Time to Buy This Driller Before it Soars

Description

Oil is whipsawing wildly as a range of fundamentals trigger bullish and bearish sentiment over its outlook. After hitting a multi-year high of over US$76 a barrel earlier this month, the North American benchmark West Texas Intermediate (WTI) has pulled back sharply to be trading at just over US$67 per barrel.

This caused many energy stocks to fall in value, creating an opportunity for investors seeking to cash in on higher oil. One quality intermediate oil producer that has failed to keep pace with crude is **Whitecap Resources Inc.** (TSX:WCP), which has plummeted by almost 29% since the start of 2018 despite WTI gaining over 17%.

Now what?

Whitecap is focused on light and medium oil production**,** holding oil reserves of 483 million barrels 85% weighted to oil as well as other petroleum liquids. This minimizes the impact of the poor outlook for natural gas on the driller's earnings. Those reserves have been independently assessed to have a before-tax net-present-value (NPV) of $15.37 per share, which is more than double Whitecap's market price.

The NPV of Whitecap's reserves will expand significantly because the current value was calculated at the end of 2017 using an assumed average price for WTI of US$58.50 per barrel in 2018 and US$58.70 in 2019, which is well below the current spot price.

Whitecap has been roughly handled by the market because of growing bearishness over the outlook for crude, the widening spread between WTI and the prices of Canadian crude blends and the impact of commodity hedges on its financial performance.

There are fears that oil prices could collapse during 2019 because of deteriorating global demand growth triggered by slower economic growth and growing supply. The prices of WTI and Canadian light oil have diverged sharply in recent months to see Canadian light trading at US$38 a barrel, representing a discount of US$28 per barrel.

The most significant issue impacting in Whitecap currently are the commodity risk management contracts, which it has established to mitigate the financial impact of weaker oil. For the first half of 2018, Whitecap incurred a net loss of $174 million on its commodity and foreign exchange hedges. The majority of that was caused by WTI trading at well above the price set by those risk management contracts.

As a result, Whitecap reported a first-half net loss of $11.4 million compared to a profit of $104 million for the same period in 2017 despite significantly higher crude. That issue will also impact Whitecap's second-half 2018 financial results because 55% of its overall production is hedged. However, that volume drops to 39% in 2019 and 12% for the first half of 2020.

As the volume of hedged oil production decreases, Whitecap's profitability and hence net-earnings will receive a healthy bump that should push its stock higher. The profitability of Whitecap's operations is illustrated by its high operating netback, which for the first half before hedging losses was $34.41 per barrel produced.

This was 20% greater than a year earlier because of firmer oil. This indicates that should oil keep rallying then Whitecap's earnings will expand at an even greater rate.

So what?

Firmer oil coupled with a significant portion of Whitecap's oil price hedges unwinding at the end of 2018 will give the driller's earnings a solid lift, which should drive its stock higher. If WTI rallies higher for a sustained period, it is highly plausible that Whitecap's stock will double in value. While investors wait for this to occur, they will be rewarded by its sustainable monthly dividend yielding over 4%.

CATEGORY

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1. TSX:WCP (Whitecap Resources Inc.)

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