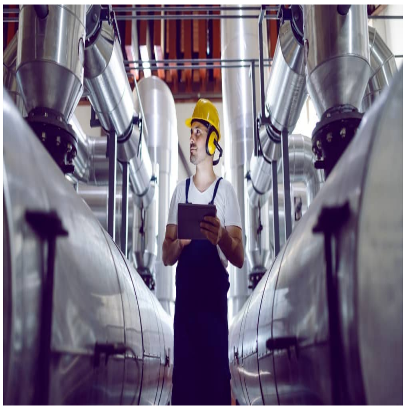

Why MEG Energy (TSX:MEG) Stock Seems Ready to Break Out

Description

We are in the middle of the second-quarter earnings season, and the overall picture continues to be gloomy. However, things are quite different in the energy sector. Oil and gas companies are reporting record earnings growth, thanks to higher energy commodity prices.

MEG Energy reports solid Q2 earnings

Canadian energy bigwigs are yet to report their Q2 earnings results. But their smaller counterparts have seen enormous growth so far. For example, **MEG Energy** (TSX:MEG), a $5 billion Calgary-based energy company, reported another stellar set of numbers on July 28.

Its earnings came in at $0.72 per share for the quarter that ended on June 30, 2022. In the same period last year, the company reported earnings of $0.22 per share, marking a solid 227% growth year over year.

Oil prices have been rallying strongly almost throughout this year due to severe supply constraints. Thus, MEG reported an average realized WTI crude oil price of US$111 per barrel for the quarter — a steep jump from US$68 per barrel last year.

Apart from the earnings growth, it is the improving balance sheet strength that has been driving energy stocks higher. For example, MEG Energy repaid $379 million of debt during the quarter with its incremental cash flow. So, since the pandemic, its net debt has significantly come down due to this capital discipline.

Solidifying balance sheet

And it's not just MEG. Almost all Canadian energy companies are focusing on strengthening their balance sheets. Their emphasis has not been to allocate higher for capex but to repay debt aggressively and distribute the rest to shareholders via dividends.

MEG Energy does not pay dividends at the moment. However, if it continues to repay debt at the same pace, we will likely see dividends from MEG in the next few quarters. Note that repaying debt lowers the company's interest expense, ultimately improving its profitability.

Moreover, the company plans to buy back more than 27 million shares by March 2023. So far in 2022, it has bought back MEG shares worth $139 million. Notably, buybacks indicate that management perceives its shares are undervalued and offer attractive growth prospects. Also, buying back shares reduces total outstanding shares in the market, effectively boosting the company's EPS.

Valuation

Like many energy stocks, MEG stock has also been trading weak since June. Recession fears weighed on crude oil prices, which brought down oil and gas stocks. As a result, MEG stock has dropped 30% since its record high in June. However, it is still sitting at 65% gains for the year.

Notably, it currently looks highly undervalued, and its solid Q2 numbers could trigger the rally. It is trading three times free cash flow and eight times its earnings, which looks attractive and presents handsome growth potential.

Lower oil and gas prices remain a key risk for the sector. However, considering the supply constraints and geopolitical tensions, energy commodity prices will likely remain higher.

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