Is Baytex Energy Corp.'s 228% Rally Finally Over?

Description

Investors who missed the opportunity to get in on **Baytex Energy Corp**. (TSX:BTE)(NYSE:BTE) would be wise to be patient rather than jump in at current price levels. As of writing, Baytex is trading at about $6.40 share, which is 288% off the closing price on January 20, which represented the day Baytex shares bottomed.

Baytex did exactly what investors who entered below $2 thought it would—it served as a leveraged proxy for the price of oil, which saw a much smaller 53% run up in prices since January 20. The main source of Baytex's excess return was the fact that it was trading at a discount of about 50% to its peer group on a forward price-to-cash flow basis.

As oil prices recovered, this gap closed, giving Baytex huge upside. While Baytex will be in a bull market as long as oil prices are, the near-term downside of buying at current prices (which are the highest they've been since early October), exceeds the upside.

What multiple of cash flow should Baytex trade at?

To answer the question of whether or not Baytex has more upside left, it is important to ask what a proper valuation for Baytex is. Analysts at **TD Bank** see oil prices averaging US$45 per barrel for 2016, and at these price levels, TD assumes Baytex would earn 2016 cash flow per share of $1.45. With Baytex currently trading at $6.40 per share, this means that Baytex is trading at 4.4 times its 2016 cash flow or has a price-to-cash flow ratio of 4.4.

How does this stack up against Baytex's peers? **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG) is trading at 6.7 times, **Peyto Exploration** is trading at 9.28 times, **Bonavista** is trading at 2.43 times, and Baytex's overall peer group has traded between five and seven times forward cash flow since 2013.

Crescent Point is probably Baytex's closest comparable due to the fact that of the names in their peer group, Crescent Point and Baytex are both the most oil weighted. Unfortunately, Baytex is unlikely to trade (at least in the near term) up to Crescent Point's 6.7 times cash flow.

This is for a few reasons. Firstly, close to half of Baytex's Q4 2015 oil production comes from heavy oil drilling in western Canada. Baytex announced in its last earnings report that it would be suspending its heavy oil drilling campaign and shutting in 7,500 barrels per day of negative-margin heavy oil production.

While Baytex plans on bringing much of this production back by mid-year, the shut ins and suspending drilling campaign mean Baytex is expecting to have total production of about 70,000 barrels per day in 2016, which is a 17% decline from 2015 levels. Meanwhile, Crescent Point expects to grow its production in 2016.

Baytex's heavy oil exposure (compared to Crescent Point's 100% light oil) is a detriment in a lower-price environment, since heavy oil receives a discount to light oil and therefore has higher breakeven prices. Baytex also has significantly higher debt levels than Crescent Point with an estimated 2016 debt-to-cash flow ratio of six compared to 2.5 for Baytex.

While Baytex could see some multiple expansions from the current level of 4.4 times cash flow if oil prices stay at current levels (as the market becomes less concerned about debt, as more secure that the oil rout is over, and as Baytex brings production back online), it is difficult to see how Baytex shares could continue to rise unless oil prices continue with a substantial move up and stay at higher levels.

Oil prices have some near-term headwinds

Baytex currently trades at 4.4 times 2016 cash flow, assuming Baytex's 2016 cash flow is $1.45 per share (which would require an average oil price of US$45 for the year). This is likely a reasonable average oil price for 2016. While oil prices may rise as the year progresses, it is also likely there will be another down-leg in oil prices beforehand, which should keep the average price for the year between US$40 and US$45 per barrel. Baytex's current share price seems to be pricing in this expectation.

Another down-leg is likely because the oversupply that caused the oil rout still exists, with the EIA still reporting weekly stockpile builds and inventories still well above historical levels. This should both add some pressure to oil prices and also give patient investors another opportunity to get into Baytex at lower prices before the next leg of the oil bull market continues.

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Author
amancini