Sorry Folks: Penn West Petroleum Ltd. Is Not Getting Acquired

Description

The refrain is the same for seemingly every cheap stock out there.

It goes something like this.

A stock trades at a mere fraction of its book value, usually for one of many reasons. It might have too much debt, which makes bankruptcy a concern. Investors might doubt the value of the company's assets. Accounting irregularities or other quality concerns can also play a role.

Because the assets are priced so cheaply, investors are convinced a buyout offer is all but inevitable. Sure, the company will try to turn itself around, but if it fails, it isn't a big deal. Some bigger company will show up, eager to pay a premium for the assets.

This theory has been part of the **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) bull thesis for years now. On the surface, it makes all sorts of sense. Even though shares of the beleaguered energy producer trade at $1.28 each on the Toronto Stock Exchange, the stated book value as of the end of 2015 was $5.84 per share. There's a lot of excess value there.

Unfortunately, the reality isn't that simple. Here's why Penn West doesn't make an attractive acquisition candidate even with such a gap between its market value and its book value.

Why buy?

Let's take a minute to look at Penn West as a standalone operation.

The company is currently in the middle of a program to sell its non-core assets, which are defined as basically anything besides its operations in the Greater Viking and the Cardium fields in Alberta. Everything else is expendable.

The program has been working. Since the company really made paying down debt a priority, it hassold $2.1 billion worth of non-core assets. Sales have been in excess of $1 billion since the beginningof 2015 alone.

Although the program has been pretty successful on its own, a few things have really hampered the company's ability to repay its debt. The big one is the price of oil hitting the skids. Another is the Canadian dollar weakening significantly compared to the U.S. dollar–a move which is a big deal to a company with so much of its debt denominated in greenbacks.

As I write this, Penn West still owes approximately $1.9 billion in net debt. Add that to its market cap, and suddenly a company that acquires Penn West has a total price tag of approximately $2.5 billion, give or take a few million.

And, as we all know, a takeover offer at today's price isn't likely to get a deal done. It would take a big premium over today's price. Thus, the total price tag would likely approach $3 billion.

There's also the distinct possibility Penn West's book value is overstated. Let's face it; with crude hovering around $40 per barrel, many reserves aren't worth anything until the price goes up. We're all assuming that will happen, but what if it doesn't?

Besides, there just isn't much money floating around the sector. In today's environment, the sellers outnumber the buyers at least 10 to 1–more likely 50 to 1. Unless an energy company has the cash on hand to make an acquisition, it's unlikely it'll happen. It's hard to attract acquisition capital at this point in the cycle for anything but small deals. This is why Penn West is having more success selling chunks of its business rather than the whole thing.

And finally, the nail in the coffin: if Penn West goes into bankruptcy protection, there's the distinct possibility that buyers of its non-core assets will get a better deal than negotiating with the company directly. Remember, the management team wants to get top dollar for these assets in order to stave off bankruptcy. A judge doesn't have the same motivation.

It's easy to fall for the Penn West sum-of-the-parts thesis. In a normal energy market, there's a lot of merit to that explanation, too. But in today's depressed environment, I have bad news for Penn West investors: a miracle takeover offer is just about impossible.

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