Why ARC Resources Stock Plunged 17% in January 2023

Description

Oil and gas are inherently some of the most volatile commodities, as we have seen in the recent past. Natural gas saw an epic ascent early last year amid the war in Europe. However, since August 2022, it has dropped a brutal 75% due to the oversupply and relatively milder weather. Thus, gas-weighted energy stocks fell in tandem and are among the most beaten-down names in the Canadian oil and gas universe.

What's next for ARX stock?

Shares of **ARC Resources** (TSX:ARX), Canada's third-biggest natural gas producer, dropped 17% in January. They have been quite volatile lately and have lost 35% since its 52-week high mid-last year.

Warmer weather led to lower natural gas consumption in the last few months, weighing on prices. Gas prices in Europe saw a rather steeper decline in the same period due to higher inventories and milder weather. It once seemed that Europe could struggle badly during winter months with its Russian gas supply under sanctions. However, its storage tanks are full and appear to have avoided the disaster at least for this season.

ARX Resources is a $10 billion energy producer, with more than 60% of its production focused on gas. Apart from gas, it is Canada's largest condensate producer. Notably, condensate prices have been relatively higher than natural gas, compensating ARC for the damages to some extent.

ARX intends to produce 350,000 barrels of oil equivalent per day in 2023, approximately 3% higher than in 2022. Its high-quality Montney assets, coupled with owned infrastructure, facilitate lower costs, ultimately securing better margins.

It will report fourth-quarter (Q4) 2022 earnings next week. Along with its free cash flow growth, how its balance sheet has improved in Q4 will be interesting to see. ARC repaid millions of dollars of debt in the last few quarters and has bolstered its balance sheet.

TSX energy stocks and their capital discipline

While broader markets are suffering from margin squeeze due to higher interest expenses, the energy sector has seen a much lower impact of the higher interest rates.

Oil and gas producers have focused on repaying debt, as they saw record free cash flow growth in the last few quarters. Their concerning leverage levels before the pandemic forced investors to stay away from the sector. But now the leverage has dropped significantly and, thus, it is one of the investors' favourite sectors.

The recent drop in ARC Resources stock could be an opportunity if gas prices change course later this year. Its strong balance sheet and profitability make it an appealing bet in the Canadian energy space. It is currently trading at a free cash flow yield of 18%, which indicates that the stock is undervalued. In comparison, TSX energy stocks are trading at a free cash flow yield of 15%.

Moreover, ARX offers handsome total return prospects with an expected allocation of 50% to 100% of its 2023 free cash flow toward shareholder returns. It pays a dividend of $0.60 per share, implying a yield of 3.6%.

Bottom line

ARC Resources stock is trading close to its 52-week low of around $14. The drop has made it more attractive from a valuation standpoint. It remains to be seen whether the drop extends based on its upcoming quarterly earnings and gas price movement from here. However, its strong balance sheet and focus on shareholder returns could create considerable value.

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