This Driller Is Among the Best Small-Cap Plays on Higher Oil

Description

Oil has once again rallied after pulling back sharply because of a range of bearish factors emerging, and this volatility — along with Canada's growing heavy-oil crisis — is weighing heavily on **Pengrowth Energy** (TSX:PGF)(NYSE:PGH). While the North American benchmark West Texas Intermediate (WTI) has gained a respectable 17% since the start of 2018, Pengrowth has seen its stock plummet by 22% for the same period.

This sharp decline has occurred despite the promise held by Pengrowth's flagship Lindbergh thermal oil project and its significantly improved balance sheet. Even though it constitutes a speculative investment, the market's perceived level of risk regarding the company is overbaked, creating an opportunity for risk-tolerant investors.

Now what?

A key issue impacting Pengrowth's performance despite higher oil are the hedges it established to mitigate the risk of weaker oil.

You see, the rally in crude witnessed since the end of 2017 was not anticipated by most analysts and industry insiders. As a result, many upstream oil producers purchased risk-management contracts based on a range of derivatives to protect against the downside associated with weaker oil.

By the end of the second quarter 2018, Pengrowth had hedging contracts in place covering 10,000 barrels daily of production, representing just under half of its total average daily oil output. For the second quarter, Pengrowth realized a loss of $20 million on those risk-management contracts compared to $300,000 a year earlier. It is this which had a sharp impact on the company's financial performance during the first half of 2018 and will continue to weigh on Pengrowth's financial performance for the remainder of the year, unless oil prices collapse.

Nonetheless, the good news for investors is that those hedges unwind at the end of 2018. This means that Pengrowth will be able to fully benefit from higher oil prices during 2019, which will give its earnings and cash flow a solid boost.

That becomes evident when the company’s operating netback before hedges is considered. Pengrowth reported a second-quarter operating netback of $34.20 per barrel before the losses incurred from risk-management contracts were considered. This was achieved with an average realized sales price for bitumen of $52.47 per barrel and $71.45 for light oil.

It is highly likely that oil will remain firm for the remainder of this year and into 2019 because of a range of positive catalysts that will act as powerful tailwinds. These catalysts include firmer demand growth because of a stronger economy and geopolitical risks that will negatively affect supply.

Importantly, Pengrowth is positioned to expand production at a decent clip. For 2018 Lindbergh is forecast to average 16,500 barrels daily and it is estimated that will grow to around 20,000 barrels by 2020. Total company-wide oil output is forecast to be 22,500-23,500 barrels daily for 2018 and for this to grow to 24,000 barrels daily by 2020.

In an environment where WTI is trading at around US$70 a barrel or even higher, this will give Pengrowth’s earnings a healthy boost. This becomes even more notable when it is considered that the deep discount applied to Canadian heavy crude is expected to improve as pipeline capacity expands and crude by rail grows.

Furthermore, many U.S. refineries are configured for heavy oil, which — along with the marked decline in Venezuela’s heavy oil production — means that demand for Canadian heavy crude can only grow.

So what?

Pengrowth’s latest pullback has created an opportunity for risk-tolerant investors seeking to cash in on the optimistic outlook for crude. Once its oil hedges unwind, Pengrowth’s earnings will soar, causing its market value to surge.

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