Baytex Energy Corp.: Big Risk, Even Bigger Potential Reward

Description

It's been a painful 18 months for **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE).

Much of the company's pain can be attributed to the decline in oil, of course. When crude was above $100 per barrel, shares traded hands at $40 each. It paid a $0.24-per-share monthly dividend and had seemingly endless amounts of liquidity. It borrowed heavily to buy Aurora Oil and Gas in 2014, right at the peak of the market.

It's the debt that has really been an issue. At the end of 2015, the company owed more than $1.8 billion to creditors, and that number actually improved after management issued some 35 million shares earlier in the year to help lessen the burden.

The other problem has been expenses. While the company has been successful in lowering its costs by some $150 million annually by axing staff and pressuring outside contractors to cut prices, breakeven costs still average somewhere close to $40 per barrel. These costs are lower in the Eagle Ford formation in Texas at about $35 per barrel. But they're higher in the company's two big projects in northern Alberta, averaging closer to $45 per barrel.

In a world where crude is averaging less than $40 per barrel and companies like Baytex are guarding any available liquidity closely, production is bound to start creeping lower. The company can only really dedicate any internal cash flow to capital expenditures, since borrowing is off the table in this environment. Unless crude recovers in a hurry, production will slowly but surely head lower.

All of this combined looks to be very bad news for Baytex. But there is a potential saving grace.

The potential reward

Let me explain a concept I call coin-flip investing.

For the sake of argument, let's say Baytex has a 50/50 chance of recovering back to highs we last saw in the early part of 2015 when crude rallied to surpass $60 per barrel. That price target might seem a little hopeful now, but remember, just a few years ago just about everyone assumed between $80 and

$100 per barrel was the new normal price for crude.

Collectively, we're not very good at predicting the price of crude oil.

At $60 per barrel, Baytex traded at between $20 and $23 per share on the TSX, a far cry from today's levels of approximately $4.50 per share. Let's be a little conservative in our model and assume Baytex would trade at $15 per share in a world where crude is worth $60 per barrel.

On the downside, it's obvious what the risks are. Baytex could end up going to zero. While I'd argue that outcome is remote at this point–mostly because the company has no long-term debt maturing until 2021–the risk still exists.

At $15 per share, the potential upside on this stock today is approximately 250%, while the potential downside is 100%. If each of these outcomes have a equal chance of happening, it's a bet investors should make every time.

The potential risk

Coin-flip investing isn't quite as simple as I make it out to be.

Many investors don't want to deal with a company they own potentially going to zero. This is precisely the reason why investing in blue chips is so popular. The perceived security of these stocks trump the additional upside offered by true value stocks–at least for most investors.

Baytex is also a huge levered bet on crude going higher. Without cooperation from the commodity, investors would likely be in a tough spot after a year or two of holding Baytex. There are less volatile choices that have exposure to oil, some of which even pay dividends.

Baytex is a risky stock; I won't sugarcoat it. The company isn't out of the woods yet, and likely won't be barring a big increase in the price of crude or a surprise acquisition. But you can't deny the possible reward if the thesis plays out.

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2. Investing

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1. TSX:BTE (Baytex Energy Corp.)

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nelsonpsmith