Why Now Is the Time to Buy Frontera Energy (TSX:FEC)

Description

Upstream oil producer and explorer **Frontera Energy** (TSX:FEC) continues to garner considerable negative attention from investors and analysts alike. The driller, once known as Pacific Rubiales and then Pacific Exploration, filed for bankruptcy protection and emerged in 2016 after restructuring, which essentially wiped out existing equity investors.

The company, since emerging from bankruptcy, has struggled to deliver value for shareholders, with it battling to resolve a range of legacy issues, including financial obligations relating to pipeline transportation contracts.

Improving operations

Frontera has also been plagued by operational outages relating to its mineral concessions in Peru, where oil output has failed to meet estimates. Before the third quarter 2019, Frontera had terminated its transportation contracts in Colombia, meaning that no fees were payable, significantly reducing the driller's expenses.

For the third quarter, oil and gas operating costs decreased by a notable 32% year over year, while payments for pipeline contracts fell to zero. Frontera's general and administrative expenses have also been gradually falling, decreasing by 20% year over year for the third quarter.

Those improvements have significantly boosted Frontera's profitability, seeing its operating netback climb by 15% year over year to US$29.61 per barrel, despite the average Brent price for the quarter falling by 18%.

This can be attributed to the commodity hedges that Frontera has established, which see 60% of its fourth quarter 2019 hedged and will progressively wind down to 30% by the second quarter 2020. The expectation is that oil prices will firm significantly by the end of the first half of 2020 and by winding down its hedges Frontera is reducing its financial obligations, thereby boosting profitability.

Frontera also finished the period with a solid balance sheet. Long-term debt, including lease liabilities totalled US$378 million, which is a very manageable less than one times Frontera's trailing 12-month EBITDA. There are also no debt maturities until 2023, providing considerable time for the price of crude to recover and Frontera to generate additional cash to meet those obligations. This enhances the driller's financial flexibility, leaving it well positioned to weather another oil price collapse.

These factors — along with growing production, which, for the third quarter, expanded by 6% year over year, and firmer Brent — bode well for further earnings growth.

A key criticism of Frontera is that after allowing for dividend payments it has negative retained income, meaning that its operations are essentially worthless. This is incorrect, because for the year to date, Frontera has paid US$106 million in dividends compared to net income of $225 million for the first nine months of 2019, meaning that it has retained around US$118 million of its net income. On top of that, Frontera is free cash flow positive, generating almost US$30 million in free cash flow for the first nine months of 2019.

It should also be considered that an upstream oil company's key asset is its oil reserves. Frontera's proven and probable oil reserves have an after-tax net asset value of almost US$1.9 billion, which is $18.54 per diluted share. Not only does that illustrate Frontera's intrinsic value but highlights that it is very attractively valued, because the driller is trading at an 80% discount to its market value, illustrating that there is considerable upside ahead, making now the time to buy.

Final thoughts

It has been a long wait for Frontera shareholders. The driller has battled to unlock value from its diversified portfolio of oil assets located in Colombia and Peru. A range of operational outages and legacy liabilities have had a sharp impact on its performance, but the latest results indicate that Frontera is now delivering value for shareholders, making now the time to buy.

Its attractiveness as an investment is magnified by Frontera's dividend yielding a juicy 8%, although it should be noted that it will only make those payments when Brent averages US$60 per barrel or higher for the requisite period.

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