.

How to invest

There will undoubtedly be additional resurgences in optimism, but as mentioned, they will end in failure given that natural gas prices aren't a reflection of typical economic realities.

Major oil operators like **Exxon Mobil Corporation** and **Chevron Corporation** are still developing some of the biggest North American shale projects in history, so the problem of excess supply won't go away for a decade or more. However, there's still a way to make a fortune.

Stocks like **Encana Corp.** (TSX:ECA)(NYSE:ECA) continue to trade based on outdated perceptions. In 2013, the company produced just 35,000 barrels of oil and condensate per day. The vast majority of revenues were dependent on natural gas.

Since then, oil and condensate production has grown by more than 700%, reaching 235,000 barrels per day last quarter. Oil and condensate now account for 70% of production.

Whereas the company was booking big losses in recent years, Encana actually generated $127 million in free cash flow last quarter.

Despite the pivot to more profitable oil production, the market is still pricing Encana stock at multi-year lows. In order to capitalize, management recently launched a $1.25 billion buyback program. "We see compelling value in Encana's stock today," says CEO Douglas Suttles.

"In fact, we strongly believe that buying our own equity is an incredible value." With a net asset value between $10 and $15 per share, Encana is a true contrarian pick with multi-bagger upside.

CATEGORY

1. Energy Stocks
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TICKERS GLOBAL

1. TSX:PEY (Peyto Exploration & Development Corp)

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Date
2025/08/23
Date Created
2019/09/22
Author
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