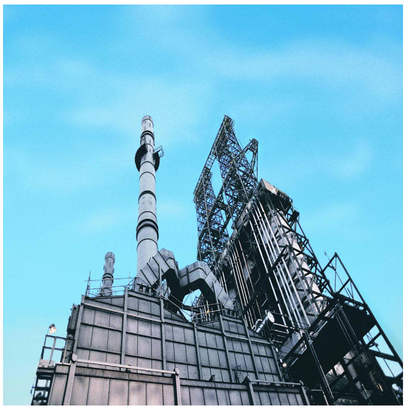

Is this Oil Stock the Best Play on Higher Oil?

Description

The recent surge in oil that now sees the North American benchmark West Texas Intermediate, or WTI, trading at over US$65 per barrel has sparked considerable interest in beaten down energy stocks. Regardless of higher oil prices, many Canadian energy stocks have failed to rally. That includes **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE), which has dropped by 15% over the last year despite WTI gaining 31%. This has created an opportunity for investors with the upstream oil and gas producer attractively valued in an operating environment in which the outlook for crude is increasingly optimistic.

Now what?

One of Baytex' most appealing attributes is its high-quality acreage in what is considered the sweet spot of the Eagle Ford shale. When WTI is at US$60 a barrel, this asset generates a whopping 85% internal rate of return for the driller.

The solid profitability of this asset, which is responsible for 52% of Baytex' total oil output, is because the light crude produced is sold at close to the price for WTI rather than at a significant discount, as is the case with Canadian heavy oil. And that coupled with low operating costs, which were $6.52 per barrel including transportation costs for 2017, means that it is highly profitable as evidenced by a notable netback of $26.20 per barrel in 2017.

Baytex forecast that with WTI trading at over US$55 per barrel, it will be free cash flow positive. With the North American benchmark now at over US$65 per barrel, the company will generate significant free cash flow during 2018, which could amount to as high as $200 million. The driller has also hedged a significant portion of its 2018 production to protect itself from lower oil prices should crude slump once again.

While Baytex has considerable debt totalling $1.7 billion, there are no maturities payable until 2021, which provides plenty of time for oil prices to recover — and allow Baytex to build up the cash and make additional debt repayments.

The company's ongoing focus on reducing costs, which saw 2017 cash costs per barrel fall by 7.5%

year over year, is also enhancing its profitability.

Notably, despite slashing capital expenditures for exploration and development, Baytex has been able to grow production. During 2017, Baytex boosted its total output by 1% year over year and expects to grow 2018 production by up to 6%, which in an operating environment in which oil is rising is an appealing attribute. Baytex will continue to grow its production, projecting that it will spend up to $375 million, which is a 15% increase over 2017 on exploration, well development, and maintenance.

Notably, most of that investment will be made in Baytex' Eagle Ford acreage boosting Baytex' light oil production. It's certainly easy to understand why the company is focused on its Eagle Ford acreage. The light oil that it produces doesn't trade at a significant discount to WTI like heavy crude produced by Baytex' Canadian operations, and those operations have some of the lowest costs. As its higher-margin Eagle Ford production grows, Baytex' earnings will receive a solid lift.

The driller is extremely attractively priced given that it's currently trading at a quarter of the after-income tax net asset value of its oil reserves, which have been discounted by 10% in accordance with industry-accepted methodology. That highlights the considerable potential upside available to investors should oil experience a sustained rally.

So what?

Baytex is an underappreciated and attractively priced play on higher oil prices. Given the increasingly positive outlook for oil, now is the time for investors to add Baytex to their portfolios, especially so given that the company could more than triple in value if there is a sustained material increase in the price of crude.

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