Penn West Petroleum Ltd. Is in the Process of a Massive Turnaround

Description

Penn West Petroleum Ltd. (TSX:PWT)(NYSE:PWE) was not prepared for falling oil prices. When oil peaked in 2014, the stock lost 90% of its value. Since hitting a low of $0.45 in September, however, shares have been on a tear. Last week, the stock topped out at over $1.50. Meanwhile, the price of oil has languished around $40-50.

Clearly, investors are singing a different tune than they were just a few months ago when shares were priced for bankruptcy. What's happened?

This is how you stage a recovery

In 2013 Penn West had a net debt level of $3.4 billion. That was back when the stock price was above $10 and oil was over $100 a barrel. After oil fell 50%, servicing the debt became nearly impossible. Drastic moves were necessary.

While selling assets in a bear market is typically not ideal given lower selling prices, it was imperative for Penn West to unload properties fast. Over the last 27 months, the company disposed of nearly $2 billion in assets, bringing its net debt down to just $1.8 billion. Notably, the company was able to sell properties for an average of $50,000 a barrel equivalent oil per day. This is surprisingly close to transaction metrics a few years ago when prices were much higher.

Costs have fallen dramatically

If you can't get higher selling prices, one of the best ways to improve profitability is to control costs. In 2013, total operating costs for Penn West's properties were about $770 million. For 2015, costs have fallen to only $620 million, representing a roughly 20% decline. Importantly, these metrics are for existing properties only, meaning that they aren't skewed by the massive asset sales.

In 2016 management expects costs to fall by another 5-10%. If this happens and oil prices stay consistent, a few of the company's major projects may turn profitable. This gives Penn West an excellent chance at breaking even next year, a previously unthinkable feat.

It’s not over yet

Even with the massive turnaround, hurdles remain. Most importantly, the company must still figure out how to service its remaining debt obligations. While some of its projects are primed to turn profitable, interest payments are still eating into profits. For every year from 2016 to 2020, Penn West faces over $200 million in annual debt maturities.

While the recent business transformation should give investors more optimism for refinancing much of this debt, it’s far from a guarantee.

Penn West does have one guaranteed lifeline, however. As of last quarter, the company still had $700 million in unused credit lines available. If refinancing proves more difficult than expected, it can cover a few years of debt payments with this facility alone. However, don’t be surprised to see more asset sales.

The turnaround is for real

While many stocks rebound strongly in anticipation of a turnaround, Penn West appears to have actually executed a revival. After avoiding disaster, the company now looks to break even in the near future, despite the low oil-price environment. If it can continue its strategy and secure refinancing for its remaining debt, shares have plenty of further upside.

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