



Should Investors Avoid Oil Completely Going into 2016?

Description

It has been a rough year for investors in Canada's energy sector.

You probably don't need me to remind you. After all, energy's demise was one of the top stories of 2014, and it kept making headlines in 2015. The **iShares S&P TSX Capped Energy Index Fund** –which I see as a reasonable proxy for the whole sector–has fallen more than 30% in 2015 alone, and that's after falling almost 10% in 2014. That translates into a 40% loss over the last two years.

Ouch.

There's even an argument to be made that energy stocks should be lower than they are today. With oil at \$35 per barrel, there's a legitimate risk for bankruptcy for many of Canada's small- and mid-sized energy producers. Most have quite a bit of lingering debt from the good times, and with breakeven prices between \$45 and \$55 per barrel for most producers, there's nothing these beleaguered companies can do besides hope and pray for the price of crude to go up.

Ultimately, an investment in energy today has to factor in two things. The company needs to have low-cost production, which will allow it to muddle along in a world where crude might take years to recover. It also needs the balance sheet strength to survive the downturn.

Where can investors find such a combination? Pickings are slim.

What about the oil majors?

The default answer for many investors has been a flight to quality. While the overall energy sector is down 40% over the last two years, **Suncor Energy Inc.** ([TSX:SU](#))([NYSE:SU](#)) is actually up over the same time period, admittedly only less than 1%. Still, that's a great performance. It even beat the overall results of the TSX Composite.

I don't get it. Yes, Suncor has exposure to downstream assets, like refining and retailing gasoline, but those activities don't represent the majority of its net income. In 2014 Suncor generated \$8.9 billion in cash from operations. That's on pace to fall to \$7.2 billion this year, and remember, oil hovered

between \$45 and \$60 for much of 2015. If it persists below \$40 per barrel, Suncor might only generate \$6 billion or so in cash from operations.

I don't want to scoff at a company being able to generate such amounts of cash in today's energy market. But at the same time, I don't see much upside in the stock once oil recovers. The price of crude has declined some 60% and cash flow looks likely to decline by at least a third. Why hasn't the stock gone down?

One possible exception

There are potentially plenty of energy bargains in the mid- to small-cap space provided you believe crude will come back. Some of these producers need crude to get back to \$50 or \$55 per barrel in a hurry, while others can survive between \$40 and \$45 per barrel.

One I'm liking at today's levels is **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE). Baytex has approximately 60% of its production coming from the Eagle Ford field in Texas, a location that boasts a current breakeven price of \$35 per barrel. Its heavy oil production in Northern Alberta needs approximately \$45 per barrel to break even. While this isn't ideal in a world where oil is at \$35 per barrel, it puts Baytex in a better spot than most of its peers.

At first glance, Baytex seems to be drowning in debt, owing \$1.8 billion compared to \$2.7 billion in equity. But management has done a nice job pushing debt maturities into the future, and the company only needs to pay the interest with no debt coming due until 2021.

There's plenty to like about Baytex, but there's also plenty that can go wrong. If crude doesn't recover meaningfully in 2016, Baytex won't generate the kind of cash needed to finance new growth internally. That means adding to the debt pile.

There are some interesting opportunities out there in the energy market. Ultimately though, investing in these companies means you're placing a bet on crude going up. I believe crude will eventually go higher; the issue is how long it will take. That issue is the crux of the matter and why I can completely understand why investors are avoiding the energy sector altogether.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:SU (Suncor Energy Inc.)
2. TSX:BTE (Baytex Energy Corp.)
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