Better Buy: Imperial Oil (TSX:IMO) (USA) vs. MEG Energy (TSX:MEG) (USA)

Description

The energy industry is at a crossroads. While many operators are still struggling to survive at US$50 per barrel oil, others are exploring new projects that have breakeven prices all the way down to US$15 per barrel. Meanwhile, nearly every oil and gas company is driving down costs to historic levels — and flipping the industry cost curve on its head.

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Two of the most heavily traded **TSX** oil stocks, **Imperial Oil Ltd.** (TSX:IMO)(NYSEMKT:IMO) and **MEG Energy Corp** (TSX:MEG), face two very different futures. If you're invested in Canada's energy sector, especially if you own the aforementioned stocks, you'll want to understand which type of company can succeed in the future ahead.

Falling cost curve

Costs are falling throughout the energy sector. Some companies are thriving, while others struggle to keep up. Consider giants like **Exxon Mobil Corporation**, **Royal Dutch Shell**, and **Chevron Corporation**. All three are targeting breakeven prices in North America that rival the cost basis of Saudi Arabia.

If you want to survive the future of oil, bringing down your breakeven production level is critical, which means operators like MEG Energy are in trouble.

MEG Energy is a pure play Canadian oil sands producer operating in Northern Alberta. If you know anything about oil sands, you know that this company is facing an uphill battle. Oil sands nearly always require more refining before hitting the market. More refining results means more costs, putting oil sands production at a permanent cost disadvantage.

Today, MEG Energy's breakeven price is likely above US$40 per barrel. When considering maintenance expenditures, reserve replenishment, and higher transportation costs due to pipeline bottlenecks, the true breakeven price could be as high as US$50 per barrel. With oil prices hovering around US$54 a barrel, the company is on thin ice.

Imperial Oil is in much better condition. Its true breakeven price is much closer to US$40 per barrel, especially given that it operates its own refineries, mitigating the extra cost of bringing oil sands output to market.

Additionally, Imperial Oil is partially owned by Exxon Mobil, which is largely considered one of the best capital allocators in the business. It's no wonder the company outperforms MEG Energy when it comes to breakeven levels and cost reductions.

Integrated or bust

MEG Energy is a pure energy producer, which means it explores and produces oil — nothing more. For refining and transportation, it relies on external partners like **Enbridge Inc**. When demand for pipeline capacity surged last year, there simply wasn't enough space for additional oil throughput.

Regional oil prices fell by 50%. Companies like MEG Energy suffered immensely, so much that the company started lobbying the National Energy Board regulator for relief.

Imperial Oil, on the other hand, sailed through the crisis nearly unscathed. Year to date, MEG Energy shares are down 37%, while Imperial Oil stock has fallen by just 7%.

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The outperformance is due to its integrated approach, which means the company owns its own refinery and pipeline infrastructure. In fact, when oil prices fall, refinery margins often rise, mitigating any commodity pricing volatility.

This year, Norway's $1.1 trillion sovereign fund decided to divest companies solely dedicated to oil and gas exploration and production. That would theoretically include operators like MEG Energy.

The fund isn't selling for environmental reasons, but rather because it believes oil prices could continue to slide long term due to reduced demand and production costs. Notably, it opted to keep its investments in integrated operators like Imperial Oil. That's a huge vote of confidence in its pipeline and refining assets.

The choice between Imperial Oil and MEG Energy is clear. Integrated companies like Imperial Oil will best survive the next decade of oil.

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2. NYSEMKT:IMO (Imperial Oil Limited)
3. TSX:IMO (Imperial Oil Limited)

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