# Pacific Rubiales: A Tantalizing High-Risk Play on Oil

## Description

Colombia's largest independent oil explorer and producer is the Canadian domiciled mid cap **Pacific Rubiales** (TSX: PRE). Like its small- to mid-cap exploration and production peers, Pacific Rubiales has had a rough year.



Halfway through 2013, its share price had plunged by almost 20%; this sell-down was triggered by investors shying away from oil explorers and producers operating in what are perceived to be high-risk emerging markets along with a bearish outlook for crude oil prices.

**Why the share price has collapsed**

The primary drivers behind the falling stock price have been declining production and rising costs.

The company's first-quarter 2013 net income fell by 52% (to $123 million), compared to the same period in 2012. There has been significant conjecture that Pacific Rubiales will lose its flagship Rubiales field in Colombia's Llanos basin when the lease expires in 2016; this field provides 69% of the company's production and holds 30% of its total proved oil reserves of barrels of oil.

Still, I believe the stock has plenty of catalysts. Even if Pacific Rubiales loses its rights to the Rubiales field the company will continue to perform strongly, with growth in its future.

**Key growth catalysts**

Already this month, Pacific Rubiales' share price has spiked 4%, rebounding from a three-year low on the back of quarterly production being at the top end of its production forecasts for the second consecutive quarter. It's expected that average daily production for the second quarter of 2013 will be around 128,000 barrels, a 38% year-over-year increase.

The company has also been able to broaden its reserve base through the acquisition and investmentin other oil juniors operating in Colombia, the most significant being C&C Energia, which was finalizedin December 2012. It also purchased a 49% interest in U.S.-based **BPZ Energy's** Peruvian operationsin 2012, further reducing this risk. Now 6% of its total proved reserves are located outside of Colombia.

A key indicator of profitability for oil explorers and producers is the netback per barrel they're able to generate. Netback measures the gross profit per barrel of oil after production and transportation costs have been deducted. Pacific Rubiales continues to generate a solid netback per barrel of $60 per barrel of oil, in an industry where an average of $40 to $50 per barrel is considered profitable.

Pacific Rubiales also has a strong exploration program in place with exploration operations in Colombia, Peru, and Brazil. During the second quarter, it completed drilling of four wells — two in Colombia, one in Peru, and one in Brazil. This resulted in an offshore oil discovery in Brazil and a natural gas and condensate discovery in Colombia. It is also waiting for the approval of an exploration and production permit in Colombia that will allow it to expand its operations into the Southern Llanos basis.

**What's it worth?**
The company appears cheap on the basis of two key valuation multiples used in the oil exploration and production industry, enterprise value-to-EBITDA and enterprise value-to-proved reserves. These multiples allow investors to make apples-to-apples comparisons of industry participants as a means of determining value.



Despite the recent spike in its share price, Pacific Rubiales has an enterprise value-to-EBITDA of 3, which is less than the industry average of around 7. It also has an enterprise value-to-proved reserves of 19, which is less than the industry average of around 27. In my view, this stock is being unfairly valued by the market.

One other positive: Last month, Pacific Rubiales announced a 50% increase in its quarterly dividend to 17 cents per share, giving it an effective forward dividend yield of 3.5%. This is a particularly solid dividend yield for a mid-cap oil explorer and producer and one of the highest among Pacific Rubiales' peer set.

**Foolish bottom line**

Despite Pacific Rubiales' promising first-half 2013 results and the significant increase in the value of its dividend, speculation that the company will lose the Rubiales field has cast a pall over the company's future.

But the ongoing focus on diversifying proved reserves through exploration and acquisition reduces this risk. Furthermore, with Pacific Rubiales focused on boosting production, cutting costs, and maintaining a solid netback per barrel, I see plenty of growth opportunities ahead. Paired with a cheap relative valuation, these initiatives make me think this is a tantalizing bet on an industry that has fallen into disfavor with investors.

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1. Investing

**TICKERS GLOBAL**

1. TSX:FEC (Frontera Energy Corporation)



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