Coronavirus and the Price War Could Send Oil to $10 Per Barrel

Description

The latest oil price sees the international Brent benchmark down by a whopping 52% over the last month. This has dragged down energy stocks, as highlighted by one of the largest energy stock ETFs, the **SPDR S&P Oil & Gas Exploration & Production ETF**, plunging 57%. Many Canadian energy stocks have suffered even greater declines. Upstream oil producer **Vermilion** has lost a whopping 84% after slashing its dividend in half earlier this month. **Whitecap** has incurred a similar loss after it too announced that it was cutting its dividend by almost half. Heavily indebted **Baytex** (TSX:BTE)(NYSE:BTE) saw its stock plummet by 74%, and there will be further losses ahead.

Weaker oil ahead

Despite the stimulus measures announced by central banks, stock markets and oil prices are cascading lower. By market close on Friday, U.S. stocks were trading at their lowest level in three years. The **S&P/TSX Composite** has shed a whopping 34% over the last month to see the TSX trading at levels not seen since late 2012. The local bourse's suffering can be blamed on its considerable exposure to oil, metals, and other commodities. Their prices have slumped significantly close to levels not seen since 2016.

There are signs that oil prices have further to fall. Some pundits claim that Brent could plunge to as low as US$10 per barrel in coming months. This is roughly a third of its current price of US$29 per barrel. That would be devastating for the oil patch, particularly when it is considered that Canadian benchmark oil prices trade at a discount to WTI.

Already, the heavy oil Western Canadian Select (WCS) benchmark price has fallen to its lowest price ever, selling for less than US$10 per barrel. Edmonton's mandatory production cuts have done little to protect Canadian oil producers at a time when oil is under pressure from a combination of swelling supply and declining demand. This means oil sands companies are now pulling bitumen out of the ground at an immense loss.

Storage could be overwhelmed

Many pointers have emerged indicating that there is worse ahead for oil. The price war between the world's second- and third-largest producers, Saudi Arabia and Russia, which could lift world production by up to 3.2 million barrels daily, will flood energy markets already awash with oil. Other nations are also ramping up production because of the need to expand output to bolster essential royalty and export income.

This will happen in a world where there is an existing supply glut and oil inventories have been steadily rising. The fear is that as production grows, oil supply will far exceed demand, swamping global storage facilities. If storage capacity is reached oil prices will collapse, potentially tumbling to as low as US$10 per barrel.

If that occurs, it is likely that Canadian benchmark oil prices, notably Western Canadian Select, could fall to less than US$1 per barrel or even into negative territory. That will have a grave impact on Canadian oil producers, likely forcing many to shutter high-cost production, leading to further financial losses.

Looking ahead

Low oil will also trigger another round of bankruptcies. Heavily indebted drillers such as Baytex, which has net debt of $1.9 billion, are particularly vulnerable. Baytex lacks the financial levers of its peers, meaning it can only rein in spending so far before it needs to consider shuttering loss-making operations and selling assets. Any divestments will be at fire-sale prices, meaning that Baytex won't be able to realize their fair value. That could prevent it from raising enough capital to significantly reduce debt. Those measures will cause production to decline at a time when Baytex needs to boost oil output to offset sharply weaker prices.

If oil trades at around US$10 per barrel for a sustained period, it could force Baytex to file for bankruptcy. Even if the driller survives, its plans to grow production and boost free cash flow have been derailed. That makes Baytex a very unattractive investment, even if oil rebounds during 2020.

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