Why Penn West Petroleum Ltd. Is Living in Neverland

Description

Falling oil prices have affected some companies more than others. One of the worst affected has been **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE). The company was struggling even before the oil rout (this included a $400 million accounting scandal), and the company's high debt level hasn't helped either. Over the past 12 months, Penn West's shares have fallen by more than 75%.

Now, it looks like there could be tremendous upside in Penn West shares, assuming oil recovers. However, the scenario that Penn West presents looks very unrealistic.

Wildly optimistic

At first glance, Penn West seems tremendously undervalued. The company's reserves have a pre-tax net present value (NPV) of about $9 per share (after adjusting for debt). That's not bad, considering the company trades for little more than $2 per share!

However, there's a big catch. This NPV number assumes a pretty robust oil recovery. To be more specific, oil prices are assumed to *average* US$65 in 2015, US$80 in 2016, and US$90 in 2017. By comparison, the U.S. Energy Information Agency is forecasting prices to average US$52.15 this year and US$70 in 2016.

Making matters worse, the valuation above assumes Penn West spends $971 million this year to develop its reserves. Its actual budget is only $625 million.

Still pitching this scenario

First, let's be fair to Penn West. These price assumptions came from Sproule, an independent reserves evaluator. Furthermore, Sproule was conducting its valuation work late last year, when oil prices were much higher.

So, Penn West wouldn't actually use this data, right? Surely, Sproule's findings would be considered obsolete, and simply be thrown away. Well, you would be wrong. In its company presentation dated March 2015, Penn West devotes two slides presenting this data.

What's going on here?

Why on earth is Penn West still pitching this pie-in-the-sky scenario? The answer likely lies in the company's balance sheet.

Penn West still has well over $2 billion in net debt, a big number for a company valued at $1 billion. Worse still, its debt has a weighted average maturity of less than four years. If oil prices don't recover by then, the company could be in serious financial trouble.

So, Penn West may need to sell more shares before long. How costly will this be? Well, that depends on its stock price. If the stock price is high, the company won't have to issue too many shares, but if the stock tanks, then current shareholders would be heavily diluted. Thus, it makes some sense that Penn West is painting us all a very rosy picture.

That said, Penn West's presentation is misleading, and investors deserve a more realistic portrayal of the company. So, until Peter Pan arrives to take you to Neverland, you should avoid this stock.

CATEGORY

1. Energy Stocks
2. Investing

Category

1. Energy Stocks
2. Investing

Date
2025/07/22
Date Created
2015/03/27
Author
bensinclair