Why Baytex Energy Corp. Is up 4% Today and Why it Will Beat the Market in 2018

Description

To be sure, **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) has its risks. But with the continued strengthening in the price of oil and continued operational momentum at the company level, Baytex is set to make massive gains.

The debt problem

The company is still heavily indebted, with a debt-to-total-capitalization ratio of 47% — far higher than its peer group.

But, as a consolation, there is no significant long-term debt that is due until 2021, giving Baytex some time. And the company is well within all its debt covenants.

So, with WTI oil trading at $65 at the time of writing, Baytex appears in good shape, notwithstanding its debt situation. And while I am not one to take this kind of debt lightly, I recognize that this leverage also means that the stock's potential upside is that much bigger.

Cash flow growth accelerating

Going forward, management has stated that they will adjust their capital-expenditure plans in accordance with the commodity price environment. So, while 2018 capital expenditures are forecasted to be between $325 and $375 million, they will respond to higher or lower cash flows by adjusting these plans.

In 2017, the WTI crude oil price averaged $50.92 per barrel. The price of oil in 2018 is off to a much stronger start, which will continue to translate into higher cash flows for Baytex, which should give the company room to continue to chip away at its debt.

For the year 2017, adjusted funds flow increased 90% to $340 million due primarily to higher commodity prices. With this, the company was able to decrease its net debt by $39 million to $1.73 billion, which is still high but moving in the right direction.

The company has 70% of its credit line undrawn, so it also has flexibility there.

The bright spots come from Baytex's operational momentum that it is seeing right now, particularly in its Eagle Ford asset (representing 53% of Baytex's production) in South Texas, considered one of the premier oil resource plays in North America.

Undervalued

By all estimations, the book value, or net asset value, of Baytex is somewhere in the range of $8-10, making the stock undervalued and implying a 108-160% stock return from current levels.

So, the stock has been hit by the fact that it was and is still carrying too much debt. But, while at sub-$30 oil, this is a huge problem, one that puts the company as a going concern at risk, at $60 oil, the story is totally different.

Also recall that at $50 per barrel, Baytex is free cash flow neutral; at $55 per barrel, Baytex generates incremental free cash flow of $75 million; and oil at $65 per barrel means incremental free cash flow of $175 million.

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