Can These 4 Oil and Gas High Flyers Keep Going Up?

Description

Over the last three months, the **S&P/TSX Energy Index** (^SPTTEN) has outperformed the **S&P/TSX Composite Index** (^GSPTSE) by five percentage points. The Energy Index has a three-month return of 13.2%, compared to the market return of 8.1%.

The energy sector is coming to life again, as we just exited a bitter cold winter that precipitated a soaring in demand for natural gas, and therefore a spike in the price of natural gas. We have seen the bellweather natural gas stocks such as **Encana** (TSX: ECA)(NYSE: ECA) profit from this shift in industry fundamentals. Its stock has risen 21% in the last three months — Encana expects 75% of its cash flow to come from natural gas liquids by 2017. Furthermore, the company will retain natural gas optionality from assets that can be very profitable and competitive if and when natural gas prices increase.

But let's look at the companies in the oil and gas sector that have outperformed their peers. These are the more junior names that have more upside in good times and more downside in bad times. These are the good times ….

Paramount Resources (TSX: POU), whose production is heavily weighted toward natural gas and natural gas liquids (97%), has risen 37% in the last three months. As we know, natural gas has been an increasingly attractive place to be, as demand has soared this past year and inventories have plummeted and are now at over 50% below the five-year average, which is very bullish for the commodity.

Diving a bit deeper into the company, finding and development costs decreased 11% in 2013, and cash flow from operations increased 22%. Lastly, the company increased proved reserves by 72%. Going forward, the company is planning on shifting its production mix in order to take advantage of the current strength in natural gas liquids pricing. The concerns with this name are that netbacks of $16 are low compared to the group, and its debt burden is high, with a debt/cash flow ratio of over 15 times.

Birchcliff Energy (TSX: BIR) operates in the Montney shale gas play and its production is comprised of 76% natural gas. The stock has increased 49.8% over the last three months as it has benefited from the macro environment as well as seen good production growth last year. Production increased over 13% in 2013 and the company expects the first quarter of 2014 to see a 23% increase in average production. Strong growth in reserves and high netbacks of $22.53 mean that the future looks good for the company. Finally, the company's debt to cash flow ratio is reasonable, at 2.6 times.

Raging River Exploration (TSX: RRX) is a more junior oil and gas producer that is heavily weighted toward oil production. The stock has a three-month return of 44.5%. The company's balance sheet is very strong, with a debt to cash flow ratio of less than 1. The company has been expanding its drilling inventory with relatively low-risk land locations being added to its portfolio. Production was stagnant in 2013, but with the addition of the new drilling locations, production growth will ramp up nicely in the upcoming year. Being heavily weighted toward oil though and the fact that oil fundamentals are weakening is a red flag for this stock.

Advantage Oil and Gas (TSX: AAV) has a three-month return of 68%. This is another company involved in the Montney area that is heavily weighted toward natural gas production (97% of 2013 production was from natural gas). In 2013, cash flow from operations increased 81%, as the company benefited from rising natural gas prices as well as continued cost reduction. The company's three-year development plan is targeting 190% cash flow per share growth, which it believes it can achieve given its low-cost structure and assuming natural gas prices of $3.75/GJ. The balance sheet is relatively healthy, with a debt to cash flow ratio of 1.8 times.

Are these companies worth an investment?

Hitting 52-week highs can be a buy signal or a sell signal. The energy producers that are geared toward natural gas production and that have healthy balance sheets are the ones that I would feel comfortable holding on to as they rise to make new highs. Oil-weighted production in today's environment and high debt levels in any environment are red flags that make me want to stay away.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:AAV (Advantage Oil & Gas Ltd.)
2. TSX:BIR (Birchcliff Energy Ltd.)

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