Don’t Buy an Oil Stock Unless it Has These 3 Things

Description

It seems that almost overnight, sentiment around oil stocks has transformed from being intensely bearish to being one of the most bullish plays on the market. The evidence is clear—the IEA stated in their recent report that prices may have “bottomed out,” hedge funds are quickly unravelling short positions and going long (in fact, last week saw the biggest decline in oil short positions since 2006), and oil prices are up over 40%.

While it is unclear as to whether or not the current short-term rally is sustainable (many think it is not), the long-term trend for oil will ultimately be up as prices in the $40-60 per barrel range will be necessary to bring on enough U.S. shale production to keep the market in balance. In other words, it’s a good time to be looking to buy oil stocks.

While many investors think all oil stocks are basically the same (in that they are all just plays on the oil price), there are several factors that, if met, will lead oil stocks to vastly outperform their peer group over time.

1. Capital efficiency

In presentations or reports, the concept of capital efficiency comes up often. Capital efficiency is calculated by taking the capital costs necessary to bring a particular well or project online, and dividing that by the daily production that will come from that particular well or project. As a result, it basically tells the investor the capital cost required to add a barrel per day of production.

This means that investors should be looking for companies that have the best capital efficiency (the lowest cost to add new production). This is important, because it means that only will these producers earn better returns (because they bring on more production at a lower cost), but they will also typically have more free cash flow, which means more opportunities to enhance shareholder returns through growing production, paying dividends, or buying back stock.

What is a good capital efficiency number to look for? According to **RBC**, $28,000 boe/d ($28,000 toadd a barrel per day of production) was the industry average in Canada for 2015, which means lookingfor companies that are below this is a good idea.

Crescent Point Energy Corp. (TSX:CPG)(NYSE:CPG), for example, is expecting capital efficiencies of about $20,000 per barrel for 2016, which makes it a fairly efficient producer. **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) is even more efficient with capital efficiencies of only $13,000 per barrel in its top drilling locations.

2. Breakeven costs

Breakeven points are also important, because this is the oil price at which a company can continue to produce. It is important to note that there are many kinds of breakeven points. Cash costs, for example, is the oil-price point below which a producer can no longer afford to produce at all.

Typically, investors look at "full-cycle" breakeven points, which is basically cash costs plus the capital costs to find as well as drill new wells. An oil company needs the oil price to be above this level in order to maintain production over time. If oil prices are below this point, production will decline since producers will not be able to afford to find and drill new wells to replace the old wells.

Crescent Point is also a leader in this regard. According to RBC, Crescent Point has the third-lowest breakeven point of its group of producers; its breakeven point was around US$35 per barrel in 2015 (and likely to be lower in 2016).

3. Balance sheet

It is important for an oil company to also have a strong balance sheet that also includes plenty of liquidity. Investors should look for companies that have fairly large lines of credit that are also mostly unused (as well as cash on the balance sheet).

Cash and unused credit lines give a company the ability to not only withstand periods of oil-price weakness, but to also continue to invest in opportunities to enhance shareholder returns. Companies are expected to have drawn between 50-60% of their credit lines in 2016, so looking for businesses with levels below this can lead to good opportunities.

CATEGORY

1. Energy Stocks
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2. TSX:BTE (Baytex Energy Corp.)
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