

Cenovus Energy Inc. (CVE) – Quality and Growth For The Patient Investor

Cenovus was created through the split of Calgary-based energy company EnCana into two separate organizations in late 2009. As a result of this split, many Canadian investors found themselves holding two very different investments: a pure-play natural gas company (EnCana) and an integrated oil & gas company (Cenovus). This document aims to provide some insight into the nature and long-term potential of Cenovus.

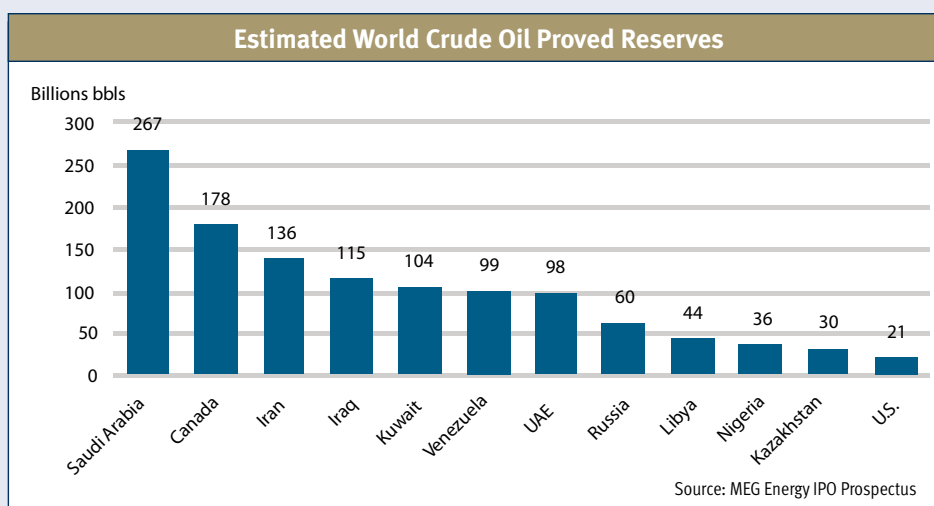
Cenovus owns oil sands projects that have a tremendous growth profile over the next decade and are widely viewed as some of the highest-quality assets in the industry. However, since inception, the shares of Cenovus have largely traded within a range. One reason is that the company has made a trade-off between near-term and future production by drawing cash flows from its natural gas business to fund growth in its oil sands business. Another reason is the sluggish earnings and cash flow performance from its refining operations.

With oil reaching an eighteen month high, Cenovus shares have recently begun to advance. We believe that investors with a long-term investment horizon will be well-served by the strong dividend, balance sheet and impressive long-term growth profile.

Primer on the Oil Sands and Steam-Assisted-Gravity-Drainage (SAGD)

Including the oil sands, Canada's oil reserves are the second largest in the world. Oil sands are composed primarily of sand, clay, bitumen and water. Bitumen is the product of oil sands production – a thick oil embedded in sand.

Recovery of bitumen is typically achieved by one of two methods: mining in open pits or drilling. Bitumen extraction using drilling is referred to as *in situ* recovery, and is generally used for reservoirs that are too deep for surface mining techniques to work economically. It is estimated that approximately 80% of the total bitumen recoverable in Alberta can only be produced with in situ recovery. The two in situ production methods in commercial use today are SAGD and Cyclic Steam Simulation. SAGD is the method used by Cenovus to extract bitumen from its oil sands reservoirs.



The SAGD process is simple in concept but complex in application. Two horizontal wells are drilled one above the other approximately five meters apart. High-temperature steam is injected into the upper well. As the steam moves into the sand, the bitumen is heated allowing it to soften. The heated oil flows more freely and gravity drains it into the lower well from which the oil is pumped to the surface.

Company Overview

In November 2009, EnCana completed a reorganization to transfer its assets into two companies: an integrated oil and gas company called Cenovus and a pure play natural gas company that retained the EnCana name. Cenovus has a suite of oil sands projects. Of these, two are currently in production: Foster Creek and Christina Lake. Foster Creek, owned 50% by Cenovus, was started by EnCana in 1996 and began commercial operations in 2002. Current gross production capacity (“gross” meaning before ownership splits) is 120,000 b/d and this is expected to reach 235,000 b/d by 2019. Christina Lake, owned 50% by Cenovus, was started in 2000 and is at an earlier stage of development than Foster Creek. Its gross production capacity is 18,000 b/d and is expected to reach 258,000 b/d by 2019.

Cenovus also has 50% interests in two refineries in the U.S. Cenovus’ refining operations include the Wood River refinery in Illinois and the Borger refinery in Texas, which are jointly owned with the operator, ConocoPhillips. These operations refine crude oil to produce gasoline, diesel, jet fuel, asphalts, petrochemical feedstock and solvents. Wood River has been going through an upgrade called the CORE project which will increase oil throughput capacity from 306,000 b/d to 356,000 b/d. The CORE project is expected to come on-stream in 2011. Borger has a processing capacity of approximately 146,000 b/d of crude oil.



Finally, Cenovus has a large base of conventional oil and natural gas properties across Alberta and Saskatchewan.

Investment Highlights

There are a number of positives to the Cenovus story including its low cost of operations, impressive growth profile, emerging oil sands opportunities, strong balance sheet, healthy dividend and technical expertise.

Low Cost Oil Sands Assets

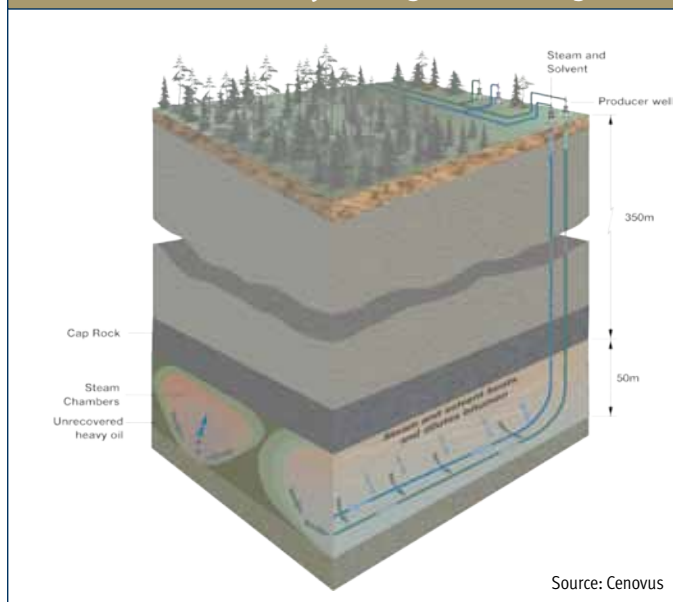
One of the key operating metrics of a SAGD process is the steam-oil-ratio (SOR). The SOR is the amount of steam it takes to produce a barrel of oil. The ratio is important because each barrel of steam produced requires a significant amount of energy which drives operating costs. Typically the heat is generated by burning natural gas.

Cenovus’ Foster Creek and Christina Lake projects boast among the lowest SORs in the industry. Cenovus achieved an SOR of approximately 2.0 at Christina Lake and 2.3 at Foster Creek last quarter. The range for the industry peer group is broadly 2.0 – 5.0+. Related to the SOR is the capital spending to build the required infrastructure. Cenovus offers industry-leading capital efficiency as it continues to bring on new phases at approximately \$22,000 -25,000 per flowing barrel of production. Competitors’ costs are typically around \$35,000 per flowing barrel of production.

Impressive Growth Profile

The plan for Cenovus’ two existing projects plus a series of emerging projects offers visibility on a decade of production growth. Oil sands production is expected to grow from the current level of 58,107 b/d as of Q3/10 to approximately 300,000 b/d by 2019, implying a 20% compounded annual growth rate.

Steam-Assisted-Gravity-Drainage Process Diagram



Upside Potential

While Foster Creek and Christina Lake are the most prominent assets in the company's portfolio, there is significant value in the emerging projects including: Narrows Lake (50% owned), Grand Rapids (100%) and Telephone Lake (100%). These three projects could represent another 295,000 b/d of production capacity (net to Cenovus after ownership splits) on top of the 246,500 b/d ultimately expected from Foster Creek and Christina Lake (net to Cenovus after 50% ownership interests).

Beyond these identified projects, the company has vast lands that could prove up new SAGD opportunities, and Cenovus continues to drill with 400-500 wells targeted for the 2010/11 winter season. Finally, Cenovus has non-oil sands opportunities in Saskatchewan including the Lower Shaunovan and Bakken plays.

Balance Sheet

With a debt-to-capitalization ratio of 26%, Cenovus has a strong financial position. The company is rated BBB+ (Stable) by S&P and Baa2 (Stable) by Moody's, and management is committed to maintaining investment-grade credit ratings.

Dividend

Cenovus pays an annualized dividend of \$0.80 per share. At recent prices, the yield on Cenovus is 2.5%, a level that is higher than many of its oil sands peers, including: Imperial Oil, Suncor, Nexen and Canadian Natural Resources.

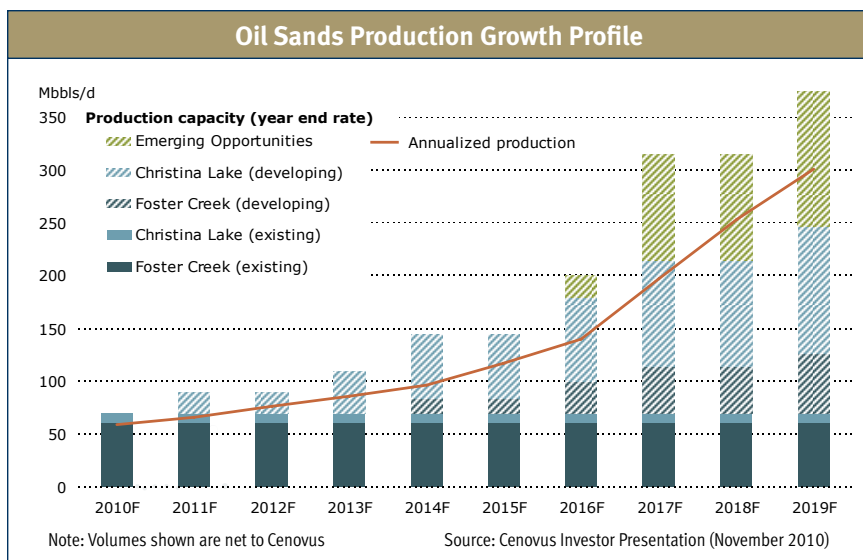
Technical Expertise

Cenovus is a technology leader with several advancements of note. The company implemented the use of electric submersible pumps, which lowers steam-oil ratios. It has successfully piloted wedge wells which are drilled between existing SAGD well pairs, and have the potential to increase overall recovery from the reservoir by about 10-15%. Finally, the company is piloting the use of a Solvent Aided Process, which utilizes a mixture of steam and solvent to enhance recovery of the bitumen.

Challenges

Shifting Production Profile and Stagnant Near Term Growth

Cenovus' conventional natural gas properties are largely established, reliable fields with efficient operations. These established assets are an important component of the company's financial foundation, generating operating cash flow well in excess of their minimal ongoing capital investment requirements. The annuity-like cash flow



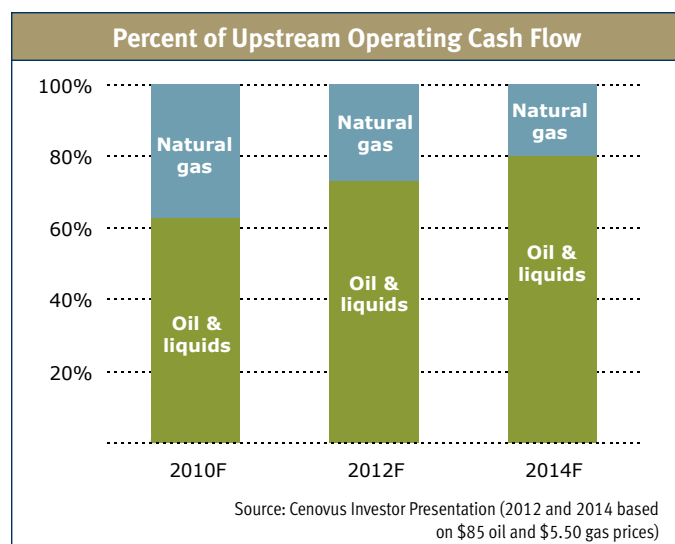
stream is thus like a financial asset that management is using to fund the development of its oil sands projects.

Unfortunately, the choice of limiting reinvestment in the natural gas business leads to a negative overall production profile for the company in the near term. RBC Capital Markets forecasts that while oil sands production will increase, natural gas declines will lead to overall production levels falling by -2% in 2011 and -4% in 2012. These near-term production declines may continue to weigh on investor sentiment for some time.

Management expects to shift its profile to roughly 80% oil / 20% natural gas over time. With natural gas being a key input for the SAGD process, keeping roughly 20% in gas will continue to provide a natural hedge.

Performance of Refining Assets (Downstream)

While owning refining assets provides long-term stability to cash flows, downstream operations have been a drag on earnings recently. Industry-wide utilization rates in downstream have been trending near the low end of the



five-year historical range throughout 2009 and much of 2010. The downstream operations may continue to underperform so long as challenging economic conditions persist. With Cenovus now expecting its CORE project to be on-stream in the fall of 2011 (previously mid-2011), this likely means there will not be meaningful cash flow from the refining business in 2011.

Execution Risk

While management's execution on its Foster Creek and Christina Lake properties has been strong, the bulk of Cenovus' oil sands production capacity remains yet to be developed. Increasing production volumes by more than five fold over the next decade is no small task. While the visibility is good, the timing of oil sands projects is always somewhat uncertain and some production is nearly a decade out from present. Finally, the oil sands industry has in the past been plagued with rising costs. While these costs have come down in the last two years, more oil sands projects are coming back into development and this issue may re-accelerate.

Scenario Analysis

Investor sentiment has ebbed and flowed on Cenovus since its inception. At times the focus has been on buying into this high growth oil sands company while it is still at an early stage of development. At other times, sentiment has swayed more to concerns over the near-term production profile. While sentiment hinges on the balance of these two views and is hard to predict, the key fundamental driver of the share price is commodity prices. With much of Cenovus' oil sands production coming in future years, a key measure for assessing the valuation of the company is to calculate the current value of future cash flows, which is referred to as "net asset value" (NAV). Over the last year, large-cap Canadian energy companies with significant oil sands projects have traded roughly within a range of 75-110% of NAV.

Base Case: The net asset value for Cenovus published by RBC Capital Markets is \$32.59, which is based on an outlook that includes long-term oil at \$85/bbl and long-term gas at \$6/mcf. Thus, in the current price environment, it is reasonable to expect Cenovus to trade roughly between \$24 and \$36 (75-110% of NAV).

Bull Case: Raising the long-term prices to \$100/bbl oil and \$7/mcf gas, we estimate a net asset value of approximately \$42.50. A range of 75-110% around this NAV would imply a share price range of \$32-47.

Bear Case: Lowering the long-term prices to \$70/bbl oil and \$5/mcf gas, we estimate a net asset value of approximately \$22.50. A range of 75-110% around this NAV would imply a share price range of \$17-25.

Conclusion

Cenovus has a proven track record of low cost operations and capital efficiency. It is poised to deliver substantial growth from its existing oil sands projects over the next decade, and has significant upside potential as it makes progress on its emerging projects. The company has been a leader in terms of technological developments and has plans to continue to lower costs through future advancements. While the near-term production profile is modestly negative, the company should be recognized for replacing its shorter life, conventional production with high quality, long life oil sands production. In sum, Cenovus offers investors a quality and growth story with a substantial development opportunity in the oil sands and a 2.5% dividend yield. We would recommend the shares for patient investors.

Ratings from our research providers are as follows:

- **RBC Capital Markets:** Sector Perform, Average Risk
Price Target C\$32.00
- **JP Morgan:** Overweight
Price Target C\$38.00
- **Veritas:** Buy
Intrinsic Value C\$31.50



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