More Bad News Rocks Penn West Petroleum Ltd. Could it Be a Speculative Play on Higher Oil Prices?

Description

Penn West Petroleum Ltd. (TSX:PWT)(NYSE:PWE) continues to be rocked by bad news. It wasn't that long ago that it unveiled an accounting scandal, was forced to slash expenditures and sell assets to shore up its cash flow, and revealed a weak balance sheet. Now, on the back of declining cash flows and a bigger-than-expected 2014 loss, there are fears that it will breach the covenants on $2.1 billion of bonds.

Nonetheless, despite this bad news, there are signs it could be a highly speculative contrarian bet on a recovery in oil.

Now what?

Despite the full-year loss being more than double than that reported for 2013, there are signs that not all is as bad as it appears. The key driver of this large loss was a $1.1 billion non-cash goodwill impairment charge against the value of its assets because of weak crude prices.

Meanwhile, the massive 23% drop in production compared with 2013 can be attributed to Penn West's asset divestment program, rather than any significant operational issues.

Since commencing this program in 2013, Penn West has already completed the sale of over $1 billion in non-core oil and gas properties. The proceeds of this have been directed towards paying down its mountain of debt, giving Penn West a far stronger balance sheet. In comparison with 2013, net-debt is now down by a very healthy 25% to be a manageable two times operating cash flow.

Furthermore, in order to preserve cash flow, Penn West has slashed its dividend a second time, this time by two-thirds to $0.01 per share. While I believe this is a prudent move, the company should bite the bullet and end the dividend altogether.

Despite this bad news, Penn West was able to boost its operating margins in 2014, with its netback per barrel increasing by almost 16% compared with 2013. This will also help to preserve cash flow and boost operational profitability.

The company has also announced that it has reached an “in principle” agreement with bondholders that will allow it to amend some of the covenants, which should see it continuing to operate on a business-as-usual basis.

However, what makes Penn West stand out as a contrarian bet is that it currently trades at a steep discount to the value of its net oil reserves of 487 million barrels of crude. These have a value of $7 billion, or $14 per share, which is a whopping eight times its current share price. Even after baking in the risks associated with developing those reserves to the point where they are commercially viable, there is considerable potential upside available.

So what?

This bad news has further frayed the nerves of investors, but there are signs that Penn West could bounce back, and with it trading at a significant discount to its oil reserves, there is significant potential upside on offer. However, it certainly doesn’t come without risk and should only be considered a speculative investment by the most risk-tolerant investors.

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