My Top Oil Stock for 2019

Description

It's been an odd six months for **Gran Tierra Energy** (TSX:GTE)(NYSE:GTE). Shares are down 35% from September highs of $5, yet the company's fundamentals continue to impress. So, while the stock hovers around decade-long lows, investors keep seeing headlines like this: "Gran Tierra Energy hits record production growth, expects more in 2019."

At a time of impressive profitability and production, why is Gran Tierra trading like a bankruptcy candidate? Is insolvency an actual possibility in 2019?

Gran Tierra has always been a story of risk expectations

Recent exogenous events have increased the complexity of Gran Tierra's investment story. In October, one of the company's pipelines in Columbia was the target of an explosion, causing an oil spill and subsequent fire.

According to **Reuters,** "Colombia's oil infrastructure is often the target of attacks by leftist guerrillas and other armed groups." Political instability has, over the last decade, created severe volatility for Gran Tierra. Since 2009, 100% gains and 50% drops have been fairly typical for the company's stock price.

At least historically, political tensions have always created terrific buying opportunities for Gran Tierra shares — as long as the fundamentals were able to support a comeback. Today, the fundamentals have seldom been better.

In 2018, the company expects to produce roughly $440 million in cash flow. By 2019, management expects cash flow to rise to $480 million. With a market cap of just $1.2 billion, Gran Tierra currently trades at less than three times this year's cash flow. Impressively, these results have been achieved with very little leverage. By the end of 2018, the company had just $420 million in net debt, significantly less than many of its peers.

Unless there’s a systemic effort to destroy Gran Tierra’s asset base, bankruptcy isn’t in the cards for 2019.

A healthy business at bankruptcy prices

Let’s do some math to figure out what Gran Tierra’s share price should be, minus the political tensions.

A reserve is considered “proved” if 90% or more of the resource is *both* recoverable and economically profitable. Companies typically separate their reporting into P1 reserves and P2 reserves. P1 reserves are more conservative and include only fully “proved” reserves. P2 reserves are more comprehensive, as they include both “proved” and “probable” reserves but make some extra assumptions.

Using a 10% discount rate, Gran Tierra’s P1 reserves have a current value of $1.9 billion. Subtracting the firm’s roughly $400 million in net debt results in a value of $1.5 billion, 25% more than the current share price. So, using the most conservative estimates available, shares appear underpriced.

Including “probable” reserves widens the discount further. Using P2 reserves, Gran Tierra’s reserve base is worth about $3.4 billion. After accounting for net debt, that values the company at $3 billion, nearly three times the current share price!

It’s difficult to justify Gran Tierra’s discounted valuation without considering external pressures. When political unrest takes a temporary backseat, expect Gran Tierra’s share price to recover strongly. History suggests this comeback could come rather suddenly.

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