



1 Top Driller to Play Higher Oil

Description

Oil is gyrating wildly as energy markets digest every piece of good and bad news. While crude has proven itself to be highly volatile, this shouldn't deter investors from bolstering their exposure to energy stocks, because it is increasingly clear that higher oil is [here to stay](#). An intermediate oil producer that is an attractive investment in an operating environment where West Texas Intermediate (WTI) is trading at close to US\$70 a barrel is **Surge Energy** ([TSX:SGY](#)).

Now what?

Surge has lagged behind WTI, only gaining 7% for the year to date compared to WTI's impressive 17% increase. This has created an opportunity for investors seeking to take advantage of higher oil, because Surge's stock is poised to soar. The company is focused on drilling for light and medium crude in oil reservoirs with conventional characteristics.

The strength of Surge's operations becomes apparent when it is considered that it is one of the very few upstream oil producers that didn't eliminate its dividend when the severity of the prolonged oil slump became apparent.

In fact, the driller recently hiked its monthly dividend by 5%, giving it a very appealing forward yield of more than 4%. Even after accounting for the higher dividend payment, it remains sustainable with an incredibly low payout ratio of 15% for the second quarter 2018.

Key to the Surge's solid performance and ability to generate cash flow, despite weaker crude, is the quality of its oil assets. The company has oil reserves totaling 95 million barrels, which are 82% weighted to light and medium crude as well as other petroleum liquids. This minimizes Surge's exposure to weaker natural gas prices and means it isn't susceptible to the [financial impact](#) that the substantial discount applied to Canadian heavy oil is having on oil sands producers.

Those reserves have impressively low decline rates of less than 25%, meaning that the amount of capital Surge needs to invest to sustain production is low relative to many other upstream producers.

The quality of those assets and the low costs associated with growing production have allowed Surge

to expand its oil output at a decent clip. This is a highly beneficial characteristic in an operating environment where oil is appreciating significantly. For the second quarter 2018, production expanded by 13% year over year to 17,072 barrels daily, which was close to Surge's forecast 2018 exit rate 17,175 barrels daily.

Another notable aspect of Surge's second-quarter operational performance was that its netback — a key measure of profitability — grew significantly. For the quarter, the driller reported a netback of \$29.46 per barrel produced, which was \$6.09 a barrel greater than the same period in 2017, highlighting the profitability of its oil assets.

Because of its strong operational results, Surge's quarterly operating cash flow soared by 37% year over year, although net income was less than half of what it was a year earlier. The sharp decline in net income despite higher oil prices can be attributed to Surge booking a considerable loss on its oil price hedging contracts as well as higher depletion and depreciation charges rather than any operational issues.

The large loss on Surge's hedging contracts occurred because, like many of its peers, it did not expect oil to experience such a strong sustained rally, which sees WTI trading at a significantly higher price than many industry insiders forecast for 2018 and 2019.

Importantly, those hedging contracts will unwind over the second half of 2018 and the first half of 2019. Once that occurs, the combination of higher crude, growing production, and lower expenses will give Surge's profitability a solid boost.

So what?

Surge is an attractively valued play on the increasingly positive outlook for oil, and its stock will soar in coming months as profitability grows. While investors wait for that to occur, they will be rewarded by its sustainable monthly dividend, which yields just over 4%.

CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing

TICKERS GLOBAL

1. TSX:SGY (Surge Energy Inc.)

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