3 Reasons to Buy Surge Energy Inc. Now

Description

Intermediate oil producer — and relative newcomer to the patch — **Surge Energy Inc** (TSX: SGY) continues to go from strength to strength and offers considerable value for investors despite its stock price already rising 27% for the year to date.

The company has built an enviable track record and utilizes the dividend-plus-growth model to unlock value for shareholders. This model focuses on consistently paying a monthly dividend while growing the company's underlying value through the development of existing assets and accretive acquisitions.

Let's take a look at three reasons why Surge offers a compelling investment opportunity.

1. Crude production continues to grow

A key driver of the performance of companies operating in the patch, and in particular those utilizing the dividend-plus-growth model to unlock value for shareholders, is the ability to consistently grow crude production. Surge Energy has an enviable track record in this respect, with second-quarter production up by 9% compared to the previous quarter and 36% compared to the equivalent quarter in 2013.

This has seen Surge Energy's oil production result in an impressive compound annual growth rate of 38% since 2010. The majority of Surge's crude production — at 87% for the second quarter of 2014 — is made up of higher-margin light oil and natural gas liquids. This allows Surge to take full advantage of higher crude margins and the lower price differential between Edmonton Par and West Texas Intermediate.

The strong production growth and high production weighting to oil and NGLs can be attributed to a range of accretive acquisitions made by the company and the high quality of its underlying assets.

The recent acquisition of Longview Oil Corp has considerably boosted both crude production and reserves by 38% and 51% respectively, giving Surge credible oil reserves of 111 million barrels. It also has over 1.9 billion barrels of original oil in place, highlighting the extensive exploration and development potential of Surge’s existing acreage and the prospective growth of its oil reserves.

Thus, there is considerable potential for further production growth. As well, Surge can achieve its revised 2014 guidance, which will continue to boost its bottom line.

2. Margins are improving

An impressive aspect of Surge’s crude production is the solid margin, or netback per barrel of crude produced, that the company is able to generate. For the second quarter of 2014, this netback jumped a healthy 10% quarter over quarter and 32% year over year to $54.07 per barrel. This was primarily on the back of firmer crude prices and a significant drop in transportation costs.

This netback is well above the average of $42 per barrel for oil producers operating in North America, and superior to many of its peers in the patch. This includes light oil titan **Crescent Point Energy Corp** (TSX: CPG)(NYSE: CPG), which reported a netback of $52.65 for its last reported quarter.

Given both the high quality of Surge’s asset base and the stronger fundamentals in the patch, I expect the company to continue reporting solid netbacks per barrel, which will ensure its continued profitability.

3. It continues to pay a juicy dividend yield

A very appealing aspect for investors is Surge’s juicy dividend yield of 7%, which is one of the highest in the patch and well above Crescent Point’s very attractive 6%. More impressively, this yield is sustainable. The company has targeted a total payout ratio of 89% for 2014, and with the dividend payout ratio for the second quarter of 2014 being 75% of net income, this appears achievable.

However, when the dividend payout ratio is calculated as a proportion of funds flow from operations — which is a more realistic measure in an industry where cash is king and net income includes a range of non-cash deductions — it falls to an even more sustainable 44%.

Clearly, Surge is a company with solid growth prospects by virtue of its solid asset base and ability to grow production. This, in addition to its high margin per barrel of crude produced, will see its bottom line continue to grow. As a result, the tasty dividend yield in excess of 7%, is sustainable and will continue to see shareholders rewarded for their patience as the company develops its assets.

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