



The 2 Biggest Risks You Need to Know Before Buying Baytex Energy Corp.

Description

Without a doubt, investors who missed the opportunity to buy **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE) at its low of below \$2 per share earlier this year are regretting it more than ever—Baytex shares recently surged above \$5.80 per share, thereby generating a 230% return since January 20.

This is common when shares rally suddenly off a low, and Baytex has a large amount of both institutional and retail money waiting on the sidelines for an opportunity to re-enter, likely in the \$4.30-5.00 range, which marks the prior low and represents a decent entry point from a valuation perspective.

These investors, however, need to focus on the risk present in a Baytex purchase at current prices. Investors who bought at under \$2 when oil was under US\$30 had an extremely attractive risk/reward profile—oil was at an unsustainably low level, and Baytex was deeply undervalued compared with its peer group due to debt concerns.

At current prices, the risk levels are much higher.

1. A lower-for-longer oil-price scenario is bad news for Baytex

It almost goes without saying that the biggest risk for Baytex is oil prices. More specifically, however, the timing and size of an oil-price recovery is important for Baytex. While oil prices are almost certainly headed upward, analysts differ on the time frame; some, like Eric Nuttall of Sprott Asset Management, see \$55 per barrel this year, while others, like **Goldman Sachs**, sees oil averaging US\$38 this year.

Oil recovering slowly makes a big difference for Baytex. Firstly, the company has three major operating segments: shale oil fracking in the Eagle Ford, conventional heavy oil drilling in Lloydminster, and multi-lateral horizontal wells in Peace River that target heavy oil.

In 2015 Baytex produced 34,974 barrels per day of heavy oil out of a total 69,353 barrels per day of total oil and NGL production. This is a significant percent and, unfortunately, much of Baytex's heavy oil production is uneconomical at oil prices under US\$40 per barrel.

It is for this reason that Baytex decided to shut in 7,500 barrels per day of low/negative-margin heavy

oil production. In addition to this, Baytex will be suspending its heavy oil drilling program for 2016, directing most of its capital towards the Eagle Ford.

The end result? The low end of Baytex's production guidance has dropped from 72,000 barrels per day in 2016 to 68,000 barrels per day. Baytex's Peace River and Lloydminster assets have breakeven costs at US\$46 and US\$43 respectively and, as a result, Baytex's production growth and cash flows will be limited in a slower recovery environment due to the large heavy oil exposure.

2. Baytex still has a high debt load

The largest concern investors have for Baytex is generally its debt load. Baytex has a net-debt-to-cash flow ratio of 8.3 at current oil prices, according to **RBC**, compared with a peer-group average of 3.9.

Fortunately, while this is still a concern, Baytex recently made amendments to its debt covenants (which are basically limitations that banks put on a company's debt levels), so there is virtually no risk of the company breaching its covenants (whereas there was a significant risk before).

In exchange for reducing available credit facilities and securing its debt load with assets, Baytex has seen its debt limits changed from total debt being no more than 5.25 times earnings before interest, taxes, depreciation and amortization (EBITDA) to secured debt that is no more than five times EBITDA.

Baytex's secured debt is currently only \$269 million compared to total debt of over \$2 billion, and secured debt is currently only 0.49 times EBITDA, far from exceeding the debt covenants.

The end result is that although investors do not need to worry about Baytex's debt load under any reasonable oil price assumption for 2016, they do need to worry about a slower-than-expected recovery in oil prices. At \$5.85 per share, Baytex is trading at 4.75 times its 2016 cash flow at average prices of US\$41 per barrel for the year.

This is below the long-term average of 6.4, which suggests Baytex is pricing in a lower oil price, but it also suggests that if analysts at Goldman are correct, Baytex has little upside remaining for the year.

Cautious investors would be wise to wait for a pullback to the \$5 level before entering.

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