After Rising 157%, Is Baytex Energy Corp. Now Overvalued?

Description

Baytex Energy Corp. (TSX:BTE)(NYSE:BTE) has become the desired means for bullish oil investors to play a recovery. A quick look at trading volumes among junior and intermediate producers reveals why. Over the past month, Baytex has been the most actively traded name, and for the week ended March 18, Baytex had a 10-day average volume of 14.3 million shares traded (over three times what **Crescent Point Energy**—a much larger company—saw).

The fact that Baytex has also been a top-performer during this time frame indicates that there is strong bullish sentiment behind this volume. It makes sense why investors are flocking to Baytex—the company largely operates out of the Eagle Ford, which is one of the more economical plays in North America with breakeven costs of US$35 (including a 10% return).

In addition, Baytex is one of more leveraged names in its peer group, which has kept investors away as oil prices plunged. As oil prices rise, Baytex's overall leverage declines, which would lead Baytex shares to rally as the valuation discount caused by the company's high leverage position unwinds.

This has certainly happened, and investors sitting on the sidelines may be wondering if the shares have gone too far.

Examining Baytex's current valuation

As of writing, Baytex is trading at $4.98 per share (although oil has been declining, which will likely put pressure on Baytex shares over the coming days). Current strip pricing for 2016 suggests average West Texas Intermediate (WTI) oil prices of slightly over US$40 for the year. Analysts at **Royal Bank** see Baytex earning cash flow of about $1.10 per share, or $231.66 million in 2016.

This means that Baytex is currently trading at a forward price-to-cash flow of 4.5 times. Interestingly, this suggests that if futures prices end up being correct for 2016, Baytex is not overvalued, but is in fact significantly undervalued. Baytex's peer group of junior and intermediate producers are trading at an average of 9.7 times 2016 cash flow at US$40 WTI.

This means the market is currently applying a 46% discount to Baytex, even after the recent rally (in addition to this, Baytex is also trading at only 60% of its net asset value, or the value of its assets minus its debts). In order for Baytex to trade in line with its peer group, it would need to earn cash flow of $0.51 per share (53% less than the $1.10 expected at US$40 oil), which would require significantly lower oil prices than US$40 per barrel (likely slightly below US$30 per barrel based on the sensitivities Baytex released).

Does this mean Baytex is a buy?

Since the market is essentially pricing US$30 per barrel oil for 2016 into Baytex, does this mean Baytex has significant upside if oil prices stay the same or rise? That depends if Baytex should be rewarded with a valuation that is in line with its peer group.

It is important to remember that one of the reasons Baytex suffers from such a discount compared with its peers is that it closed 2015 with a net debt of about $2 billion, which works out to 3.8 times cash flow–well above its peers. There are some concerns Baytex could breach debt covenants (or limits) with its banks, and if Baytex can successfully loosen or eliminate these covenants (by pledging assets against its debt), it could reduce anxiety about its debt levels.

Baytex has stated this is an option, and in the event this occurs and oil prices continue to rise, Baytex could have massive upside. For investors, the wisest thing to do in this scenario would be to wait to buy Baytex on a pullback. Many experts are predicting the current rally in oil prices is due for a pullback due to continued growth in stockpiles, and this should provide a lower-risk opportunity to buy Baytex.

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