Should You Buy Baytex Energy Corp (TSX:BTE) or Encana Corp (TSX:ECA)?

Description

The collapse of the Canadian oil sector last year crushed the stock prices of many notable names. Now that conditions are stabilizing, many investors are jumping back in at bargain prices.

For example, in February, Warren Buffett bought nearly 1% of **Suncor Energy**. *Reuters* reported that this investment "could revive investor interest in the languishing Canadian energy sector."

Two popular stocks that many investors are returning to are **Baytex Energy** (TSX:BTE)(NYSE:BTE) and **Encana** (TSX:ECA)(NYSE:ECA). Over the past 12 months, shares of both companies are down around 40%.

Is either stock a true bargain today?

Avoid this stock completely

Over the past year, WTI oil prices are only down by a few percent. Baytex stock, meanwhile, has lost more than a third of its value. Why the disconnect?

In 2018, the stock market finally bought into the idea that oil sands projects may be worthless.

One of the best ways to value the potential of an oil project is to calculate its energy return on investment, or EROI. This metric calculates the number of barrels that can be produced for every barrel invested.

Global averages typically range between 15-to-1 and 20-to-1. So, for every one barrel invested, these projects produce 15-20 new barrels.

Oil sands projects, however, are off the chart, and not in a good way. Even under aggressive assumptions, oil sands projects have EROIs of just 3-to-1. The best oil sands projects perhaps generate an EROI of 5-to-1. Even worse, many of those estimates were made when oil prices were 50% higher, meaning today's EROIs could be less than 1-to-1.

"I don't think that if you put billions of dollars into a new tar sands project that you will see a decent return on it," said Jeremey Grantham, co-founder of GMO LLC, one of the world's largest hedge fund managers.

The reality that oil sands projects won't create long-term shareholder value is finally being priced in by the market. Baytex management is still betting big on these projects, creating massive risk for investors. It may see volatile upswings, but I wouldn't buy this stock at any price.

Is Encana the winner?

If you shouldn't touch Baytex stock with a 10-foot pole, what about Encana shares? Fool contributor Matt Smith thinks it's time to jump in.

"It appears that the market has failed to appreciate the success Encana is experiencing with pivoting its portfolio to greater liquids production and bolstering its portfolio of quality low-cost U.S. petroleum assets," he wrote in February. "This means that it is very attractively valued."

Since 2016, Encana has grown its liquids portfolio by 30% annually. Roughly 75% of its capital spending this year should go towards growing this exposure further.

Due to the better economics of liquids, Encana should be able reduce capital expenditures this year while continuing production growth. That's a great recipe for ramping cash flow.

2019 should be the company's second year in a row generating free cash flow. That's impressive considering, on many metrics, competitors like Baytex are on the brink of bankruptcy.

This financial flexibility has allowed Encana to delever the balance sheet, grow its dividend, and initiate a US$1.25 billion share buyback — more than 10% of the entire company.

Encana stock will still move based on the underlying price of energy, but it has significantly more control over its long-term fate than Baytex. If you're going to bet on an embattled energy sector, stick with the company that you know will be around in a few years: Encana.

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rvanzo