Has Vermillion Energy Stock Finally Bottomed out?

Description

Canadian energy stocks have had a weird ride over the past year. Last February these stocks seemed unstoppable as global crude supply remained tight and Russia invaded Ukraine. Now, oil and gas prices have dropped to pre-invasion levels and energy stocks have seen a correction too.

Vermillion Energy (TSX:VET) is probably the biggest loser. It's trading near a 52-week low. Has the energy stock bottomed out yet? Here's a closer look.

Vermillion's key issue

Vermillion stock has lost roughly 50% of its value since August 2022. That's noticeably worse than most other energy stocks. The underperformance probably stems from Vermillion's geographical footprint.

Unlike most Canadian energy stocks, Vermillion's operations are not fully domestic. About one-third of its energy production is based outside Canada – specifically, in Europe and Australia. These international operations are also much more profitable than the domestic arm. Half of the company's free cash flow is generated from production outside Canada.

While the selling price of crude oil and natural gas is levelized across the world, production costs and regulations are different in every country. Vermillion expects Europe's windfall taxes to cost it about $300 million in 2023. Meanwhile, Australia already imposes a Petroleum Resources Rent Tax (PRRT) that could add further costs.

Nevertheless, Vermillion expects to generate $3.1 billion in free cash flow between 2022 and 2024 despite the added windfall tax burden. The company also expects to spend 75% of free cash flow on paying back debt and rewarding shareholders. That means the stock is probably undervalued and the dividend yield is likely to soar in the years ahead.

Stock valuation

Vermillion is worth $3.2 billion in total market capitalization. That’s precisely the amount of free cash flow it expects within two years. The stock also trades at just two times earnings per share.

When the price-to-earnings ratio is this low, it usually indicates that investors are worried about future earnings. Of course, oil prices have dropped recently and Vermillion faces a larger bill for windfall taxes in some jurisdictions. However, even if future cash flows are adjusted lower, the stock is still thoroughly undervalued.

Put simply, the stock may have hit a bottom and could deliver substantial gains if its valuation simply adjusts to the industry average.

Bottom line

Vermillion Energy has been drifting lower in recent months. Since August, the stock is down roughly 50%. That means the company has underperformed the stock index as well as the rest of the energy sector.

Investors are understandably worried about lower energy prices and windfall taxes. However, Vermillion’s valuation may have already factored in these issues. Investors seeking a bargain in the energy sector should add this to their watch list.

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Date
2025/09/26
Date Created
2023/02/10
Author
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