

Is Penn West Petroleum Ltd. the Best Way to Play the Rebound in Crude?

Description

The rout in crude prices continues to weigh heavily on the energy patch. This has triggered a frenzied sell-off of oil stocks, leaving many companies attractively priced and offering considerable potential upside when crude prices rebound. One company that stands out is a one-time favourite of investors, **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE).

So what?

Over the last five years, Penn West's share price has come crashing to earth with a resounding thud, plunging by a massive 87% over that period, but not without good reason. It has battled a range of internal issues for some time, including being over-leveraged after going on a debt binge and splurging on marginal oil and gas assets. Then, while it battled to shore up its balance sheet and reduce debt through asset sales, it was rocked by an accounting scandal that further shook investor confidence.

The final nail in the coffin was when it broke the news that it was negotiating with lenders because a breach of its lending covenants was in the cards.

However, there are now signs Penn West may be one of the best speculative plays for a recovery in oil. In recent months, it has come a long way in adjusting its operations so as to remain viable in the difficult operating environment now being experienced. This saw it slash expenses, capital expenditures, and its dividend to preserve cash flow and shore up its balance sheet.

Penn West is also focused on shutting down uneconomic operations and investing capital to develop its Cardium and Viking light oil assets. This bodes well for future margin growth, with Canadian light oil trading at a significantly lower discount to West Texas Intermediate (WTI) than Canadian heavy crude.

The outlook for crude is becoming increasingly positive, with signs that oil prices will rebound over the long term. Rig counts, particularly in the U.S., are already falling as companies wind down uneconomic production. This, coupled with growing long-term global energy demand, will alleviate the global supply glut we are now witnessing. As a result, the price of oil has already rebounded by 18% since touching its lowest point in five and a half years.

More telling is that Penn West is trading at a significant discount to the value of its key asset: its oil reserves. After crunching the numbers on these reserves, which consist of 500 million barrels of crude, and allowing for a WTI price of US\$52 per barrel, Penn West has an after-tax value of \$7 per share. This represents a 100% premium over its share price, emphasizing just how undervalued the company currently is.

Nonetheless, investors should be aware that this factors in undeveloped and non-producing oil reserves and doesn't account for either the costs or risks associated with developing those reserves.

Now what?

Penn West's share price has almost doubled since oil prices rallied at the start of February and should this continue, with WTI moving back to over US\$60 per barrel, it is easy to envision Penn West's share price doubling again from current levels.

But this investment certainly doesn't come without risk.

Penn West is a levered play on oil, with the company having unwound its oil hedges some time ago. As a result, it is now heavily exposed to the price of oil and any sustained drop will see its share price plunge further. This certainly doesn't make it an investment for the faint of heart as it requires a high degree of conviction that oil prices will rally further. Nonetheless, the potential upside is tremendous, and if oil does rally further, both its cash flow and the value of its oil reserves will also grow, supporting further growth in its share price.

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