



## 1 Attractively Valued Upstream Oil Producer Yielding 7% to Buy Today

### Description

Oil continues to perform strongly outstripping many earlier analyst estimates as a combination of supply constraints and stronger than anticipated demand growth buoy prices. This has seen the North American benchmark West Texas Intermediate (WTI) gain 30% since the start of 2019 to be trading at over US\$60 a barrel at writing.

The improved outlook for crude makes now the time for investors to bolster their exposure to energy stocks. One driller that has failed to keep pace with oil is **Surge Energy Inc.** ([TSX:SGY](#)), which has lost 10% for the year to date irrespective of the latest oil rally. This has created an opportunity for investors to acquire a quality intermediate upstream oil producer at an attractive valuation.

### Quality assets

Surge owns a portfolio of light and medium oil producing properties in Western Canada, which have proven and probable reserves of 123 million barrels of oil equivalent as at the end of 2018. This represents a notable 29% increase from 2017 that can be attributed to Surge's successful drilling program, which saw it report an impressive reserve replacement ratio of 133%.

Those proven and probable reserves have been determined to have a net asset value of \$5.58 per share, more than four-times greater than Surge's current market price. That highlights the considerable potential upside available to investors should oil rally higher.

### Solid operating results

Surge reported some impressive 2018 results, including record production of 18,058 barrels of oil equivalent daily, 21% greater than a year earlier. The driller's oil output was 81% weighted to oil and natural gas liquids, meaning that it was able to avoid the impact of sharply weaker Canadian heavy oil and natural gas prices during the second half of 2018.

For 2018, Surge reported an operating netback before hedges of \$23.40 per barrel pumped. This was,

however, 1% lower than 2017 despite the average price of WTI over the course of 2018 being 25% greater. That decline can be attributed to a sharp increase in operating and transportation expenses, which rose by 8% and 6%, respectively.

Typically, an increase in operational costs is cause for concern, but in this case they aren't the result of operational failings. The higher expenses can be attributed to higher operational costs associated with the properties acquired by Surge during 2017 and 2018 as well as higher shipping expenses because of the need to use road transportation in the areas impacted by pipeline transportation constraints.

Importantly, in an operating environment where the price of oil is rising, Surge expects 2019 oil production to expand by 2% year over year to 22,000 barrels daily, which is forecast to be 84% weighted to oil and other petroleum liquids. That, along with firmer oil will give Surge's earnings a solid boost. This will, however, be offset by higher operating and transportation costs during 2019, but aided by a moderate 5% decrease in general and administrative expenses.

If WTI averages US\$65 per barrel over the course of 2019 Surge estimates, then it will generate \$70 million in free cash flow with an all-in payout ratio of 70% when its dividend payment is included.

Surge has also protected its 2019 earnings from another [potential downturn](#) in the price of crude by establishing a hedging strategy that establishes an average floor of US\$70 per barrel for around 17% of its oil output.

Most of those contracts will expire at the end of 2019, leaving less than 5% of Surge's oil production hedged, which will allow the driller to fully benefit from the anticipated increase in oil, with some analysts predicting that WTI will average over US\$70 a barrel during 2020.

The mandatory [production cuts](#) implemented by Alberta's provincial government will also bolster Surge's earnings because they caused the benchmark prices for Canadian crude blends to more than double from the record lows witnessed during the second-half of 2018.

For as long as they remain in place, they will support a narrower price differential for the light oil benchmark Edmonton Par against WTI.

## Why buy Surge?

Surge appears attractively valued, and as crude rises further its stock will rally, especially once earnings expand because of the healthy uptick in production forecast for 2019. While investors wait for this to translate into a higher share price, they will be rewarded by its regular monthly dividend which in the current operating environment appears sustainable and is yielding a very juicy 7.5%.

### CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing

### TICKERS GLOBAL

1. TSX:SGY (Surge Energy Inc.)

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