Betting on an Oil Rebound? Consider Precision Drilling Corporation

Description

Precision Drilling Corporation (TSX:PD)(NYSE:PDS) is an oil-production services company, providing drilling services for oil and natural gas exploration and production companies primarily in Canada and the U.S. In 2016 the company reported significantly lower revenues and adjusted EBITDA compared to 2015 due to a pervasive weakening of commodity prices from 2015 through to the end of 2016.

The company reported a net loss for Q3 2016, which was approximately half of the 2015 loss experienced during Q3 2015 as oil prices have started to rebound from the lows experienced in Q1 2016. The company's total loss for the first nine months of 2016 is slightly higher than the first nine months of 2015; Precision reported a net loss for this period in 2016 of $0.43 per diluted share compared with a loss of $o.32 per diluted share in 2015.

I'll discuss what a sustained long-term recovery in oil prices would mean for Precision–a company that has its revenues and earnings tied closely to market movements.

What an oil rebound would mean for Precision

Precision noted in its most recent financial statements that the large drop in top- and bottom-line income is due to a reduction in drilling activity–directly related to the most recent drop in oil prices. In Canada, rig-drilling activity is estimated to be down 9% since 2015; in the U.S., rig-drilling activity is down by as much as 32% year over year.

As commodity prices have softened over the past two years, Precision has experienced a lack of demand from oil-production companies that have cut capital expenditure budgets, delaying or halting capital projects that would have involved Precision.

It is interesting to look at the strength of oil-drilling companies in times such as these. Precision presents an interesting case study as a “canary” of sorts with respect to oil prices; drilling activity is generally a function of market sentiment on the future of oil prices and sector profitability in the medium to long term. Most oil projects span a relatively long period of time, and companies need to project the cash flows generated by the potential project for years (sometimes decades).

The “new normal” level of oil prices has thrown a wrench into long-term calculations with respect to cash flows. When oil was hovering around the US$100 level, a significant buffer was available to oil-production companies to maintain profitability below a certain threshold, and it appears that while capex for many major corporations has slowed significantly as prices have breached that threshold, it seems the recent recovery in oil prices is already starting to manifest itself in certain types of wells.

Precision has noted that the recovery in oil prices has led to “relative strength” in Tier 1 high-grade rigs, and “strength in natural gas and gas liquids drilling activity related to deep basin drilling in northwestern Alberta and northeastern British Columbia.” I will continue to monitor Precision’s financial statements in the coming quarters, paying specific attention to the market outlook for oil prices and drilling activity.

For right now, the outlook appears to be somewhat positive, but a sustained rebound needs to happen before I will consider Precision stable enough to warrant investment.

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