Baytex Energy Corp. Was Downgraded; Is This a Signal to Sell?

Description

Intermediate oil producer and one-time investor darling **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) recently saw its outlook downgraded. This is because it was caught up in the latest round of analyst downgrades triggered by weak oil prices.

However, while analyst downgrades are an indicator of the outlook for a company, it is still important for investors to "lift the hood" and review its fundamentals before making a decision to buy or sell.

Let's take a closer look at Baytex.

So what?

Baytex fast became a popular stock among investors after making an acquisition that fundamentally changed the company's outlook for the better and boosted its dividend.

Nonetheless, like its peers, it was hit hard by the rout in crude and was forced to slash capital expenditures, costs, and its dividend. Since then, it has revised its 2015 capital budget, and despite the negative view taken by some analysts, I believe that it represents a solid play for investors willing to bet on a rebound in crude.

Baytex slashed its capital budget by a further 17% from its last budget, further restricting the funding available for drilling and other well development activities. The 2015 daily oil production is now expected to average 84,000 to 88,000 barrels, a reduction of 4% from its prior 2015 guidance and 2% lower than expected full-year 2014 production.

Such a minor reduction in production, despite capital expenditure being slashed so savagely, is a testament to the quality of the oil assets held by Baytex and the efficiency of its operations.

Baytex has shrewdly decided to focus 80% of its capital expenditure for 2015 on its oil assets in the Eagle Ford shale. This is because those light-oil assets generate the highest capital efficiencies and netbacks of any oil assets in the company's portfolio. Such a decision bodes well for Baytex to preserve cash flow. This is because it allows the company to maximize its higher margin production, while slowing down production at less efficient properties, including its Canadian heavy oil assets.

You see, the heavy oil produced by those properties is subject to a markedly higher-price discount to the North American benchmark oil price, or West Texas Intermediate (WTI), than the light sweet crude produced in the Eagle Ford.

Since the start of 2015, the price differential between Canadian heavy crude has already widened by over 3% to now see it trading at a 31% discount to WTI. Furthermore, I expect this differential to increase with U.S. light crude inventories at their highest level since 2010, and light sweet crude production to continue to grow, despite falling rig counts.

The company has also focused on cutting costs in 2015; operating, drilling, and equipment costs are expected to be 10% to 15% lower than 2014. This, in conjunction with Baytex's focus on its higher-quality Eagle Ford assets, will help to preserve margins or netbacks and cash flow.

Now what?

Despite lower forecast production and the impact markedly softer crude prices will have on Baytex's cash flow, I believe the company offers investors one of the best-levered plays on a rebound in crude. This is even after its analyst outlook was recently downgraded. I have formed this view for all of the reasons discussed and particularly because of its high quality assets in the Eagle Ford shale and the strength of its balance sheet.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. TSX:BTE (Baytex Energy Corp.)

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