2 Key Metrics for Understanding Risk in Canada's Oil Patch

Description

Investing in oil explorers and producers is a risky business; it is a capital intensive industry that is exposed to a range of market, operational, and regulatory risks, many of which are mitigated using a range of risk management strategies.

But investors are still exposed to considerable investment risk regardless of the quality of an oil company's operations and it is important for investors to be able to assess the level of investment risk they face when investing in the patch. Today, I will take a closer look at how investors need to understand risk and how risk in the patch can be measured.

Two key generic ratios are typically used by investors to determine investment risk. The first is the debt-to-equity ratio, which is an indicator of the strength of a company's balance sheet, and the second is the current ratio, which indicates whether a company has sufficient cash on hand to meet its short-term obligations.

Both of these ratios are useful tools for investors for assessing the financial health of a company prior to investing. There are also industry specific measures that give a clearer picture as to the health of an oil company; two such metrics are superior for assessing risk in oil companies — net-debt-to-EBITDA and net-debt-to-operating-cash-flow.

Net-debt-to-EBITDA
This is a measurement of a company's degree of leverage. It measures the ability of a company to pay back its net debt.

The reason for using EBITDA in place of net income is that EBITDA provides a more representative picture of an oil company's core profitability, with many non-cash items impacting a company's net income. Typically, an optimal net-debt-to-EBITDA ratio is between 1 and 2, with a ratio of over 4 setting off alarm bells because it indicates a company is overleveraged and unable to manage its debt burden.

Net-debt-to-cash flow
This is a particularly useful ratio for identifying the financial strength of an oil company. It gives investors an indication of how well an oil company is able to cover its debt obligations from cash flow,

in a capital-intensive industry where cash is king. The lower the multiple, the better an oil company is able to carry its debt load, with a ratio of less than 2 considered optimal and anything over 3 of some concern.

How do companies in the patch stack up using these ratios?
In an earlier article I identified that **Pengrowth Energy** (TSX: PGF)(NYSE: PGH) and **Penn West Petroleum** (TSX: PWT)(NYSE: PWE) were the most attractively priced on the basis of their EV-to-EBITDA and price-per-flowing-barrel.

But in a second article reviewing the operational profitability of various players in the patch, I found that **Lightstream Resources** (TSX: LTS) offered the best value. So let's see how these companies compare to their peers using the ratios discussed in the table below.

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While Penn West may have some attractive valuation metrics, it is clear it is a higher risk investment than many of its peers with the highest EV-to-EBITDA ratio and second highest net-debt-to-operating cash flow multiple.

Investor favorite **Whitecap Resources** (TSX: WCP), a proven operator in the patch, along with troubled Lightstream also appear heavily leveraged. **Crescent Point Energy** (TSX: CPG)(NYSE: CPG) is the least risky investment based on these metrics, with the lowest EV-to-EBITDA and net-debt-to-cash flow ratios. Both appear expensive in comparison to their peers.

But it is **Canadian Oil Sands** (TSX: COS) that stands out overall, with relatively attractive valuation metrics coupled with a high netback per barrel and a low degree of leverage.

Clearly there is more to evaluating whether an oil company is solid investment opportunity than valuation ratios. Investors need to form a complete picture before taking the plunge into what is a high-risk, capital-intensive industry. This includes not only determining whether a company is attractively priced, but also assessing the profitability of its operations coupled with its degree of leverage and therefore risk.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:VRN (Veren Inc.)
2. TSX:WCP (Whitecap Resources Inc.)

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