Why Penn West Petroleum Ltd. Could Quadruple if Oil Prices Recover

Description

For **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) and its investors, the bad news just keeps coming. Thursday was no different, as the company reported results for the fourth quarter of 2014.

In the quarter, Penn West's total production dropped by 20% year over year (mainly due to asset sales), and the company posted a net loss of $3.57 per share. The quarterly dividend, which had already been cut from $0.14 to $0.03, was slashed down to $0.01. Penn West also acknowledged that "if crude oil prices persist below US$50 per barrel in to the second half of 2015, we do foresee potential challenges complying with our covenants."

Of course, the company's stock has been crushed over the past year; it's down about 80%. This brings up the all-important question: Is Penn West in bargain territory? To answer this, we take a look at the value of the company's reserves.

What's the real value of Penn West?

According to an independent evaluator, Penn West's reserves are worth $5.8 billion after-tax, assuming a 10% discount rate. After adjusting for cash, debt, and hedges, the company is worth $4.1 billion, or just over $8 per share. That's a lot of upside from its $2 share price!

Not so fast

Before we all go rushing to buy Penn West shares, let's take a look at how we got to those numbers above. After all, to value a company's reserves, you need to have some assumptions about future oil prices. Penn West's assumptions appear to be very optimistic.

To illustrate, Penn West is assuming an average oil price of US$65 in 2015 (keep in mind that the oil price has averaged around US$50 so far this year, and we're already in mid-March). From there, the company is assuming US$80 oil in 2016, and US$90 oil in 2017. In other words, in order for Penn West to be worth $8 per share, oil prices need to almost double in just a couple of years.

Making matters worse, developing these reserves will require capital spending of $1 billion in each of the next three years. Penn West does not have this kind of money.

An extreme bet

Let’s be frank. Penn West is a company with over $2.1 billion in total debt, a big number for a company valued at only $1.0 billion. Even scarier, the company’s short-term debt is over four times its cash balance! So, if the oil rout persists, the stock is likely worthless.

On the other hand, if oil does recover, and Penn West is able to fully exploit its reserves, the stock could quadruple. The stock is really an oil bet on steroids.

Personally, I’m going to sit this one out. There are too many reasons to believe the oil rout isn’t over, and I don’t want to hold a stock with this much downside. However, if you are really confident in the sector, it doesn’t hurt to make a small bet on Penn West. Just make sure to blow on the dice before you roll.

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