This Oil Stock Is on Sale at a 69% Discount to its Net Present Value

Description

The latest oil price collapse, which began in October 2018, has sparked considerable pessimism over the outlook for crude and weighed heavily on energy stocks. While many upstream oil producers focused solely on Canada have been marked down by the market because of the poor outlook for crude, **Parex** (TSX:PXT) has soared by 16% for the year to date with signs of further upside ahead.

Quality assets

Parex's operations are focused on Colombia, where it has amassed 2.2 million gross acres, holding 22 blocks in the Llanos and Magdalena basins. During 2018, it embarked on a strategic review aimed at realizing greater value for investors, and this included considering whether it was better to sell its developed oil-producing assets and become a pure oil-exploration company.

At the end of that process, management concluded that Parex's value wasn't being recognized by the market, and the company would embark on a share buyback, targeting the purchase of 10% of its outstanding float. It was also decided not to sell the developed oil-producing assets because an acceptable offer hadn't been received. In the current difficult operating environment, it is unlikely that one would be forthcoming.

That appraisal also outlined the driller's strengths, including its growing oil reserves and production, rock-solid balance sheet, quality assets, and strong cash flow, which all underscore its considerable appeal as a play on higher oil.

Oil reserves are growing

Parex recently announced that its oil reserves had increased by 14% year over year by the end of 2018 to almost 185 million barrels. Those reserves are 97% weighted to oil, meaning that Parex is not exposed to the poor outlook for natural gas.

The company's oil reserves have been independently determined to have an after-tax net present value of $32.07 per share based on Brent averaging US$63.50 per barrel over the course of 2019. This is 69% higher than Parex's price of $19 a share, highlighting the substantial upside available, particularly with analysts tipping that Brent will average between US$65 and $70 a barrel during 2019 because of growing supply restrictions, including the crisis in Venezuela, OPEC production cuts, and Trump's plans to further limit Iran's oil exports.

Robust balance sheet

Key to Parex's success, especially in the current operating environment, has been its judicious use of debt. Unlike many of its North American peers, which, at the height of the last oil boom, loaded up on debt to fund acquisitions and expand their operations Parex maintained a clean balance sheet. By the end of the third quarter 2018, Parex had cash of US$361 million. By the end of December 2018, its strategic report showed no long-term debt, an undrawn credit facility totaling US$200 million, and forecast positive working capital of US$200 million.

Clearly, that endows the driller with considerable operational flexibility, which is enhanced by Parex's ability to generate substantial free cash flow, despite oil's ongoing slump.

Growing production, high netbacks, and solid cash flow

For the third quarter 2018, Parex reported free cash flow of almost US$38 million, where Brent averaged US$75.84 per barrel. It is Parex's ability to access international Brent pricing which gives it a financial advantage over its peers operating solely in North America.

You see, Brent is trading at a US$9-a-barrel premium to the North American benchmark West Texas Intermediate (WTI), giving Parex a handy financial advantage over Canadian drillers, which can only access North American pricing. This is a crucial reason why Parex has been reporting industry-leading netbacks, which are a key measure of operational profitability.

For the third quarter, Parex reported an operating netback of US$44.41 per barrel with Brent averaging US$75.84 during the quarter. A focus on controlling expenses, which saw production and transportation costs for the quarter fall by 2% and 32%, respectively, is also supporting Parex's significant profitability.

Parex has forecast that during 2019 it will produce 52,000-54,000 barrels daily, which, at the upper end of that estimate, is 22% greater than its 2018 oil output. If Brent averages US$60 during 2019, it will generate a netback of US$32-34 per barrel, which, when combined with such impressive production growth, should see Parex generate free cash flow of around U$260 million after allowing for capital spending.

Why buy Parex?

High-quality oil assets, the ability to access premium Brent pricing, low operating expenses, industry-leading netbacks, strong production, as well as reserves growth highlight why Parex is an attractive investment. Robust 2019 free cash flow estimates, a rock-solid balance sheet, and management's focus on unlocking value for investors further magnifies the driller's considerable appeal, making it a must-own stock to play higher oil.

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