What Makes Penn West Petroleum Ltd. Such an Ideal Takeover Target?

Description

As markets closed on October 2, **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) traded for a measly $0.85 per share. But in the days since, the company's stock price has absolutely taken off.

Penn West's fortunes are particularly sensitive to higher oil prices, so that has played a big factor. But oil prices alone don't explain why the company's shares have jumped so much.

There's another reason why Penn West has soared: the $4.3 billion bid for **Canadian Oil Sands Ltd.** by **Suncor Energy Inc.** The bid caused COS's shares to jump 55% in just one day, and investors think Penn West could be next.

So, what makes Penn West such an ideal takeover target?

A weakened company

Even before oil prices collapsed, Penn West was struggling mightily. It all started in 2008, when the company made a big acquisition that did not turn out well. From there, its balance sheet became a major strain. Penn West responded by selling assets, but didn't always get a fair price.

Now that oil prices have collapsed, the company is on the verge of bankruptcy. After the latest round of asset sales, Penn West's net debt stands at roughly $1.8 billion, which is way too much for a company with less than $50 million in funds flow last quarter.

This puts Penn West in an extreme position of weakness. The company doesn't have enough cash to fully exploit its properties, and is forced to sell assets right into a buyer's market. Those factors depress Penn West's value even further, which should make acquirers that much more tempted.

Quality assets

Lost in all the negative headlines is the fact that Penn West has very quality assets. In fact, wells in its core Viking and Cardium areas generate 30-47% returns at current oil prices. Such strong economics would certainly be very attractive to any consolidator, especially one with lots of money to drill new wells.

A depressed share price

There are other reasons why Penn West's shares have been hit so hard. To start, the company endured a brutal $400 million accounting scandal in the summer of 2014. It also got criticized for backdating stock options, a practice that enriches executives at the expense of shareholders. And income investors fled when Penn West suspended its dividend.

As a result of all these factors, Penn West stock traded well below what it would be worth to an acquirer. And that made it a prime acquisition candidate.

Ironically though, the opportunity to acquire Penn West may be gone, at least for now. With the stock up so drastically, the price tag on the company has ballooned. So, we'll have to wait awhile to see what happens.

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