Can Encana's (TSX:ECA) Stock Double Your Money?

Description

Last week I talked about how investors can double their money through investing. Using the rule of 72, investors can determine out how many years it will take for them to double their money. Similarly, they can use the rule to determine the rate of return required if they have a pre-determined time frame.

It's worth noting that the margin of error with the rule is small when the required rate of return is 20% or less. The higher the rate of return above 20%, the higher the margin of error and the less useful the number becomes.

Case in point, the rule of 72 implies that a return of 72% would result in a double in only one year. We know this to be factually inaccurate as a double requires a 100% return.

Encana (TSX:ECA)(NYSE:ECA) is a perfect example where the rule of 72 doesn't give an accurate picture. Encana is an oil & gas producer that's had a tough year. In 2019, the company's stock price has cratered, losing approximately 38% of its value.

The good news for investors looking for a bargain, Encana is one of the cheapest on the **TSX Index**. It's trading at a mere 6.27 times earnings, about half times its historical averages. It hasn't been this cheap since the financial crisis in 2009.

Encana's fortunes are dependent on commodity prices. Although it is aggressively growing liquids production, the company is still highly susceptible to the prices of natural gas and natural gas liquids (NGLs). Combined, they accounted for almost 50% of revenue through the first six months of the year.

In 2019, the price of NGLs has dropped by 28%, while the price of natural gas has touched near record lows. Although it has rebounded recently, natural gas is still trading at a 22% discount from the start of the year.

Despite the challenging price environment, Encana is on strong financial footing. Through the first six months of the year, it has increased cash flow by 50% and costs have dropped to $12.78 per barrel of oil equivalent.

Management has recognized that the company's stock price is not reflective of its underlying value. It is trading at a discount to book value (0.75) with an enterprise value (EV) to EBITDA of only 4.14, below the industry average.

As such, management has announced an aggressive share buyback program in which it expects to purchase for cancellation up to 10% of the company's outstanding shares.

Once the company returns to trade in line with averages, investors would be looking at a near double. It would imply a price of $10.55 per share, a 90% upside from today's price of $5.56 per share. Analysts are even more bullish with an average one-year target of $13.70 per share (146% upside).

Circling back to the rule of 72 and using the potential upside from its historical averages, Encana's stock would be expected to double in 0.80 years. However, we know that's impossible given that it only points to 90% upside. The real number would be 1.08 years. Likewise, assuming a linear pattern, a 146% return would imply a double in 0.49 years using the rule of 72. In reality, a double would only occur in 0.77 years.

The Encana example helps illustrate the drawbacks of using the rule of 72 for large rates of return. That aside, Encana is certainly a candidate for outsized returns over a short period. Any significant rebound in the price of NGLs or natural gas could translate to triple-digit returns for this undervalued industry leader.

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