



Why MEG Energy (TSX:MEG) is Among the Best TSX Energy Stocks

Description

Despite the recent [correction](#), Canadian energy stocks have notably outperformed broader markets this year. The **TSX Composite Index** has dropped 10%, while energy stocks, on average, have gained a handsome 45%. What's more, some small and mid-cap names have gone through the roof, outperforming their large-cap peers. Calgary-based **MEG Energy** ([TSX:MEG](#)) is one of them. MEG stock has gained 60% this year and approximately 1,000% since the pandemic.

Should you buy MEG stock?

Interestingly, MEG stock still looks attractively valued even after such a steep rally. Thanks to the recent volatility in [oil](#) prices, MEG stock followed its peers and has corrected 25% since June. So, this could be an opportunity for long-term investors to act on its recent weakness.

MEG stock is currently trading at an enterprise value-to-cash flow ratio of 2.6x, close to its peers' average. It's also trading at a free cash flow yield of 33% and looks attractive. The stock has created massive wealth for shareholders in a short amount of time. Given the company's fundamentals and current valuation, it could continue to create sizeable value in the future as well.

MEG Energy produces thermal oil and aims to produce around 95,500 barrels of oil per day in 2022. The Christina Lake project, MEG's key asset, hosts high-quality, low-decline reserves. It has close to two billion barrels of oil in proved and probable reserves, giving it a reserves life index (RLI) of 55 years, one of the highest in Canada. A reserves life index is the duration obtained by dividing the total reserves by its annualized production.

Higher crude oil prices have caused the entire energy upstream space to see record earnings and free cash flow growth in the last few quarters. Rising demand due to re-openings and geopolitical tensions in Europe sent oil and gas prices far higher this year. Even if they have come down notably since June, oil prices are still higher compared to last year. So, energy investors can expect earnings and margin expansion to continue for at least the next few quarters.

Solid earnings growth and fortifying balance sheet

MEG Energy reported free cash flows of \$736 million in the first half of 2022 against \$51 million in the same period last year. A large portion of this incremental cash flow was used for debt repayments, strengthening its balance sheet. Management is optimistic about the free cash flow growth and has guided about its allocation.

During Q2 2022, MEG achieved its first net debt target of \$2 billion. By the end of next year, it's expected to achieve a net debt target of \$800 million, translating to 1x the net debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio. MEG has already deleveraged its balance sheet significantly compared to what it was in late 2020. Note that once it achieves next year's debt levels, the company will allocate 100% of its free cash flows to shareholder returns in the form of dividends or share buybacks.

MEG's share buybacks

MEG intends to buy back 27.2 million shares by March 2023. Although shareholders tend to prefer higher dividends, buybacks also offer some unmatched benefits. For example, the company's per-share earnings automatically increase while also expanding the promoters' stake. Plus, it reduces the selling pressure and saves billions in dividend taxes, ultimately improving profitability.

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