Is Pengrowth Energy Truly Undervalued?

Description

"*It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price.*"
— Warren Buffett

In light of the Oracle of Omaha's pearl of wisdom, it's time to take a closer look at an energy company that is getting more attention from analysts, with some believing it is undervalued as its restructure takes effect. This company is Canadian-domiciled intermediate oil producer **Pengrowth Energy** (TSX: PGF)(NYSE: PGH), which back in 2012 slashed its dividend and implemented a range of measures to strengthen its balance sheet and retain capital.

What are the key improvements resulting from the restructure?

Recent operational and financial results highlight that this strategy has already significantly improved the company's performance. This has seen its share price pop a massive 37% over the last year, with some analysts calling further upside as a result of stronger industry fundamentals and growth in crude liquids production and margins.

For the first quarter of 2014, EBITDA, a measure of core profitability, rose a healthy 54% compared to the previous quarter and 22% against the equivalent quarter in the previous year. This is despite revenue growing only a modest 27% quarter over quarter and 8% year over year.

In addition, Pengrowth's operating netback jumped a massive 43% quarter over quarter and 20% year over year to $29.71 per barrel, highlighting that the profitability of its operations has grown significantly. This can be attributed to higher crude and natural gas prices, coupled with the price differentials between Canadian crude blends and WTI narrowing over the last year.

However, this netback is still significantly lower than many of its Canadian peers, including **Lightstream Resources'** (TSX: LTS) first-quarter 2014 netback of $56.11 per barrel, **Crescent Point Energy's** (TSX: CPG)(NYSE: CPG) $52.65, and **Whitecap Resources'** (TSX: WCP) $45.80 per barrel.

Despite these stronger results, the key question for investors is whether Pengrowth is undervalued and a worthwhile investment. Is it?

What is Pengrowth's true value?

The key assets of an oil explorer and producer are its oil and gas reserves, with those reserves classified as "producing" being the most important. This is because those reserves are known to be commercially recoverable and revenue-generating for the company. In contrast, undeveloped reserves, although meeting the criteria to be defined as reserves, require considerable capital to develop and may ultimately be found to be commercially unrecoverable.

At the end of 2013, Pengrowth was independently assessed to have reserves of just over 477 million barrels of crude, which were deemed to have a net asset value (with a 10% discount rate applied and before income tax) of $4 billion, or $7.52 per share. This is equivalent to Pengrowth's current share price, indicating that the company may in fact be fairly valued.

While ongoing turmoil in the Middle East is driving crude prices higher and the company's ongoing development of existing assets is increasing its oil reserves, which will increase the value of its core assets, there are a range of issues which will offset those factors.

One key issue is the view among some analysts that the price differentials between Canadian light and heavy crudes to WTI will widen as the pipeline crunch prevents oil producers like Pengrowth from getting their crude to key refining markets.

The pipeline crunch is also affecting transportation and operational costs, which for the first quarter of 2014 spiked an unhealthy 1% quarter over quarter and 8% year over year, impacting cash flow growth and profitability.

Another issue is that a significant portion of the company's crude reserves — around 35% — is composed of natural gas, which continues to suffer from low prices, decreasing demand, and higher costs. This is troubling because the outlook for natural gas remains gloomy, with prices expected to remain flat or even decline over the next two to five years because of growing supply and increasing competition from alternative energy sources.

It is also in stark contrast to Lightstream, Crescent Point, and Whitecap, which all have a significantly lower portion of their petroleum reserves composed of natural gas. This allows them to generate superior margins while having a higher value for their oil reserves, which are not subject to the downward pressure created by softer natural gas prices.

Despite signs that Pengrowth's restructure is having a positive impact on the company's performance, it is increasingly clear that Pengrowth is fairly valued at this time. However, if fundamentals in the patch grow stronger and Pengrowth is able to significantly boost crude liquids production, then it would be time to give the company another look.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:VRN (Veren)
2. TSX:VRN (Veren Inc.)
3. TSX:WCP (Whitecap Resources Inc.)

Category

1. Investing

Date
2025/07/26
Date Created
2014/06/17
Author
mattdsmith