



3 Reasons Baytex Energy Corp. Shares Will Be Higher a Year From Now

Description

Baytex Energy Corp. ([TSX:BTE](#))(NYSE:BTE) has become an enormously popular name since the oil recovery began earlier in the year. The 50-day average volume is about 6.6 million shares traded per day at the start of the year compared to 11 million now.

With shares that have rallied about 85% year to date, Baytex has been the eighth top-performing name in its 40-name peer group. It has outperformed both WTI oil prices (28%) and the **iShares Capped Energy Index** (18%). Baytex is considered a high-beta name, which means that in the event of continued upward movement in oil prices, Baytex can expect to demonstrate further outperformance.

After such strong performance, however, investors sitting on profits are likely wondering whether or not to sell, and investors who missed the rally and wondering if it is too late to get in. It is important to take a long-term view on names like Baytex, and for investors looking a year out, there is a very strong case for higher prices, even though prices may stay flat or even decline beforehand.

Oil prices will very likely be higher a year from now

When it comes to investing in any commodity stock, getting the call on the underlying commodity correct is far more important than picking the right name. Baytex has much going for it in terms of quality assets and operational excellence, but shares will do poorly if oil prices do poorly.

It is very difficult to see how oil prices could be lower than current levels of about US\$47 one year out. U.S. crude oil production has been declining for seven straight months, and global storage is being continually drawn down. The IEA recently stated their original prediction of a global oversupply of 1.5 million bpd at the end of the first half of 2016 is now about 0.8 million bpd, driven by stronger-than-expected demand growth and unexpected supply cuts.

The IEA now anticipates 2017 to see a global draws of around 0.1 million bpd. With supply and demand coming into balance, the backdrop for oil is good. It is important to note, however, that the IEA sees demand growth of 1.3 million bpd in 2017, and with OPEC production largely maxed out, U.S. production will need to rise, and it will be unable to do so significantly with oil prices under US\$60 per barrel, which is the price point required for most U.S. producers to be able to grow production without

relying on debt. This is good news for Baytex.

Baytex's debt ratios will come down and support the stock's valuation

Baytex's debt levels have been a key concern and were likely a source of the valuation discount versus its peers. Baytex's above-average debt ratio (expected debt-to-cash flow of 6.9 for 2016 at US\$40 oil versus 3.08 for Baytex's oil-weighted peer group) can largely be attributed to the poor timing of its entry into the high-quality Eagle Ford play via the purchase of Aurora Oil & Gas in 2014.

Baytex has made several key moves to reduce concerns over its debt, including cutting its capex (to within cash flow to prevent further debt accumulation) and renegotiating its debt covenants to ensure they would not be breached. Baytex's new covenants allow it to borrow five times its EBITDA in secured debt, and its current ratio is only 0.61 times EBITDA.

For 2016, Baytex is expected to generate slightly positive free cash flow of \$39 million according to analysts at **TD Bank**, assuming average oil prices of US\$45 per barrel. If oil prices recover into 2017, Baytex will see its debt ratios fall as cash flow rises both due to rising prices and rising production as the company has more cash flow to invest into capex.

Baytex's heavy oil production becomes economical at higher prices

Finally, a good portion of Baytex's asset base is not being fully utilized due to lower prices. Baytex is still running heavy oil wells in Lloydminster and Peace River, but it will not be drilling new wells until prices improve more. As they do into 2017, Baytex can expect more production growth and cash flow.

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1. TSX:BTE (Baytex Energy Corp.)

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