# Is Painted Pony Energy Ltd. a Stock to Be Avoided?

## Description

The outlook for natural gas remains grim, despite many analysts believing that consumption will rise significantly over the next two years, primarily because of increased demand for electricity generation. This is because supplies continue to grow at a rapid clip as natural gas producers ramp up activity, despite sharply weaker prices since mid-2014.



Nonetheless, natural gas is cyclical, and there are indications prices will firm in the foreseeable future, making low-cost natural gas producers with high-quality assets attractive investment opportunities. One that stands out is **Painted Pony Energy Ltd.** (TSX:PONY), which, even after rallying strongly over the last month, is still down by 49% over the last year, and this is despite it reporting some solid first-quarter 2018 results.

**Now what?**

For the first quarter, Painted Pony reported record production of 364 million cubic feet (mcfe) of natural gas, which comes to 60,703 barrels of oil equivalent daily. This was a stunning 69% higher than the same quarter in 2017.

Importantly, in an operating environment weighed down by a protracted slump in natural gas, Painted Pony realized an average sales price of $3.08 per mcfe of natural gas sold. It was able to achieve this through a combination of financial hedges, fixed-price contracts, and diversified sales points.

As result of this solid operational performance, revenue grew by a healthy 55%, and cash flow for the quarter shot up by an impressive 63% year over year, yet net income plummeted to an $8.4 million loss. The reason for that loss was additional acquisition costs, an unrealized loss on risk-management contracts, and increased financial expenses.

That situation should improve over the remainder of 2018, and it is important to note that Painted Pony is focused on the Montney formation in western Canada, which is considered to be the most economic natural gas liquids play in Canada. For that reason, Painted Pony is among the lowest-cost natural gas producers in the energy patch, reporting first-quarter operating expenses of $0.62 per mcfe. These costs were the same as a year earlier, but general and administrative expenses were a remarkable

18% lower year over year.

As a result, the driller reported a netback — a key measure of operational profitability — of $2.18 per mcfe, which was 5% greater than the first quarter 2017. Because of the ongoing weakness of natural gas prices, Painted Pony adjusted its 2018 guidance downward, reducing capital spending by $20 million and its forecast production volumes.

Nevertheless, even after this revision, Painted Pony's projected 2018 production will be 348-360 mcfe, which is 35-40% higher than 2017. This — along with the driller's focus on reducing costs — will give its cash flow and bottom line a solid bump, which should cause its stock to appreciate further.

Painted Pony also has considerable reserves totaling 969 million barrels of oil equivalent and have been valued at $2.6 billion after tax, which comes to $16 per share, or more than eight times its market value. That indicates the tremendous potential upside available, but it should also be remembered that it includes the value of undeveloped reserves, which may prove uneconomical to extract.

**So what?**

Painted Pony delivered some solid results for 2018, and despite weaker natural gas and revising its annual guidance downwards, it appears on track to deliver some credible results for the year. That — along with rising oil prices and growing optimism over the outlook for gas — will give its stock a boost over coming months.



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