This Oil Company Is Buying Back Stock at Bargain Prices

Description

There are plenty of ways to create shareholder wealth. The easiest is to organically grow profits and cash flow, but repurchasing stock can be just as effective.

Companies always have infinite ways to spend their cash. Earning an adequate return is the tough part. When the company's stock is trading at a discount, buying back shares can provide an immediate return for shareholders.

While it's not always a guarantee, companies that repurchase stock are often signaling to investors that it believes its stock to be underpriced.

One Canadian company recently said, "a share buyback is the most appropriate method to return capital to our shareholders." Meet **Seven Generations Energy** (TSX:VII).

This is how you compound capital

Investing in new projects can provide a company with a reasonable rate of return over time. But it can take years or even decades to fully realize the upside.

Share buybacks, however, can see an immediate return on invested capital.

Stock prices can do bizarre things, remaining mispriced for long stretches of time. These are the value discrepancies that skilled investors hope to capitalize on.

If a company's true worth is $100 per share, and the market assigns the stock a depressed $50 per share valuation, a share-buyback program can realize 100% returns overnight simply by repurchasing stock. It's as if a company spotted an attractive acquisition opportunity, except in this case, it wants to acquire itself.

Seven Generations, a $3.1 billion oil company in northwestern Alberta, is hoping to capitalize on the mispricing of its own shares. If management is correct that its shares are grossly underpriced, their new share-buyback program could compound wealth for shareholders quickly.

Buying low is key

This week, Seven Generations stock closed below $9 per share, an all-time low. While investors sell, the company is buying.

With US$55-65 oil prices, management believes its asset based can generate “very strong returns.” Along with debt reduction, the company is planning to direct as much capital as possible towards repurchasing stock.

The total value of the company’s assets currently stands at $8.2 billion. In each year since 2014, the value of its asset base has grown. With total liabilities of $3.4 billion, the equity value of the company is roughly $4.8 billion, 55% higher than the current valuation.

Book value can be a tricky figure, however, as it’s simply an accounting method for estimating a company’s worth.

The true value of the assets can vary from book value, but Seven Generations’s management team seems confident that the underlying worth of the company is much higher than the current share price implies.

If the company’s executives are correct, Seven Generations could be earning an immediate 55% on its investment by repurchasing stock. Even if the company’s assets were impaired by 20%, the company would still earn a 24% return by repurchasing shares.

Seven Generations believes it will become “a substantial free cash flow generator” in 2019. Using this cash to bet on itself adds a lot of leverage to its potential upside.

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Date
2025/08/24
Date Created
2019/05/12

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