How Oil Derivatives Have Crushed Crescent Point Energy Corp.

Description

One of the most interesting and least-analyzed aspects of a commodity-based business is hedging. How companies choose to hedge exposures to currencies or volatility in commodities prices can often be the difference between large companies earning a profit or experiencing a significant loss.

Crescent Point Energy Corp. (TSX:CPG)(NYSE:CPG) has seen a massive unrealized loss from its hedging portfolio, amounting to more than the company's total net loss for the first nine months of 2016. I'll be taking a look at how and why this happened, and why this could be a disaster for investors expecting a continued rebound in oil prices to help bolster Crescent Point's stock price moving forward.

You're telling me oil went up, and Crescent Point lost money?

Crescent Point's operations are very closely tied to the price of oil and foreign currency. As the price of oil decreases (and it's been on quite the slide since 2014), the company's operating margins get squeezed, and the company becomes less and less profitable. Downside hedges and oil derivatives pay out as the price of oil falls, softening the blow.

The thing is, in a rising commodity price environment, these downside hedges also work the other way.

The hedges Crescent Point put in place in 2014 and 2015 have been paying off. The company realized a total derivative gain of $416 million relating to hedges that were previously put in place and settled in the first nine months of 2016.

The company can buy or short derivatives or futures contracts up to three-and-a-half years out and up to 65% of net royalty interest production, meaning the old hedges are paying off due to the slide in oil prices, but the new downside hedges will become very expensive in the future.

This is shown by the fact that the company announced a $568 million unrealized dividend loss during the first nine months of the year — a 180-degree reversal from a $131 million unrealized gain last year. This unrealized loss has not been paid out, but it still has to be accounted for on Crescent Point's books.

Should oil continue to rise, the unrealized losses in future years will continue to increase, and at the time of maturity (at the expiry of the three-and-a-half-year contracts), the losses will become realized, significantly eating into the oil company's profits.

Conclusion

Crescent Point's year-end financial statements are due to be released on Thursday, and we'll see whether the company's hedging portfolio has been reduced or if the losses for the fourth quarter will be larger than expected.

With Prem Watsa of **Fairfax Financial Holdings** recently deciding to close all of his equity index hedge positions, and other large institutional investors following suit, it may be time for Crescent Point to reconsider the scope of its hedging portfolio. In any case, it will be interesting to see what the company decides to do moving forward.

Stay Foolish, my friends.

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Date
2025/08/05
Date Created
2017/02/23
Author
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