Latest Results Confirm This Oil Stock Is a Buy

Description

I have been bullish on the prospects of intermediate upstream oil producer **Surge Energy Inc.** (TSX:SGY) for some time. Its focus on conventional light oil production, high-quality assets, and robust balance sheet have made it an ideal candidate for investors seeking exposure to higher crude.

Oil's latest pullback sees the North American benchmark West Texas Intermediate (WTI) trading at around US$60 a barrel, which is well below the multi-year high of over US$76 a barrel reached early last month.

This has triggered a sell-off of energy stocks that has seen Surge plunge by 31% over the last month creating an opportunity for risk tolerant investors looking to bet on higher oil.

Now what?

The attractiveness of Surge as an investment is illustrated by its solid third quarter 2018 results. Oil production expanded by an impressive 20% year over year to 18,029 barrels daily, and it was 79% weighted to crude and other petroleum liquids. The considerable weighting to oil and natural gas liquids minimizes the impact of the poor outlook for natural gas on Surge's finances.

This, along with higher oil, saw Surge realize an average price of $68.89 per barrel sold compared to $48.29 a barrel a year earlier, gave operating cash flow and earnings a solid boost. Third-quarter cash flow from operating activities surged by 51% year over year to $37 million and net income soared to $9 million compared to an $8 million loss for the equivalent period in 2017.

The quality and profitability of Surge's oil assets are highlighted by its solid company-wide operating netback, an important measure of the operational profitability of an upstream oil company's producing assets. Surge reported a third-quarter operating netback, including the losses triggered by commodity hedging contracts of $28.75 per barrel, which was a remarkable 40% greater than the same quarter in 2017.

This significant improvement despite higher production and transportation expenses can be attributed to discernibly higher oil prices. That netback is among the highest in the energy patch and significantly greater than heavy oil producers illustrating the profitability of Surge's operations.

Unlike many of its peers such as **Whitecap Resources Inc.** the impact of Surge's risk management contracts on its earnings was minimal. For the third quarter, the driller incurred a $3.2 million loss on its commodity risk management contracts, which equals a loss of $1.91 per barrel of crude sold. Surge established those hedges to protect against the financial downside associated with lower oil, as like many industry insiders, management didn't expect crude to rally as fully as it has since the end of 2017.

A good proportion of Surge's hedges, covering almost a quarter of its daily average production, will unwind at the end of 2018 thereby giving its 2019 earnings a healthy bump, particularly if WTI returns to trading at above US$60 a barrel. Almost the remainder of those risk management contracts will expire at the end of the first-half 2019 giving Surge's earnings a further boost should oil remain firm.

Despite the negativity surrounding oil's long-term outlook there are signs that WTI will continue to trade in the US$60 to US$70 a barrel band.

Another appealing aspect of Surge that underscores the quality of its oil acreage is its impressive drilling success rate. For the nine-months ending 30 September 2018, the company drilled 32 gross wells with a 100% success rate, indicating it is highly likely that its oil reserves and production will continue to expand.

Further, unlike many of its peers, Surge didn't load-up on debt at the height of the oil boom. The company ended the third quarter with net-debt of $282 million, which is a manageable 2.3 times Surge's trailing twelve months operating cash flow. That ratio will fall over coming months as cash flow rises because of firmer oil prices.

For these reasons, Surge was able to retain its monthly dividend, although at the height of the slump it slashed that payment to an eighth of its pre-slump high.

Since the end of 2016, Surge has hiked its monthly dividend three times to see it yielding a very tasty 5%. This appears sustainable with the driller's all-in payout ratio, which includes dividend as well as exploration and development expenditures, falling to 85% for the third quarter 2018.

Nonetheless, the company's dividend you could be cut once again if oil prices collapse as some analysts have predicted.

So what?

Surge is an attractive leveraged play on higher oil. As its commodity hedges roll-off and production continues to grow, earnings will receive a healthy lift, which along with firmer oil, will cause the company's stock to appreciate.

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