3 Ways to Manage Risk in the Energy Patch

Description

The oil rout continues to play havoc with the energy patch. Late last year industry insiders were tipping that oil prices were set to recover, but there are signs that prices will remain depressed in the foreseeable future. This has triggered a massive sell-off of energy stocks, creating some solid buying opportunities.

Now what?

Low oil prices also underscore the need for investors to understand how to manage risk when investing in the energy patch. Here are three key tools for managing risk when choosing to invest in oil companies.

First, companies that own their own infrastructure are far better equipped to control costs. This is particularly important in the current harsh operating environment, where many oil producers are generating thin margins. Very few upstream or pure oil producers have own their operating infrastructure.

One company that does own a considerable amount of infrastructure is Colombia's largest independent oil producer **Pacific Rubiales Energy Corp.** (TSX:PRE). It owns considerable interests in a range of Colombian pipeline networks, but is set to sell those interests in order to shore up its over-leveraged balance sheet.

Typically, it is integrated energy majors like **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) that own considerable amounts of their own infrastructure. Not only does their ownership of supporting infrastructure allow them to more effectively control costs, but their refining operations give them the ability to better manage weaker crude prices. This is because as crude prices fall, refining margins grow, which help to offset the profitability lost from their upstream operations.

Second, it is important to invest in companies that are willing to manage commodity risk by hedging their output.

One company that quickly expanded its hedging book to shield itself from the risk of weaker oil prices was **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG). It has over half of its 2015 oil production hedged at an average of $89 per barrel and one-third of its 2016 production hedged at $84 per barrel.

In comparison, **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) which unwound its hedges some time ago, now finds itself struggling because of the impact of significantly weaker crude prices on its cash flow.

Finally, companies with strong balance sheets and low degrees of leverage have a level of financial flexibility that bodes well for their ability to weather the current storm in oil prices.

So what?

With a number of quality oil companies having had their share prices slammed because of the oil rout, there are a number of attractive buying opportunities in the patch.

However, investors should be advised to ensure that the companies they select are capable of managing costs and weaker commodity prices, so as to emerge from the current storm relatively unscathed.

CATEGORY

1. Energy Stocks
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1. Editor's Choice

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3. TSX:FEC (Frontera Energy Corporation)
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