2020 Warning: The #1 Thing to Avoid in Energy Stocks

Description

According to the lawyers in the Energy and Restructuring Practice Group of Haynes and Boone, one of the *American Lawyer* top 100 law firms, there has been an uptick in the number of bankruptcy filings from North American oil and gas producers.

In the first three quarters of 2019, there were 33 bankruptcy filings versus 24 bankruptcies in full-year 2017 and 28 in 2018.

Watch out for high debt levels

Going one step further, it's worth noting that there are many oil and gas producers that are doing very badly, even if they're clinging on to the edge of the cliff to keep from falling into the depths of the bankruptcy abyss.

And the one thing that's weighing them down is the number one thing you must avoid in energy stocks: high debt levels.

Does an oil price rally help?

You'd think that an oil price rally would be a great relief for these nearly bankrupt companies. The reality is that oil prices go up and down. At best, we can only be sure that the profit boost is temporary.

High oil prices are not expected to be sustainable, because there's only marginal increases in demand for the black gold. And there are hidden forces that seem to keep WTI oil prices between the range of roughly US$50 and US$70.

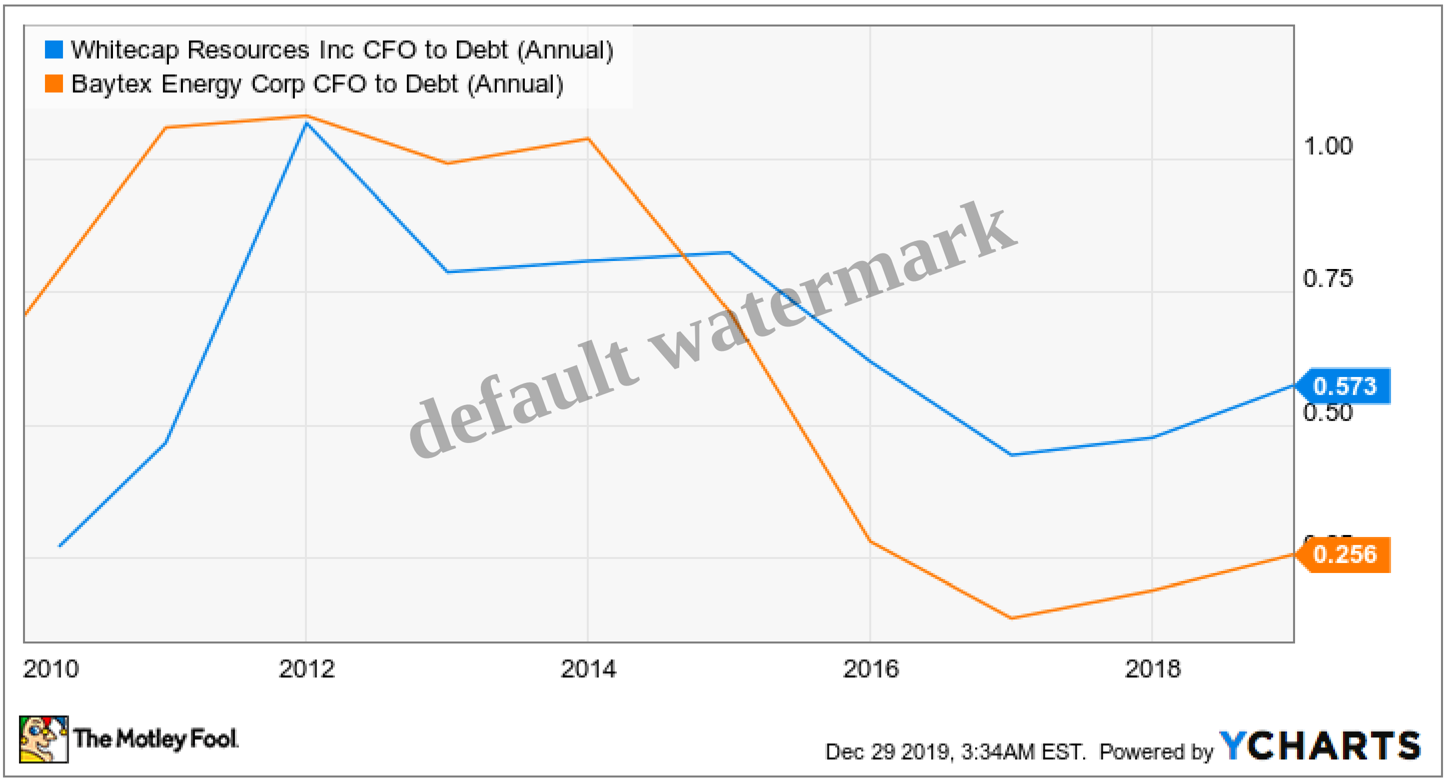
Since early October, the WTI oil price rallied from the low US$50s to the low US$60s. The stocks of oil-weighted producers should have rallied with it. Why did some rally less than others? One reason is that they are debt-laden.

Producers with weak balance sheets are weighed down. For instance, **Baytex Energy** only appreciated about 24% from its December low, while **Whitecap Resources** flew 54% from its October low!

Baytex has $1.9 billion of long-term debt on its balance sheet. Its debt-to-cap ratio is 38%. It's debt-to-equity ratio is 62%.

Whitecap has long-term debt of $1.2 billion on its balance sheet. Its debt-to-cap ratio is 27%. It's debt-to-equity ratio is 39%.

Whitecap's cash flow-to-debt ratio is more than twice as strong as Baytex's, which may have caused the energy stock to rally more than twice as much as Baytex stock from its low, as mentioned above.



CFO to Debt (Annual) data by YCharts.

Investor takeaway

You can strategically book incredible price gains of 20-50% by buying oil and gas producers at lows and selling them in rallies, such as the one we're experiencing now.

However, it's risky business to buy and sell at the right time. If done at the wrong time, you could be sitting in the red. To increase your success rate, take heed to avoid companies that are laden with debt.

For the safest energy stock investment, turn your attention to this 5% yield stock instead.

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