How Risky Is an Investment in Baytex Energy Corp.?

Description

Heavily indebted **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) is reeling under the weight of weak oil prices and appears to have hit its breaking point. With crude at under US$40 per barrel, it has made the decision to further reduce capital expenditures and its cost base by turning off the spigots at wells that remain unprofitable in the current operating environment. This is never a good sign and has created considerable nervousness among investors.

Now what?

Baytex is struggling to remain afloat as the harsh operating environment weighs heavily on the company. As a result, it has made the decision to yet again cut its capital budget by a further 33%, end its heavy oil development program, and shutter 7,500 barrels of daily oil production. This will see overall 2016 production fall to 75,000 barrels daily, 11% lower than it was in 2015.

When coupled with sharply weaker crude prices, this will see a decline in Baytex's revenues over the course of the year and could place further pressure on its already precarious financial position.

Baytex is heavily indebted with long-term debt of almost $1.9 billion; it pays out about $112 million in annual financing costs alone. This debt is also more than 3.3 times Baytex's cash flow from operations, highlighting just how heavily leveraged the company is and the burden this creates.

The decision to shutter production from existing operations and further cut investments in exploration and development doesn't bode well for Baytex's ability to pull through the current storm unharmed.

You see, one of the greatest concerns is that Baytex will be unable to replace those oil reserves lost through production and the natural decline of its existing well.

Nonetheless, to offset this risk, Baytex has decided to concentrate its capital expenditures and development program on its Eagle Ford acreage.

This makes sense because Baytex's Eagle Ford acreage is far more profitable than its Canadian assets. Eagle Ford produces light, tight oil that receives the spot price for West Texas Intermediate (WTI). Its Canadian assets produce heavy crude that is known as Western Canada Select, and this trades at a considerable discount to WTI. At this time, the discount is at about 33%, but it was as high as 50% earlier this year.

Furthermore, Baytex's Eagle Ford operations have lower cash costs than its Canadian operations. For 2015, these cash costs were US$16 per barrel compared to $16.50 for its Canadian operations.

Both of these factors mean that Baytex's Eagle Ford acreage is far more profitable and remains cash flow positive in the current harsh operating environment.

So what?

Baytex’s recent measures make it abundantly clear that sub-US$40 oil is the breaking point for many small Canadian upstream oil producers.

There are concerns about Baytex’s moves to cut its capital budget again and reduce spending to a point where it is not investing sufficient capital to replace oil reserves lost through production. However, the problem is not as severe as it first appears. The focus on its light tight oil assets in Eagle Ford makes sense as they are far more profitable and productive than its Canadian heavy oil assets.

Furthermore, with Baytex using the majority of its revised capital budget to continue drilling and fracking in Eagle Ford, its reserves and production of more profitable, light, tight crude can only continue to grow.

CATEGORY

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