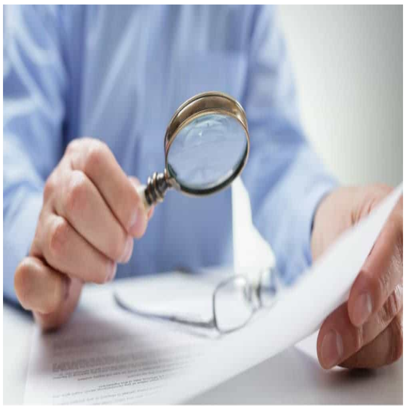

Is it Time to Buy Cenovus (TSX:CVE)?

Description

Oil's latest rally, which sees the North American benchmark West Texas Intermediate (WTI) up by 14% for the year to date to be trading at US$57 per barrel, has breathed life into Canada's beaten-down energy patch. This has sparked speculation that now is the time to invest in the oil sands with **Cenovus Energy** (TSX:CVE)(NYSE:CVE), which has gained 16% since the start of 2019, emerging as a favourite among market pundits.

Operational profitability is a concern

Canada's third-largest oil sands operator was savaged by the market during the second half of 2018, when it was pumping bitumen at a loss because of the extreme differential between the Canadian heavy oil benchmark Western Canadian Select (WCS) and WTI. That saw WCS subject to a deep discount, because of the massive oil glut that had developed in Western Canada due to a lack of pipeline exit capacity, which saw it plunge to a low of less than US$6 per barrel, despite WTI trading at US$50.

To bolster WCS prices thereby reducing lost royalty income and boosting the profitability of oil sands companies, the government of Alberta elected to introduce mandatory oil production cuts. These gave the Canadian benchmark price an immediate lift and eventually allowed the province to drain the enormous local oil supply glut which had emerged.

This was a tremendous boon for Cenovus, which had campaigned heavily for such a measure to be introduced. That is apparent from its third-quarter 2019 results, where Cenovus reported a net profit of $187 million compared to a $241 million loss a year earlier, despite total hydrocarbon production falling by 10% year over year.

That can be attributed to Cenovus's average sales price for the quarter of $51.48 being 13% higher, even though WTI's average price was 15% lower compared to a year earlier. The reason for this is simple, because of the production cuts and reduced local oil inventories WCS's price differential to WTI was a stunning 46% lower. Even significantly higher transportation and operating expenses, which rose by 66% and 3% year over year, respectively, did little to impact the profitability of Cenovus's operations.

In fact, the company's operating netback, which is a key measure of profitability, soared by 43% compared to a year earlier because of the higher average price per barrel of crude sold.

Nonetheless, higher transportation and operating expenses bode poorly for Cenovus, because there is every risk that WCS prices could collapse once again.

Edmonton has been steadily unwinding the production cuts, despite the new conservative government vowing to keep them in place, and it was recently announced that new conventional oil wells will be exempt from those limits.

A key problem for Alberta's oil sands industry is the considerable lack of pipeline exit capacity, which means it is becoming increasingly costly and difficult for oil sands companies to ship the bitumen produced to vital U.S. Midwest refining markets. Pipelines are the most economic and efficient means of shipping oil, notably bitumen, to crucial energy markets south of the border. By removing the production cuts, domestic oil output will continue to grow, placing ever greater pressure on already significantly constrained infrastructure, ultimately pushing the price of WCS lower.

This is evident from the WCS price differential to WTI widening sharply over the last week. The Canadian benchmark is now trading at around US$35 per barrel compared to US$39 a barrel at the end of October, after a leakage on the Keystone pipeline forced it to be shut down. That highlights just how dependent the oil sands is on a limited number of pipelines and how a lack of transportation capacity can have an immediate impact on WCS prices, reducing the profitability of bitumen producers.

Foolish takeaway

Cenovus's considerable dependence on oil sands production coupled with its lack of refining capacity makes its earnings highly dependent on the price of WCS. This increases its vulnerability to pipeline outages and other events that can push WCS lower. For these reasons, Cenovus is the least-attractive play on higher crude among Canada's major oil sands producers.

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