You Want to Own Shares of Penn West Petroleum Ltd. if Oil Prices Recover

Description

The fall in oil prices has hurt each of Canada's energy producers, but **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) has been hit particularly hard. The company was struggling with its balance sheet even before the oil plunge, and was selling assets to reduce its debt load.

Thus, when the oil crash came, Penn West's debt burden became much more onerous and selling assets became a lot harder. Unsurprisingly, the company has eliminated its dividend, slashed its workforce, and renegotiated its debt covenants. And, of course, Penn West's stock price has plunged, falling by over 90% in the last 12 months.

That leaves the all-important question: should you buy Penn West shares today? We take a look at what kind of bet you would be making.

A lottery ticket

Penn West's stock is not unlike a lottery ticket. After all, the moment a lottery ticket is bought, it will probably end up worthless. But there is a very slight chance the ticket will reap a huge reward, which is why so many people buy them.

Likewise, Penn West's shares will probably go to zero. Just last quarter, the company generated only $47 million in funds flow, which wasn't enough to cover its $64 million in capital expenditures. To plug the funding gap, the company sold off more assets. But its debt load remains stuck at nearly $2 billion. Making matters worse, oil prices have sunk significantly since the end of the quarter.

So, even if oil prices stay level from this point forward, then Penn West will almost certainly go bankrupt.

That said, there is always that slight chance that oil prices will recover, and if this happens, then Penn West shares will soar beyond belief. To put this in perspective, the company's reserves were valued late last year at $5.8 billion, or roughly $11 per share. Even after deducting debt, as well as the asset sales since then, that's a lot of upside from Tuesday's opening price of $0.66. But that assumes a very robust oil recovery.

The bet

Let's suppose that oil recovers to US$50 per barrel. Penn West would still be in big trouble and would still likely go bankrupt. But there would be a better chance of survival, so the stock price would still take off. This would be analogous to a lottery ticket getting the first number right.

If you own Penn West shares, you don't need to hope for a full recovery in order to make any money. But it's still a very levered bet on the oil price.

Should you buy Penn West shares?

You would never want to spend a big portion of your savings on lottery tickets. And for the same reason, you should only buy a small amount of Penn West, if you want to buy any shares at all.

And there's one final thing to remember: lottery players as a whole lose. Just as an example, only 47% of Lotto 649 ticket sales go towards the main prize pool. Yet people play anyways, lured by the possibility of instant wealth. It's something to think about before buying any shares of Penn West.

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1. Energy Stocks
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