



Why These 2 Oil Stocks Have +50% Upside in the Next 2 Years

Description

It's buying season again for oil-stock investors, and with the market currently consolidating before what may be a historic run-up in prices over the next few years, the selection of the right names to ensure proper leverage to this increase is essential.

Currently, the oil market is likely set for some weakness or range-bound price action, and these are perfect conditions to accumulate exposure to high-quality names. This weakness is likely to be driven by a few factors. Firstly, the explosion of hedge funds closing short positions (which has been driving prices higher) is ending (the total short position is now fewer than 100 million barrels—the point where prior short-squeeze cycles have ended).

Secondly, huge inventories are still weighing down the market (143 million barrels above the five-year average) at a time when demand is seasonally weak and the market is cluing into the fact that chances of an OPEC freeze deal are tiny.

This should give investors some time to buy oil names before the next leg up.

Oil should exceed US\$60 per barrel in 2017 and 2018

If oil prices do not perform well, neither will oil stocks. Fortunately, there is a good case to be made for oil prices above US\$60, which is a range shared by plenty of analysts from **TD**, **Bank of America**, and **Sprott Energy Fund** (Canada's top-performing energy fund).

It was recently reported that global oil discoveries have hit the lowest level since 1947, thanks to the fact that two years of low oil prices and a collapse in lending have left companies needing to drastically cut capex. This is concerning, because fewer discoveries mean less future production growth and less ability for companies to replace the wells they are drilling.

These cuts are coming at a point where oil demand is expected to grow strongly; demand is expected to grow from 95 million barrels per day (bpd) this year to 105 million barrels per day 10 years from now. This means 10 million bpd of new production is required, and this doesn't even include the fact that the current global supply declines at a rate of about 5% annually, which means four to five million bpd

annually needs to come online to simply keep production level.

This won't happen with oil prices below US\$60 per barrel. U.S. production is key to meeting this future demand; currently, U.S. supply needs over 200 more rigs just to keep production flat.

How to play the increase

Much of the best exposure to rising prices can be found in more junior names with strong asset bases, production growth prospects, and undervaluation compared to peers.

One name that meets these criteria is **Gear Energy Ltd.** (TSX:GXE). Gear is a small producer (6,400 bpd expected in 2016) that is about 65% focused on Canadian heavy oil with the remainder being light oil. Gear is attractive because it has very low operating costs of \$13.44 per barrel, and the company is expected to grow production to 7,000 bpd in 2017 even at low oil prices of US\$60 per barrel.

Gear's most attractive feature is the fact that it trades at only around three times 2017 enterprise value to debt-adjusted cash flow (EV/DACF). Its peer group trades at close to eight. This major discount is due to concerns over Gear's debt load (low oil prices saw the value of Gear's reserves and credit facilities reduced to less than the outstanding balance).

Gear issued equity to reduce the balance, was able to secure a new credit facility of \$50 million, and reduced its debt by 40%. Going forward, this should lead to Gear closing its valuation gap with its peers.

Baytex Energy Corp. ([TSX:BTE](#))(NYSE:BTE) is a similar story. High debt levels have resulted in Baytex being valued at 6.9 times 2017 EV/DACF, compared to 7.9 for the peer group. Baytex has dealt with this by cutting its capex and renegotiating its debt covenants to the point where a breach is nearly impossible.

Baytex has exposure to high-quality light oil assets in the Eagle Ford, as well as heavy oil assets in Canada that become more economical once oil prices cross above US\$50, giving Baytex good leverage to higher prices. Baytex has 50% upside to its 2016 highs that were set when oil was slightly above US\$50 per barrel.

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1. Editor's Choice

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