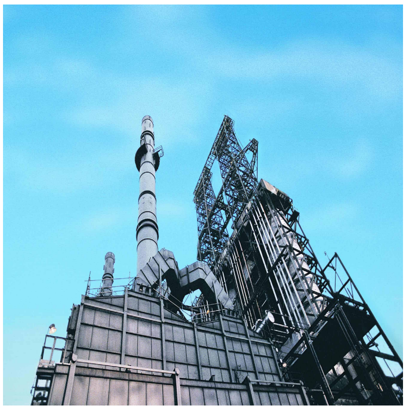

This Light Oil Producer Is a Must-Own Energy Stock

Description

Oil has pulled back sharply in recent days after experiencing a sustained rally which saw West Texas Intermediate (WTI) reach a multi-year high of over US$76 a barrel earlier this month. The latest drop, which sees the North American benchmark trading at under US$67 per barrel, has created an opportunity for investors to bolster their exposure to quality oil stocks. One which stands out is light oil producer **Surge Energy** (TSX:SGY), which has only gained 8% for the year to date compared to WTI's 14%.

Now what?

Surge is focused on producing light oil from reservoirs with conventional characteristics and low decline rates. With a consolidated decline rate of 24% and long-life reserves of 95 million barrels of oil, which are 82% weighted to light and medium crude, Surge is an attractive play on higher oil — especially when it is considered that those reserves were independently determined to have a net asset value (NAV) of $6.06 per share, which is almost three times Surge's current market price of $2.14 per share. That NAV will expand because it was calculated using a forecast price for WTI of US$55 a barrel in 2018 and US$65 for 2019, which are both below the current spot price of US$66 per barrel.

Surge's latest deal, the $320 million acquisition of **Mount Bastion Oil and Gas**, will further bolster its NAV. On completion, it will add reserves of around 25 million barrels, increasing Surge's post-acquisition oil reserves to over 120 million barrels, lifting its NAV to $6.52 per share, or more than triple its current market price. It also adds 5,500 barrels daily of light and medium oil production, will boost Surge's operating netback by 12% to $31 per barrel, expand its light oil weighting to 55%, and add over $85 million of net operating income in 2019.

The conspicuous increase in light oil production is important to note, because it trades at a significantly lower discount to WTI than heavier Canadian crude, giving Surge a financial advantage over its peers producing heavy oil.

The driller anticipates that on completion, the transaction will hike its annual dividend by 25% to $0.125

per share, which, based on Surge's current share price, will give it a juicy yield of just under 6%. The deal is expected to be funded from a combination of existing cash and Surge shares with a focus on minimizing the dilution of existing shareholders.

Surge's management anticipates that the acquisition will strengthen its balance sheet with net debt expected to be a manageable 1.6 times adjusted funds flow. The driller will also have sufficient liquidity with $135 million remaining undrawn on an existing credit facility.

What makes Surge even more attractive is that it has considerable exploration upside with a large drilling inventory, which includes 700 development drilling locations. The company, prior to announcing the purchase of Mount Bastion, anticipated that this would allow it to expand its oil production by around 3,000 barrels daily by 2020. That rate of growth should increase once the purchase of Mount Bastion is complete.

So what?

Surge is an attractive play on higher oil, which will be enhanced by accretive acquisition of Mount Bastion. The low decline rate of the driller's operational wells combined with its focus on light and medium rude as well as large drilling inventory will ensure that Surge can profitability expand its oil reserves and production. This — along with higher oil — will give its earnings a solid lift, which will cause its stock to appreciate considerably, and it isn't difficult to see Surge doubling or more in value over the next year.

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