Penn West's Turnaround Strategy Is Turning the Corner

Description

Intermediate Canadian oil producer **Penn West Petroleum** (TSX: PWT)(NYSE: PWE) continues to execute its turnaround strategy in an endeavor to return to profitability and unlock value for shareholders. While oil production continues to fall primarily due to asset dispositions, there are growing signs the turnaround strategy is continuing to gain traction and the company is returning to profitability.

Most recent quarterly results highlight the turnaround strategy is gaining traction
For the first quarter 2014, oil production fell 22% compared to the first quarter in 2013 to 110,796 barrels daily. But more importantly for investors, Penn West's netback per barrel of crude produced, a key measure of an oil company's profitability, jumped a very healthy 38% quarter-over-quarter and 32% year-over-year to $36.67.

This is lower than many of its Canadian peers, with both **Whitecap Resources** (TSX: WCP) and **Lightstream Resources** (TSX: LTS), having higher netbacks of $42.46 and $56.11 per barrel respectively. But such a significant increase in Penn West's netback per barrel of crude produced highlights that the profitability of its operations continues to grow.

Such solid growth in the profitability of its oil production was a key contributor to Penn West's funds flow from operations growing over the first quarter 2014. In comparison to the previous quarter, funds flow popped up to $279 million, a healthy 29% and 5% increase compared to the equivalent quarter in 2013.

The significance of growing operational funds flow for an intermediate oil explorer and producer can't be stressed enough, being a key measure of those companies' financial health. It is funds flow from operations that funds not only operational and other costs, but is a significant means of funding capital expenditure for exploration and development programs. Accordingly, this growing funds flow indicates Penn West is better positioned to internally fund its exploration and development program, reducing its reliance on debt and avoiding the problems that come with being overleveraged.

The key drivers of this improved financial performance were higher crude prices, a stronger U.S. dollar and lower costs. Operating costs during the quarter fell a healthy 14% quarter-over-quarter and 19% year-over-year to $176 million, while general and administrative costs dropped 6% compared to the previous quarter and 16% compared to the same quarter in 2013.

The end result of this improved operating and financial performance was a net loss of $96 million, which was almost an eighth of its fourth quarter 2013 net loss and 1% lower than the equivalent quarter for 2013. However, it was primarily net losses on assets sold coupled with foreign exchange losses, rather than a weaker financial performance, which caused this net loss.

Is now the time to invest in Penn West?
All of these factors indicate Penn West’s turnaround is well on track, leaving investors to wonder whether its share price can return to the heady highs of over $16 per share, hit in late 2012. Already over the last year, Penn West’s share price has gained 9% and it currently appears attractively priced with an enterprise-value of 15 times its oil reserves and equivalent to $72,000 per barrel of crude produced.

These are lower than peers like Whitecap Resources, which has an enterprise-value of 21 times it reserves and equivalent to $197,000 per barrel of crude produced. Even Lightstream Resources, which also saw its share price crash for many of the same reasons as Penn West and is battling its way through its own turnaround strategy, appears more expensive. It is trading with an enterprise value of 20 times its oil reserves equivalent to Penn West’s but with its enterprise-value of $105,000 per barrel of crude produced daily, it is more expensive.

A healthy dividend yield that appears increasingly sustainable
Since slashing its dividend by 48%, Penn West still trades with an attractive dividend yield of over 5%, which is starting to appear more sustainable as its financial performance continues to improve. But its dividend payout ratio as a proportion of net income continues to appear too high with the company having reported a net loss for both the full year 2013 and first quarter 2014.

However, when funds flow from operations is substituted for net income, this payout ratio falls to a very sustainable 26% and with funds flow growing coupled with falling costs the sustainability of the dividend should continue to grow.

For a number of reasons over the past year, I have not been particularly bullish on Penn West or the success of its turnaround program, particularly with the divestment of non-core assets in a market awash with Canadian oil assets being a key component.

But if Penn West is able to capitalize on its solid first quarter 2014 results and continue growing funds flow and netback per barrel throughout the remainder of 2014, I would expect to see significantly improved full year results. When coupled with a tasty dividend yield of over 5%, now might just be the time for investors to take the plunge.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:WCP (Whitecap Resources Inc.)

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