Why Long Run Exploration Ltd. Offers Considerable Upside if Oil Rebounds

Description

Hardest hit in the energy patch because of the rout in oil are small-cap oil explorers and producers. Many have seen their share prices plunge by over 60% since the rout started six months ago. Small-cap light oil producer **Long Run Exploration Ltd.** (TSX:LRE) has been no exception. Over that period its share price has plunged 83% and looks set to fall further with some analysts predicting the worst is yet to come for crude.

As a result, the outlook for Long Run like many of its peers, has been downgraded by analysts with it going from a “buy” to a “hold” on expectations that crude prices will fall further.

However, there are signs Long Run may be one of the better positioned small-cap oil stocks to weather further sustained weakness in oil prices while offering considerable upside when they rebound.

So what?

As a result of signs that significantly weaker crude prices are here to stay Long Run has revised its 2015 guidance, further cutting capital expenditures and suspending its dividend. This sees it using an assumed price for West Texas Intermediate (WTI) of US$52.50 well below the US$60 plus prices used by other operators in the patch.

In comparison to 2014, Long Run’s 2015 capital expenditures have been slashed by half to $100 million and as a result production is expected to average 33,000 barrels daily, with 43% comprised of liquids. This level of production remains relatively unchanged from 2014, despite the massive cut to capital expenditure.

The suspension of the dividend saves Long Run an additional $40 million annually and after crunching the numbers using this revised guidance I expect Long Run to generate operating cash flow of $200 million in 2015. This means its capital program for 2015 will be fully funded from cash flow despite the significantly lower crude prices.

Such a prudent move allows Long Run to shore up its balance sheet and ensure that it doesn’t incur any unnecessary debt.

More promising, the rout in oil prices has forced Long Run to focus on creating capital efficiencies by cutting costs across its operations. When oil prices rebound this will see it well positioned to generate a healthy margin per barrel of crude produced.

It is also considering the sale of several non-core properties in order to generate additional funds to strengthen its balance sheet, although I believe this may be difficult to execute in the current operating environment. Markedly lower crude prices in combination with a flood of oil assets already on the market have significantly depressed prices, making now the wrong time to consider asset sales.

However, more importantly for investors, Long Run appears massively undervalued in comparison to the value of its core assets; its oil reserves totalling 85 million barrels. After crunching the numbers and assuming an oil price of US$52.50 per barrel, Long Run's reserves have a value of $3.20 per share net of royalties and after tax. This represents a premium of 170% over Long Run's last traded share price, highlighting just how much the market undervalues the company in comparison to its core assets.

Now what?

Long Run is certainly not without risk. As a small-cap oil explorer and producer, any significant and sustained weakness in crude prices will have a severe impact on its financial performance and hence its share price.

However, impressively the company has taken measures that allow it to remain viable in the current operating environment, including cutting expenses and ensuring its capital program can be funded internally. I believe Long Run offers considerable upside for investors willing to make a speculative bet on oil prices.

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