Thinking of Buying More Baytex Energy Corp.? Buy Vermilion Energy Inc. Instead

Description

While oil prices have rallied over 80% off their February lows, the general consensus is that the oil-price rally is still far from over. Since early June oil prices have paused near the US$50/bbl level as concerns over the Brexit, a stronger U.S. dollar (driven by a likely delay in rate hikes), and returning supply from Nigeria, Canada, and the U.S. all weigh on prices.

With prices taking a break, many investors are wondering how to play the next leg up. So far**, Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) has been an investor favourite. The stock has rallied 340% since January and has been the eighth best-performing TSX energy stock over the past eight months. With prices of US$60 being necessary for U.S. producers to keep production flat, Baytex may seem poised for another run up.

This is very likely true, but at current prices Baytex will see more resistance to its share price growth due to its high debt levels and exposure to higher breakeven heavy oil. To diversify, investors should consider **Vermilion Energy Inc.** (TSX:VET)(NYSE:VET), which offers a sustainable yield, low debt levels, production growth, and natural gas exposure.

Why Baytex may see a slower pace of price growth

It is very likely that Baytex shares will be higher (potentially much higher) a year from now as the company is still significantly leveraged to oil-price increases, but investors should be aware of headwinds that could reduce its outperformance.

Firstly, Baytex is expected to post a debt-to-cash flow ratio of 6.9 in 2016 (assuming average prices of US$40 for the year according to **Bank of Nova Scotia**). While Bank of Nova Scotia's price deck is likely low, the important fact is how this figure compares to Baytex's peer group. Baytex's overall peer group of 16 trades at a debt-to-cash flow ratio of 4.6.

When looking just at Baytex's peers, which are oil-weighted (gas production of less than 50%), thedebt-to-cash flow is a much lower 3.08. Baytex sits firmly atop of this group. Baytex currently has $1.83 billion of debt ($1.5 billion of which are long-term notes with no maturity until 2021—the remainder is a bank loan).

While the company has no risk of a debt crisis at current prices (the bank is only 39% drawn on its credit facility and re-negotiated its covenants in early 2016), high debt levels are a tailwind to growth via higher interest expenses, reduced ability to borrow to fund acquisitions or drilling, and future principle repayments.

In addition to this, Baytex still obtains a large portion of its production from Canadian heavy oil (with about one-third of total production coming from heavy oil sources). Baytex's heavy oil production has higher breakeven prices (around US$45 per barrel compared to US$32 per barrel for its Eagle Ford light oil production), which means these sources will need higher prices to generate attractive returns.

Baytex is expected to show fairly flat production through 2017 as the company aims to live within cash flow and does not plan on drilling its heavy oil assets this year unless the price outlook changes dramatically.

Consider Vermilion for diversification

Vermilion is an excellent alternative as it possesses many of the characteristics that Baytex lacks. Vermilion explores for and produces oil and natural gas (with production evenly balanced between the two). Vermilion is a globally diversified business with operations in Canada, Europe, Australia, and the U.S., and the company is an exceptionally high netback business.

Vermilion's recycle ratio (which is the company's profit per barrel divided by the capital spent per barrel of reserves added) is the highest in the industry (around 3.5 compared to less than one for Baytex). Vermilion has steadily grown production every year since 2009 and is expecting a 17% growth in production this year.

In addition to this, Vermilion currently has a dividend yield of 6.25%, and the company has never reduced its dividend even during the oil and natural gas price rout. With a strong balance sheet (one of the lowest debt-to-cash flow ratios in the industry), Vermilion should be able to post continued production growth, making it a lower-risk alternative to Baytex for playing the future rise in oil prices.

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