Will Credit-Rating Downgrades Kill Oil Stocks?

Description

Collapsing oil prices have hit producers hard, especially those with high operating costs. While most larger companies have ample financial flexibility to outlast the current downturn, many smaller firms are facing spiraling profits and ballooning debt payments.

Last week, **Moody's Corporation** (NYSE:MCO) announced that it will review several hundred energy companies and may issue a deluge of credit-rating downgrades, increasing borrowing costs for those targeted at a time when excess capital is tough to come by. Even if a firm is positioned to climb out of the doldrums once prices recover, a rating downgrade may keep it from getting there, especially if the company already has a fair amount of leverage.

So while credit ratings are usually look backward, they have real effects on distressed investments.

Which companies will be targeted?

Looking at the companies most at risk, Moody's highlighted local players such as **Paramount Resources, Ltd.** (TSX:POU) and **Precision Drilling Corporation** (TSX:PD)(NYSE:PDS) as well as bigger players like **BP plc (ADR)** (NYSE:BP). If a credit downgrade occurs for any of the companies above, shares would certainly move downward to reflect higher borrowing costs. Not only will interest rates on debt rise, but maturing debt may be more difficult to roll over.

While the market will likely continue to lend to BP (albeit at higher rates), it may prove less accommodating to smaller firms like Paramount or Precision Drilling. Additionally, shares of both companies are down between 40% and 80% in the past 12 months, meaning that selling stock to raise cash is more difficult. If oil rebounds, however, most producers will be saved by higher selling prices. Unfortunately, Moody's isn't very optimistic about that either.

$33 oil for 2016

Moody's is now estimating that crude will average only $33 a barrel this year and won't reach the $40 per barrel mark until 2018. While steadily rising prices will be welcome for anyone selling oil, it may not be enough for some. Paramount and Precision Drilling both have debt levels above 90 times equity and are bleeding hundreds of millions in negative free cash flow after debt payments. Thus 2016 earnings estimates for both companies are horrific.

How much damage can a credit rating do?

If oil doesn't rebound quickly, credit agencies may have no choice but to cut their ratings, possibly dealing a death blow to overstretched companies. Some, however, argue that the effects won't be that perilous. A recent Forbes article argued that ratings downgrades don't matter that much: "Prices don't shift because ratings change, or not very much; they shift before they do."

Yes, credit ratings are largely backward-looking, but the issue is that most bond funds are limited in the variety of debt that they can buy. When downgrades are issued, it often elicits a fair amount of forced selling. While the downgrade may not indicate the future of the industry, it can do plenty to crush a company in the midst of a bear market.

If you're invested in an overleveraged oil company, pay close attention to its ability to keep funding itself, especially with credit-rating downgrades around the corner.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:BP (BP)
2. NYSE:MCO (Moody's Corporation)
3. NYSE:PDS (Precision Drilling Corporation)
4. TSX:PD (Precision Drilling Corporation)

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