3 Turnarounds in the Patch: Which Is the Best Bet?

Description

“The critical investment factor is determining the intrinsic value of a business and paying a fair or bargain price.” — Warren Buffett

This mantra forms an important part of Buffett’s investment philosophy and has been a key driver behind his considerable success as an investor. But identifying bargains is a difficult process, in many cases requiring investors to make an educated bet on troubled companies with intrinsically sound businesses.

Let’s take a closer look at three companies operating in the patch that floundered due to volatile crude and natural prices and an over-reliance on debt for acquisitions and funding dividends. Each has embarked on a turnaround strategy aimed at restoring balance sheets and improving margins by boosting higher-margin crude production, with natural gas prices remaining low.

This hot favorite among investors came crashing to earth with a thud

Lightstream Resources’s (TSX: LTS) share price came crashing to earth with a resounding thud, plunging 30% over the last two years. This was on the back of growing market concern over its significant leverage, which saw debt exceed four times operating cash flow. But the final nail in the coffin for Lightstream’s share price was management’s decision to slash its dividend by 50%, even though this move created annual cash savings of $40 million.

However, there are growing signs the turnaround is gaining momentum and unlocking value for shareholders. Already Lightstream has completed $600 million in non-core asset dispositions, placing it well ahead of schedule. The proceeds have been used to pay down debt, creating $12 million in cash interest savings.

More impressively, despite these asset sales Lightstream’s oil production dropped only marginally, leaving it well-positioned to take advantage of higher crude prices over the short term and boosting operational cash flow.

Clearly, Lightstream is turning the corner with its level of leverage falling and cash savings growing, but the key question for investors is whether it is trading at a bargain price, with its share price having popped a healthy 30% for the year to date.

Even after this solid appreciation in its share price, Lightstream continues to trade with an attractive valuation. It has an enterprise value of six times EBITDA and 20 times its oil reserves, both of which are well below the industry averages of 12 times and 21 times respectively.

Despite slashing its dividend by 50%, it still has one of the highest dividend yields in the patch of over 6%, allowing it to reward patient investors as the turnaround strategy unlocks further value.

Low-quality asset acquisitions and excessive leverage took their toll on this investor favourite

For the same reasons as Lightstream, **Penn West Petroleum** (TSX: PWT)(NYSE: PWE) had to embark on a turnaround strategy aimed at restoring its balance sheet, reducing leverage, and boosting cash flow. The perceived success of this turnaround strategy is now making it a firm favourite among bargain-hunting investors. But how successful has the strategy really been?

A key plank in the strategy is the disposition of assets. Penn West has divested itself of $661 million in assets, with those funds directed to paying down its mountain of debt. This has created considerable costs savings, with financing expenses down by 6% quarter over quarter and year over year. It is seeking to sell a further $800 million to $1.3 billion in assets before 2015.

The company has also focused on developing its core assets, with its capital program aimed at three key plays: the Cardium, Slave Point, and Viking. This approach, coupled with cost-cutting and boosting higher-margin crude liquids production, has seen Penn West's netback grow.

For the first quarter of 2014, it shot up a massive 38% quarter over quarter and 32% year over year to $36.67, which, coupled with lower financing costs and slashing its dividend by around 50%, generated stronger cash flows.

But this netback is still well below the North American industry average of around $42 per barrel, and is significantly lower than Lightstream's first quarter operating netback of $56.11 per barrel. This indicates that there is some way to go before Penn West's turnaround gains meaningful traction.

Penn West also appears expensive, with an EV of 11 times EBITDA, especially when EBITDA is expected to decline as further asset dispositions cause crude production to fall over the short term. But the company is still worth considering, as even after slashing its dividend Penn West still has a yield in excess of 5%, making it attractive to income-focused investors who are willing to make a bet on the success of its turnaround.

A rash of marginal acquisitions and over-reliance on debt caused this oil company to crash

Just like Lightstream and Penn West, **Pengrowth Energy** (TSX: PGF)(NYSE: PGH) found itself with a mountain of debt and declining cash flows. It implemented a turnaround strategy aimed at preserving capital, repairing its balance sheet, and boosting cash flows through increasing higher-margin crude production.

The first steps to implementing this strategy were to slash its dividend by 43%, significantly reduce capital expenditures, and concentrate on developing higher-margin crude liquids projects. This saw

Pengrowth focus on developing its Lindbergh SAGD project, which saw first steam in late 2012 and continues to see growing high-netback thermal bitumen production.

The successful implementation of this turnaround has caused Pengrowth’s operating expenses to drop significantly, down 5% quarter over quarter and 9% year over year. Debt repayments have also pushed financing costs lower by 1% quarter over quarter and 3% year over year.

Despite the success of its turnaround strategy, Pengrowth still has net debt of almost four times its operating cash flow and a netback of $29.71 per barrel, which is one of the lowest in the patch. It also appears expensive when its EV of nine times EBITDA is considered. There is a considerable way to go before Pengrowth unlocks value for investors and returns to profitability.

However, with a sustainable monster dividend yield of over 7%, one of the highest in the patch, it will continue to reward patient investors who willing to bet on the success of its turnaround.

Lightstream seems to be the best value bet of the three. Not only is its EV of six times EBITDA the lowest, but the majority of its production is made up of crude liquids, allowing it to generate a higher margin per barrel produced.

CATEGORY

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Date
2025/10/02
Date Created
2014/06/03
Author
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