Venezuela’s Default Is Good News for Energy Stocks

Description

The latest news to emerge from conflict-riven Venezuela is that the government has defaulted on bond payments. Last week, the president of Venezuela, Nicolas Maduro, announced he was seeking to restructure ~$60 billion in debt because of the nation’s falling currency reserves and deep economic strife.

So far, Caracas has failed to make a US$200 million coupon payment on Venezuela’s global bonds, which fell due around the same time, and there are further payments ahead that appear increasingly unlikely to be made. The likelihood of a larger-scale default by Caracas, while bad news for the people of Venezuela, is good news for Canada’s beaten-down energy patch.

Now what?

The economic crisis in Venezuela has not only taken the economy to the brink of collapse, but it’s also caused the OPEC member’s oil production to decline sharply. Data from OPEC shows that for October 2017 the Latin American nation’s oil output fell to a record low of 1.86 million barrels of crude daily as a lack of investment in critical infrastructure and maintenance keeps biting ever deeper. This was 2% lower than a month earlier, while being almost 14% lower than the average daily output for 2016.

Such significant declines can only continue because the near collapse of Venezuela’s economy has left Caracas close to bankruptcy. Foreign currency reserves have plummeted to a record low of under US$10 billion, which is less than a sixth of the roughly US$60 billion owed.

Ongoing deterioration in oil production is having a sharp impact on what has become essentially the only source of export income and revenue for Maduro’s regime. The sharp reduction in income, along with foreign currency reserves being at record lows, has left Caracas incapable of funding any critical oil field and refinery maintenance, virtually ensuring further production declines.

If Venezuela, which has the world’s largest oil reserves and is ranked among the top producers, is unable to renegotiate its debt, the pressure on, and its already precarious economic situation will only continue. The likelihood of a favourable outcome is slim because U.S. sanctions essentially prevent domestic banks from dealing with the country and make it highly unappealing for non-U.S. institutions to negotiate with Caracas.

Meanwhile, making any further debt payments will probably financially cripple what is left of the economy and even potentially bankrupt the Maduro regime. This would destroy any hope of the required maintenance on the aging oil infrastructure being performed**,** potentially causing production to collapse and removing almost two million barrels of daily oil production from energy markets overnight.

In conjunction with OPEC and non-OPEC production cuts, Middle Eastern supply disruptions and lower than forecast U.S. oil production it would create considerable supply constraints, causing energy markets to rebalance further bolstering prices. For these reasons, it isn't unreasonable to expect the North American benchmark price West Texas Intermediate (WTI) to break through US$60 per barrel, particularly with Venezuela being an important source of U.S. oil imports.

So what?

This is good news for Canada's embattled energy patch and would certainly be a boon for beaten-down upstream oil producers such as **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE). The heavily indebted company has not performed as strongly as some pundits predicted, despite the latest run up in the price of WTI because of concerns over its ability to reduce its considerable debt totalling $1.7 billion.

Nonetheless, at US$55 per barrel for WTI, Baytex is free cash flow positive, and that provides it with the flexibility to reduce debt and invest in field development to enhance production. Signs that oil will continue appreciating make now the time for investors to consider adding Baytex to their portfolios.

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