Penn West Rallies; Is Now the Time to Buy?

Description

Since hitting a 52-week low of $7.82 in January this year, intermediate oil explorer and producer **Penn West Petroleum's** (TSX:PWT)(NYSE:PWE) shares continue to rally, up 18% to date. This is despite the company's fourth quarter and full year 2013 results spectacularly missing consensus earnings targets.

But even after this solid rally, there is still a long way to go for Penn West's shares to hit the heady heights of $25 a share seen over two years ago. The question for investors is whether this rally will continue or fizzle out.

What went wrong?
Like fellow Canadian light oil explorer and producer **Lightstream Energy** (TSX:LTS), Penn West became addicted to debt. The company attempted to sustain significant capital expenditure for investment in questionable assets while paying a lofty dividend yield, which by the end of 2012 was in excess of 7%.

But because of the high level of capital expenditure required to sustain the development of these low quality assets, cash flow and net income continued falling. This forced Penn West to borrow more funds to sustain the required level of investment, leaving it with a mountain of debt and a significantly weaker balance sheet.

For the four quarters from December 2012 to September 2013, debt grew 11% yet cash and cash equivalents plunged 72% and cash flow – an important measure of an oil company's financial health – plunged 42%. The end result was that Penn West found itself with a net debt of almost four times its operating cash flow, indicating it was over-leveraged.

Fourth-quarter and full-year 2013 results missed analysts' forecasts
Penn West's final-quarter and full-year 2013 results spectacularly missed analyst estimates. Fourth-quarter 2013 net earnings missed the consensus estimate of minus $0.04 per share by a whopping 500% and the full year 2013 consensus of minus $0.18 by a massive 270%.

Such a monumental miss can be attributed firstly to a slide in revenue, which along with operating cash flow dropped 13% year-over-year. The key driver of which was a 16% decline in production caused by asset divestments completed in 2012 and 2013 with production totaling 11,000 barrels of crude per day.

The second and most significant driver of Penn West's earnings miss and net loss, were impairment charges totaling just over $1 billion made against natural gas assets in British Columbia and Alberta. These impairment charges were made because of expected weaker natural gas prices over the next year.

However, it wasn't all doom and gloom. Penn West's 2013 netback per barrel — a key measure of its core profitability — grew by almost 12% year-over-year to $29.69, while $525 million in non-core assets sales were completed. The proceeds are earmarked to pay down Penn West's mountain of debt. The company also confirmed the payment of its quarterly dividend of $0.14 per share, giving it a tasty dividend yield of 6%.

Can Penn West turn it around?
The recent rally indicates investor confidence in Penn West is improving despite the shocking fourth quarter and full year 2013 results. This renewal in investor confidence, triggered by a perception the turnaround strategy is gaining traction and the company's confirmation of its first quarter 2014 dividend, appears premature.

Penn West has stated the need to divest itself of at least another $1 billion in assets before 2015 in a market already awash with Canadian oil assets. With companies like Lightstream and **Talisman Energy** also putting Canadian oil assets on the auction block, it is fast turning into a buyers' market. This will make it difficult for Penn West to complete the required assets sales at the prices the assets are truly worth.

I also expect to see Penn West continue to report poor operational and financial results for at least the short tem. Asset sales and reduced capital expenditure for oil exploration and the development of producing assets will continue to impact oil production and reserves growth for some time to come.

Is now the time to invest in Penn West?
With its share price rallying off its 52-week low , is now the time to invest in Penn West? While the solid dividend yield of 6% is a compelling reason, investors need to take a closer look at whether Penn West is attractively priced, given the risk of whether it can successfully pull off the turnaround.

With an enterprise-value of 9 times EBITDA and 13 times its oil reserves, Penn West does not appear attractively priced, even more so in comparison to its peers. Lightstream appears far cheaper on the basis of its enterprise-value of 5 times EBITDA, as does **Whitecap Resources** (TSX:WCP) at 8 times EBITDA. Both are also only marginally more expensive on the basis of their oil reserves, with an enterprise-value of 16 and 17 times respectively.

More concerning is Penn West's low netback per barrel of oil, which at $29.69 is 68% lower than Lightstream's $50 per barrel and 44% lower than Whitecap's $42.62 per barrel. Those numbers suggest that Lightstream's and Whitecap's core profitability is substantially higher than Penn West's, partly due to their higher quality assets.

Furthermore, both companies have hefty dividend yields. In the case of Lightstream, even after slashing its dividend by 50% at the end of 2013, it has a monster yield of almost 9%, while Whitecap's is almost 6%.

Foolish bottom line

Penn West's rally indicates renewed investor confidence in the company. But with the jury still out as to whether the turnaround will be truly successful, along with more expected short-term pain and a less than attractive valuation, investors can find superior opportunities elsewhere.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:WCP (Whitecap Resources Inc.)

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