Here’s the Only Way Penn West Petroleum Ltd. Can Come Back From the Grave

Description

Penn West Petroleum Ltd’s (TSX:PWT)(NYSE:PWE) stock has been absolutely crushed over the past year. The stock blew up last year and crashed 73.5% and it’s still off a sickening 73.1% from its 52-week high. Because of this there is a real worry that it could be on the brink of bankruptcy. But only one thing has to go right for the company to have the potential to pull itself out of the grave. It needs the helping hand of a rally in the price of oil.

A review of what went wrong

It has been famously said that the “best laid plans often go awry.” Well, that would describe Penn West’s turnaround story, which has gone awry because the company got the price of oil all wrong. This is clear from an update it gave its investors on its second-quarter operations as the company included the following statement on its oil hedges, which are used to protect the company against volatility.

> “As of July 1, 2014, we are now participating fully in the currently strong crude oil price environment with the last of our WTI hedge positions expiring on June 30, 2014. This allows us to immediately realize 100% of current market pricing which currently exceeds our 2014 budget assumption by approximately $10 per barrel.”

Penn West Petroleum thought that oil prices were going to remain robust for the balance of 2015, which is why it let all of its oil hedges roll off so it could capture an extra $10 per barrel. However, by realizing 100% of the current market prices it was opening itself up to not only the upside of the oil market, but its downside. Unfortunately, the company ended up with a whole lot more downside than it bargained for as oil prices began descending right after the last of Penn West’s oil hedges rolled off as we see here.

WTI 2014
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The only thing that matters

Penn West, like so many of its peers, really misjudged the oil market. Not only did it miss the top, but it can’t seem to call the bottom either. We see this in its preparations for its 2015 budget where the company originally figured that oil prices would be $86.50 in 2015. However, a month later in mid-December it needed to reevaluate that model and then settled on a $65 oil price in 2015. In obvious hindsight that number has proven to be way too optimistic as well.

However, as CEO Dave Roberts noted at the time, the company has never relied on optimism, but it uses really conservative estimates to plan for the future. He said that, “Penn West’s business model assumes a conservative long-term commodity price, however, the recent downturn falls outside our lowest probabilistic expectations.” Said another way, the company didn’t see this coming, not even in its worst nightmares.

Unfortunately, the company's nightmare oil price scenario is a reality and its $65 oil price expectation this year is nowhere near the current price. This means oil prices need to rally in order for the company to come back from the grave this year. It already shut in 2,000 barrels of oil equivalent production per day because it was losing money on that production, and that's when it was banking on oil prices of $65 per barrel. Given where oil is now, it may be forced to shut-in even more wells if the current oil price persists.

Investor takeaway

Penn West Petroleum can certainly muddle through the downturn for a while as it can sell assets in order to keep its head above water. However, the company really needs oil prices to head higher as oil is the key to its turnaround plan. The good news is that if oil price do rebound, it should provide all the fuel Penn West's stock needs to pull back from the abyss.

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mdilallo