Avoid Natural Gas Stocks

Description

Despite the claims of some pundits that natural gas is due to rally because of a looming winter and marked growth in demand, there are signs that what is regarded as the clean fossil fuel will remain caught in a long-term slump. Natural gas has lost a whopping 21% since the start of 2019, and there were fears, even in the run-up to winter, that it would fall below US$2 per MMBtu. While this is unlikely, and natural gas will firm as winter approaches, the long-term outlook for the fuel remains poor, despite growing consumption, which will see the fuel make up 40% of the global energy mix by 2040.

Poor outlook

A key factor weighing on natural gas is that global production continues to expand at a furious clip. By the end of 2018, annual U.S. dry natural gas production had soared to a record 83 billion cubic feet (Bcf) daily and marketed output continues to grow, with the U.S. EIA expecting 2019 output to increase by 10% year over year to almost 92 Bcf per day. This makes the U.S. the world's largest producer, having overtaken Russia in 2011 and being responsible for almost 22% of natural gas produced globally.

This massive surge in production is being driven by the shale oil boom, where natural gas for many drillers has become an almost worthless by-product. Such strong production growth caused U.S. natural gas exports to grow at a rapid rate, reaching a record 3.61 Tcf for 2018, which saw it become a net exporter of natural gas for the second year running.

Canadian natural gas output is also steadily expanding, further contributing to a growing global supply glut.

According to the International Energy Agency (IEA), world demand for natural gas soared by almost 5% in 2018, which was the fastest pace since 2010. The agency also expects global demand to expand by 1.6% annually until 2024, primarily driven by China's rapidly expanding consumption. What is increasingly apparent is that global natural gas supply is growing rapidly and exceeding demand, which is weighing heavily on prices as well as the outlook for natural gas.

For these reasons, most natural gas stocks are an unappealing investment.

Natural gas producers are struggling to deliver value

Even drillers like **Painted Pony Energy** (TSX:PONY), **Peyto Exploration and Development**, and **Birchcliff Energy**, which own quality assets, have been punished by the market for the poor outlook for natural gas, losing 57%, 66%, and 40%, respectively, for the year to date. Not only are they being sharply impacted by weaker natural gas prices and the fuel's poor outlook, but the Canadian benchmark AECO natural gas price trades at a 25% discount to the North American Henry Hub price.

The impact weaker natural gas is having is on Canadian drillers is evident from their second-quarter 2019 results. Painted Pony reported a net loss of almost $15 million for the period and a weak operating netback of $1.26 per thousand cubic feet equivalent (Mcfe) of natural gas produced, which was 35% lower year over year.

Peyto's netback also declined, falling to $2.06 per Mcfe, which was 21% lower than a year earlier, whereas Birchcliff's netback plunged by almost 14% to $1.90 per Mcfe. The sharp decline in their netbacks, which is a key measure of operational profitability, can be blamed on softer natural gas prices and a wider price differential between the AECO benchmark and North American Henry Hub price.

Painted Pony recently sold a 75% interest in its Montney acreage for $45 million as part of its efforts to raise capital to strengthen its balance sheet and reduce the risks posed by weaker natural gas. The driller also slashed its capital spending to preserve its balance sheet and improve financial flexibility in a difficult operating environment, where softer natural gas continues to weigh on its performance. That will impact its ability to grow production.

Foolish takeaway

The poor outlook for natural gas combined with its latest weakness doesn't bode well for natural gas producers, making them highly unappealing investments. Among the worst affected are Canadian drillers like Painted Pony, where their profitability and earnings are further impacted by the discount applied to the Canadian benchmark AECO natural gas price. For these reasons, investors seeking exposure to energy should look elsewhere.

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