Is Penn West Petroleum Ltd. a Screaming Buy at $1.70?

Description

The rout in oil prices has been painful for every Canadian energy producer, but **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) has been hit especially hard. Its stock price has suffered as a result and is down 80% in just the past 12 months.

What's gone wrong for the company? More importantly, is now the time to step in?

A perfect storm

Even before oil prices collapsed, Penn West was facing problems. It all started back in 2008 with the acquisition of Canetic Resources Trust. There were operational challenges with the Canetic assets, leaving the company with a heavy debt load.

In an attempt to repair the balance sheet, Penn West sold some assets early last year. But the price tag was very disappointing, and CEO Dave Roberts was heavily criticized. Then came a $400 million accounting restatement. And just when the ship seemed to have turned, oil prices plummeted, forcing Penn West to slash its sky-high dividend.

Now Penn West is in desperate straits for a number of reasons. To start, it has over $2 billion in long-term debt, about 2.5 times the company's total market value. Making matters worse, the company is spending more than it is making. And to top it all off, production is in decline.

To deal with these issues, Penn West has sold some royalties and non-core assets. Debt covenants with lenders have also been renegotiated. As mentioned, the dividend was cut. But these are only temporary solutions.

Sky-high upside

As you might have guessed, there is tremendous upside for Penn West if oil prices recover. According to its annual information form, its reserves are worth roughly $5.8 billion (using a 10% discount rate), equal to roughly $11.60 per share. Even after subtracting $4.40 in debt (as well as the assets that were sold off this year), Penn West's $1.70 share price looks like the bargain of the century.

But to get this $5.8 billion number, one has to make some very lofty assumptions: an average WTI oil price of US$65 this year and US$90 in 2017. Furthermore, Penn West would need to spend $3 billion over the next three years to realize this value. The company simply doesn't have that kind of money.

Where does that leave us?

Even if oil prices stay level without declining further, the company will likely go bankrupt. But if oil prices even slightly recover, the stock could easily double. Clearly, this stock is a big roll of the dice and should only be bought in small quantities.

But if you're extremely confident in an oil rebound, and want to make an extreme bet, then by all means, this is the stock for you. Just don't say you weren't warned.

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