Why Baytex Energy Inc. Is a Profitable Way to Play an Oil Rebound

Description

With West Texas Intermediate crude prices up 41% since mid-March, there is reason to be cautiously optimistic regarding the price of oil. This, in turn, has sparked discussion about how best to play a potential oil rebound.

Oil companies have vastly different sensitivity to the price of oil, meaning that while some companies earnings and share price move in almost perfect tandem with the price of oil, others track the price of oil much less. The level in which a company tracks the price of oil depends on things like how much oil production they have, the level of hedging, and debt levels.

Canadian Oil Sands Ltd., for example, produces 100% crude and has no hedging and is extremely leveraged to the price of oil, with a US$10 increase in oil prices boosting cash flow by 80%. This is also very high risk should oil prices fall. **Baytex Energy Inc.** (TSX:BTE)(NYSE:BTE) provides a much better alternative, providing solid leverage to oil prices with much lower risk should prices stay flat or fall.

There is reason to be bullish on oil prices

Before looking at Baytex, it is important to quickly look at oil prices, since improving oil prices are essential to Baytex having increases. Prices are up 41% since mid-March, and the overall U.S. rig count has dropped from 1,600 in October to below 800 at the end of April.

While it is possible prices could fall again, the consensus is that absolute lows for oil prices are likely behind us. Although WTI prices are important for Baytex, it is important to remember that Baytex produces about 42% heavy oil, which means that Baytex has earnings that are sensitive to Western Canadian Select (WCS) prices.

While WCS tracks WTI and increases with it, there is a differential between the two, and things have been looking much better for WCS than WTI. WCS prices, for example, are up 70% since mid-March, almost doubling WTI's performance, and is the best performing benchmark in North America. This is largely due to improved market access to refineries.

Why Baytex has strong leverage to oil prices

Baytex had one of the worst stock performances of its peers from September 30th 2014, to December 15th, when markets first bottomed, demonstrating its strong leverage to the price of oil. While the peer average was 50%, Baytex saw its stock drop an enormous 64%.

The reason at the time was because Baytex had acquired a significant amount of debt due to its early decision to purchase Aurora Oil & Gas for $2.6 billion in 2014. This gave Baytex one of the highest debt loads in the industry, with 65% drawn on its credit facilities, and a debt-to-cash flow ratio of 3.2, compared with the peer average of 2.2.

Couple this with the fact that Baytex has very low hedging compared with its peers (with only 37% hedged), and the reasons for the large fall are clear. Fortunately, Baytex has addressed the debt by issuing $606 million worth of shares in early April 2015. Baytex used the equity issue to repay its bank loan, and now only has 14% drawn on its credit facilities, giving Baytex a huge amount of liquidity and enormously reducing its risk. In fact, Baytex now has a below average debt load.

At the same time, some of Baytex's hedges are expiring. The company has about 23% of its production hedged for the remainder of the year, with only 11% hedged in 2015. As a result, Baytex's exposure to any upside in oil price is increasing, and its overall risk is decreasing due to the fact its debt load has fallen

The increase will be driven by netbacks

Baytex has fairly low operating costs, with a total operating cost per barrel of only $10.75, including $13.57 on its Canadian production. This is compared with Canadian Oil Sands, which has operating costs as high as $36 per barrel on its oil sands assets.

As a result, **TD Bank** estimates that Baytex could have its netbacks (profit per barrel) on its Canadian production increase from the current $7.35 per barrel to $27 per barrel if WCS prices just stay at current elevated levels, which should drive cash flows and the share price much higher.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. TSX:BTE (Baytex Energy Corp.)

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