Baytex Energy Corp. Dropped 9% Yesterday: Time to Buy?

Description

In a recent article, I asked readers to consider the question of how long **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) can survive in a low commodity price environment, identifying specific fundamental factors that put the company's long-term solvency at risk. In response, Fool contributor Matt Smith countered the question of whether or not Baytex is doomed to fail, claiming that the company is not in real trouble or in danger of bankruptcy if crude does not recover.

The fact that the company's share price has continued to decline sharply and steadily, dropping another 9% on Wednesday, indicates that others in the market believe a significant risks remain, and this default/insolvency risk is currently being priced into Baytex's stock price.

This counter argument, however, is based on two key ideas, both of which I have trouble with.

The first is that my assumptions about Baytex's debt position are flawed. Let's do a quick check:

- Baytex added more than $71 million of debt to its balance sheet this past quarter in comparison to a reported net income of $11 million (numbers can be found in the company's financial statements; net debt was actually closer to $78 million).
- The company is able to add debt; *however, the debt has become more expensive due to debt downgrades over the past two years.*
- The interest expense Baytex is currently paying is almost three times its net income.

These numbers can be checked. They are correct.

In response to the second argument made in opposition to my article, that the company's ability to raise debt or cut costs in the short term until the laddered portfolio of bonds become due starting in a few years (with the idea that oil will likely rebound before 2021), I note the following:

- There is no indication that oil will be able to sustain levels above $55 per barrel in the near to medium term (before 2021), given the long-term downward pressure of a global production glut which continues to increase, despite efforts by oil cartels to reduce the glut, spurred by increasing production of renewable energy and a focused global initiative to cut fossil fuel demand (despite

recent events with the U.S. pulling out of the Paris Climate Accord).
- There is no indication that the Western Select discount to WTI or Brent will reduce over time. Baytex's profitability depends largely on macroeconomic factors that are very hard to predict, such as exchange rates and global production rates affecting relative crude prices.
- Much of the company's debt is due to the Eagle Ford acquisition in 2014. In order to maximize the value of the acquisition, which boasts a $30 WTI breakeven, the company will need to invest substantially more, pushing its free cash flow lower in the short term and forcing it to increase its debt load.
- Current trailing 12-month free cash flow estimates show Baytex is currently producing at negative cash flow, hindering the company's ability to increase its capex budget meaningfully without raising more debt.

Bottom line

It is unwise to say that any stock has a 0% chance of bankruptcy. Indeed, even in the most well-run companies, a small but perhaps immaterial default risk amount is factored into the stock price. Companies have proven to not be immortal, and the question of how long a company has left is a legitimate question to ask.

Catalysts such as high debt loads (more than twice those of its peers) and negative free cash flow should not be taken lightly.

Stay Foolish, my friends.

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Date
2025/07/08
Date Created
2017/06/08
Author
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