Will Baytex Energy Corp. Surprise the Market?

Description

This month, **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) reported first-quarter earnings of $0.00 a share. While the company merely broke even, the results beat the average estimate by a whopping $0.31 a share.

Since the year began, shares are up over 40%, potentially beginning a long climb back to $20. Will Baytex shares continue to surprise Wall Street analysts and push back towards its historic highs?

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Approaching breakeven

A big help in nearly reaching profitability has been a dramatic reduction in operating costs. A big part of this effort stems from reallocating production to the most profitable regions.

In the first quarter this year, production was only 76,000 barrels per day, 16% lower than the year before. Most of the production decrease, however, was from the company's heavy oil segment, which isn't nearly as profitable as higher-quality reserves. Estimates show that these heavy oil deposits sold for just US$10 a barrel in the final quarter of 2015, incentivizing the company to limit output in those regions.

Savvy production management helped keep operating cash flow positive at roughly $64 million. While capital expenditures totaled $81 million, resulting in negative free cash flow for the quarter, it's clear that the company is approaching breakeven with the recent run in oil prices.

Just in time

The rise in energy prices came at just the right time for Baytex.

On February 3, **Moody's** downgraded Baytex's debt below investment grade, giving the company a negative outlook. "The downgrade reflects the material decline in Baytex's cash flow we expect in 2016 and 2017, which will result in weak cash flow-based leverage metrics," a Moody's analyst said. "Baytex will also breach financial covenants in 2016 and will need to get relief from its banks."

While rating downgrades are typically backward looking, it has a real impact on the short-term cost of financing. Most companies that fall below investment grade see their bonds forcibly sold off by mutual funds that are mandated to only hold investment-grade securities. This also creates lower demand for future debt rounds.

With oil prices surpassing US$40 a barrel, Baytex stock has shot up to nearly $7 a share while opening up more options for debt financing. About 80% of 2016 oil production is hedged through a variety of contracts. In all, the hedges give Baytex a boost in profitability with prices under $50 a barrel. If the oil market sustains its recent rebound, Baytex can count on its continued survival, investing for the future instead of focusing on short-term issues.

You must think long term

Despite the near-term optimism, investing in Baytex must be a long-term proposition. All-in production costs are still estimated to be US$40-45 a barrel, so without continued pricing improvements, the company would still face future financing troubles. If you're looking to play the oil rebound that's set to occur over the coming years, however, Baytex looks like a great choice to ride the wave, as long as you're willing to put up with volatility in the interim.

CATEGORY

1. Energy Stocks
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1. TSX:BTE (Baytex Energy Corp.)

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