Why I'd Avoid This Major Canadian Energy Services Company

Description

Due to the nature of their business, energy services companies are some of the most volatile energy stocks. Demand for services are higher when companies want to ramp up production, and they are the first to get cut when producers are pulling back. This tends to make energy service companies a lot more volatile.

Finding the right investment in the energy services space can be difficult. Companies need to have geographic diversification to mitigate themselves from political risk. Location of operations is as important as efficiency of the operations.

The Canadian market is a perfect example of why a company needs to be diversified. In the last few years, as the market has gone through an unprecedented period of uncertainty and many producers are reducing production, competitors in the U.S are increasing production.

One company that has been weathering the storm pretty well is **Ensign Energy Services** (TSX:ESI). Ensign is an oilfield service company based in western Canada. It operates in three geographical segments: Canada, the U.S., and international.

Canada

The Canadian portion has been a laggard for the company, especially with all the uncertainty in western Canada. Total revenue came in about 8% lower in 2018 than it did in 2017. This dropped the Canadian operations portion of revenue from 26% of total company revenue the prior year to 21% in 2018.

With oil curtailments in Alberta and the ongoing issue regarding lack of takeaway capacity, it looks as though the Canadian market will continue to lag. Currently, only 22% of Ensign's Canadian rigs have contracts with more than six months remaining.

United States

Operations in the U.S saw the most growth, increasing 40% year over year. Revenue from the American operations counted for about 55% of total company revenue, up from 46% in 2017.

The increase in business was primarily a result of increased activity in the U.S energy sector, a contrasting performance to the Canadian sector. This is proving that Ensign's geographic diversification is paying off.

Going forward, management is expecting the drilling rig count in the U.S to remain mostly flat. Currently, 35% of the American rigs have contracts with six months or more remaining.

International

The international segment was relatively flat year over year. Going forward, Latin American operations are going to be negatively impacted by the U.S sanctions on Venezuela.

In the Middle East, the company expects production to remain flat. Ensign is, however, expecting the operations in Australia to see a small increase through 2019. Currently, only 36% of its 50 international rigs have contracts lasting six months or longer.

Debt reduction

The major risk with Ensign is its rising liabilities. In 2018, liabilities increased by $760 million, now totalling over $2 billion. At the end of Q1, net debt/EBITDA was 3.9 times. This is a considerably high debt load, and it has investors slightly concerned.

Management has been quick to state their plans to reduce debt throughout 2019. So far, management has committed $100 million towards debt reduction. Management also suggested that should some assets be sold, the profits could also go to reduce debt.

The bottom line

Ensign, with the acquisition of Trinidad Drilling completed earlier this year, has positioned itself as one of the largest drillers in Canada and the United States. This is an important strategic move, as historically, large companies with better scale have tended to have better long-term results.

Currently, only 47% of Ensign's total rigs are being operated and less than 31% have contracts lasting longer than six months. While this isn't because Ensign did anything wrong, it shows how it is at the mercy of the global oil industry. The stock yields an attractive 8.4% dividend; however if uncertainty persists, that may need to be cut.

Although the company has built large scale, is well-run, and has lots of future potential, given the current environment in Canada and political environment globally, Ensign has a lot of headwinds. I'd avoid the stock for now until the landscape for the energy industry can improve.

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