



These 2 Oil Stocks Will Outperform Their Peers if the Rally Continues

Description

While the idea of investing money in oil stocks with a high leverage to oil prices (a relatively large change in revenue for every dollar change in oil prices) may sound risky, it is anything but. A close look at the oil market reveals that the potential upside for oil—even being conservative—exceeds the downside over the next 12-24 months.

Given this good risk/reward setup, even conservative investors are better off investing a small amount of capital in highly leveraged names (and the rest of the capital elsewhere) then they are to miss out on what could be a substantial wealth-generating opportunity by investing in larger and less volatile names.

Why does oil present an attractive risk/reward trade-off? Oil's downside is limited for a few key reasons. Firstly, OPEC and Russia (about half of global oil production) have clearly indicated both in words and actions that they simply cannot tolerate lower oil prices. Saudi Arabia has burned through \$200 million in foreign exchange reserves, had a \$100 billion deficit last year, and has been cutting wages and bonuses.

This combined with the fact that U.S. production can't grow under US\$40 puts a solid floor under oil prices in the \$40-45 range. As for the upside, oil demand is growing by 1.2 million bpd annually through to 2020, and production will need to only cover this growth, but also offset about three million bpd annually in declines. It is tough to see where this production will come from given the massive cuts that have occurred.

With these dynamics at work, here are two names that should greatly outperform the price of oil and their peers in a further rally.

Baytex Energy Corp. ([TSX:BTE](#))(NYSE:BTE)

Baytex is consistently listed as one of most leveraged names to oil-price increases. This is for a few reasons. Firstly, the company has heavy debt levels (4.9 times cash flow at US\$60 oil, the second highest in its immediate peer group). This means Baytex has very high interest payments. In the first half of 2016, Baytex had interest payments of \$52 million, which is 43% of cash flow.

This means that at lower oil-price levels, Baytex can't easily grow production due to the fact that less cash flow is available for growth capital. Investors know this and will therefore discount Baytex to its peers. When oil prices rise, however, Baytex benefits in several ways.

Because its interest expenses are such a large portion of its revenues (leaving it with less cash flow), a change in oil prices will lead to a greater percentage boost in cash flow than a peer with smaller interest expenses, all else being equal. In addition, if Baytex begins to grow its production under higher oil prices, because a large portion of its costs are fixed (the interest expense), Baytex will see more of the extra revenues fall to the bottom line than a company with fewer fixed expenses.

As oil prices rise, investors would also reward Baytex with a higher valuation, since its interest payments are less of a concern, and Baytex can also focus on repayment. With no debt payments until 2021, plenty of liquidity, and breakeven costs of about US\$50 per barrel, Baytex is well suited even for continued weakness.

Cardinal Energy Ltd. ([TSX:CJ](#))

Unlike Baytex, Cardinal has extremely low debt, while retaining strong leverage to rising oil prices. Currently, Cardinal's debt is only 0.6 times cash flow at US\$60 oil. This is actually one of the lowest debt levels in the entire sector.

At the same time, Cardinal benefits from rising oil prices due to the fact they produce medium oil (thicker than light oil), which receives a discount to WTI oil prices. This means Cardinal's revenues will grow by a greater percentage than companies without this discount as oil prices rise.

Cardinal just purchased a new asset from **Penn West**, which has yet to have modern drilling technology applied to it, and which is expected to have extremely attractive economics. This will support Cardinal's production growth in 2017.

CATEGORY

1. Energy Stocks
2. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. TSX:BTE (Baytex Energy Corp.)

Category

1. Energy Stocks
2. Investing

Tags

1. Editor's Choice

Date

2025/09/20

Date Created

2016/10/18

Author

amancini

default watermark

default watermark