



## Is Penn West Petroleum Truly Undervalued?

### Description

Generic valuation multiples such as price-to-earnings and price-to-sales have very little relevance when attempting to determine whether an oil explorer and producer is undervalued. The same can be said for price-to-book, which measures the value of a company's net assets per share in comparison to its share price. If the ratio is less than one then the stock is undervalued, but there are a range of factors that make this multiple irrelevant when valuing upstream oil companies.

Key among these are the capital-intensive nature of the industry, the risk that measured reserves may not be commercially viable once developed, and high debt levels that may distort an oil company's true value. However, I continue to see investors relying upon these multiples, and in particular price-to-book value, when hunting for bargains in the patch.

This has seen a number of pundits recently call **Penn West Petroleum** (TSX: PWT)(NYSE: PWE) a deep-value investment opportunity because it is trading with a price-to-book multiple of 0.69. They claim this indicates Penn West is trading at a 31% discount relative to the value of its net assets. However, it is necessary to dig deeper to truly understand whether Penn West is an undervalued opportunity in the patch.

The market took a negative view of Penn West after the company's cash flow dropped and its degree of leverage rose to unsustainable levels after gorging itself on debt to fund marginal acquisitions and an unsustainable dividend. This saw it implement a company-wide restructure focused on asset divestments and capital retention.

### What is Penn West's true indicative value?

When determining whether an oil producer is undervalued, investors must consider the value of its core assets: its discovered oil reserves. It is these assets, and more specifically, developed producing oil reserves, that are responsible for generating future revenues, cash flows, and earnings.

In order to assess the value of an oil company's reserves, future cash flows from those reserves are then calculated using an assumed realized crude oil price, with all future income discounted in order to give a net present value, or NPV. The accepted industry standard is known as NPV-10, where the

future value of cash flows generated by those assets is discounted by 10%.

This is a superior methodology to relying solely upon book value, because the company's book value includes assets that don't generate revenue and therefore have little to no intrinsic value.

At the end of 2013, Penn West's discovered net oil reserves totaled 554 million barrels of crude. These reserves have an after-tax NPV of \$7.5 billion, or \$15 per share, which is a 52% premium over its current share price. But when net debt of \$2.1 billion is deducted, the net asset value, or NAV, falls to \$4.6 billion, or \$9.37 per share, a discount of 5% compared to its current share price.

It is also important for investors to consider that this value does not take into account the costs of developing those discovered reserves classified as non-producing, nor does it take into account the risk that those non-producing reserves are potentially commercially unrecoverable. Of Penn West's total discovered oil reserves, 49% are classified as developed producing, and these have an after-tax NPV of \$5 billion, or \$10 per share, which is a premium of 2% over its current share price.

However, when net debt is deducted, the NAV of these producing oil assets falls to \$2.1 billion, or \$4.32 per share, a 57% discount to its current share price.

Another significant factor for investors to consider is that the company is in the midst of a significant turnaround program, a key component of which is the divestment of non-core assets both producing and non-producing. As these assets are sold, Penn West's NAV will continue to fall, as will its ability to generate future cash flows from its existing assets.

For all of these reasons, I believe that while Penn West maybe trading at a considerable discount to its book value, with the company's share price having spiked a healthy 14% for the year to date it is fast approaching its fair value. Unless, of course, management can drive higher margins by further cutting costs and increasing the efficiency of its producing oil assets.

## **CATEGORY**

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