Why Now Is the Time to Avoid Penn West Petroleum Ltd

Description

Shares in troubled Canadian intermediate oil producer **Penn West Petroleum Ltd** (TSX: PWT)(NYSE: PWE) have plunged to all-time lows as the company is wracked by internal problems fueled by an accounting scandal. But a number of analysts and market pundits are now claiming its depressed share price represents value for investors.

However, the accounting probe and the implementation of the company's turnaround strategy is still in its infancy, leaving me unconvinced that it represents a solid investment opportunity even at these lows.

Let's take a closer look at why Penn West will likely continue to struggle to deliver value for investors.

1. Penn West appears cheap but is trading at close to fair value

A growing chorus of analysts claim that now is the time to invest because the company appears cheap, with its shares trading at half of its book value. But this is not an accurate means of gauging the value of an oil producer.

Book value includes a range of intangible assets such as goodwill as well as taking into account the value of plant, property and equipment, which generally have little to no value for an oil producer.

The key assets for oil companies are their oil reserves and Penn West's last independent report disclosed net oil reserves of 534 million barrels. After applying a 10% discount factor in accordance with industry standards, these have a net present value after tax of $7.5 billion, or $15.34 per share. But when net debt of $2.9 billion is deducted this falls to $4.6 billion, or $9.37 per share, a premium of 33% compared to its current share price.

Furthermore, only 49% of those total oil assets are producing, with the remainder undeveloped. The net present value of those reserves do not take into account the costs and risks associated with bringing them online to commercially viable production, which further discounts the value of those reserves.

The value of Penn West's oil reserves will also continue to fall, with the company seeking to divest another $310 million of assets prior to 2015. Crude prices are also expected to soften as U.S. oil production continues to ramp-up, flooding refining markets with light sweet crude.

2. Asset quality remains low

Another problem plaguing Penn West is the low quality of its oil producing assets, as evidenced by its less than satisfactory production mix. A number of wells continue to have higher than expected decline rates, while Penn West's production remains heavily weighted to lower margin natural gas than its peers.

For the first quarter 2014, 65% of Penn West's production was weighted to crude and liquids, whereas **Lightstream Resources Ltd**

(TSX: LTS) had 80% of its crude production made up of higher margin light oil, and **Crescent Point Energy Corp** (TSX: CPG)(NYSE: CPG) had over 90%.

Higher than expected well decline rates along with the asset divestment program has seen oil production fall for the last eight consecutive quarters. In Q1 2014 alone, crude production dropped a massive 11% quarter-over-quarter and 29% year-over-year. I also expect this trend to continue with Penn West targeting the completion of further asset divestments prior to 2015. All of this will continue to affect revenue and cash flow.

All of these factors contribute to Penn West generating a poor margin or netback per barrel of crude produced. For the same period, its netback was $36.67 per barrel, which is one of the lowest in the patch. Both Lightstream and Crescent Point continue to report solid netbacks, which for Q2 2014 were $57.49 and $54.75 respectively.

Until these issues are successfully dealt with, Penn West will continue to struggle with profitability and underperform its peers, making it increasingly unlikely the company will unlock further value for investors.

3. Accounting probe has larger ramifications

Penn West's management recently identified a range of accounting irregularities, which reduced operating costs and increased the company's reported capital expenditures and royalty expenses. As a result an internal probe has been launched with the end result unknown, but expect to see a range of historical financial statements restated, reducing cash flows and negatively impacting 2014 guidance.

This has the potential for Penn West to be in breach of the covenants on its unsecured revolving syndicated bank facility and the terms of its senior unsecured notes. These irregularities have also spawned a range of class action lawsuits against Penn West for breach of fiduciary duties and making misleading and deceptive statements. These couldn't come at a worse time for the company, being costly matters to defend and settle, while diverting valuable resources from the successful implementation of its turnaround strategy.

Penn West is a company in trouble and for all of the reasons discussed I believe it offers little to no value for investors, even at its currently heavily depressed share price. There are also a range of superior investment opportunities in the patch including Lightstream and Crescent Point.

CATEGORY

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