Is Penn West Petroleum Ltd. a Value Trap?

Description

One-time deeply troubled **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) has reinvented itself, emerging from near bankruptcy to be a far nimbler, more focused upstream oil and gas producer. It did this by divesting itself of a considerable portion of its assets and reducing its debilitating level of debt to a manageable level.

Penn West will change its name to Obsidian Energy in an effort to distance itself from its troubled past. While its almost Lazarus-like rise from near death has rekindled investor interest in the once high-flying dividend darling, there are signs that Penn West could very well be a value trap.

Now what?

Since selling off the majority of its assets to survive the prolonged slump in crude, the main problem faced by Penn West is that the company is simply a shadow of its former self. It now only has 114 million barrels of oil reserves and production of just under 26,000 barrels daily, both of which are less than a third of what those numbers were at the company's peak.

Herein lies the problem, Penn West must fund as well as successfully complete a massive exploration and drilling program to lift its oil reserves and production. It had originally planned to invest $180 million in its 2017 drilling program, the majority of which was to be directed to exploration and development. That budget is now under threat because of the latest slump in crude, which sees West Texas Intermediate (WTI) trading for less than US$45 per barrel.

If WTI remains below US$50 per barrel or weakens further, then Penn West will have to wind back its exploration and development budget, meaning that it will be unable to complete the activities required to boost oil reserves and production.

Another hurdle is the unproven nature of Penn West's Alberta Viking acreage. While management and other pundits believe that it holds the same potential as the Saskatchewan Viking assets, which Penn West sold in June 2016, that has yet to be proven.

Given that its Alberta Viking acreage has a breakeven price of US$41 per barrel, well above the US$35 per barrel for Penn West's Cardium and Peace River assets, it makes sense for the company to wind back investments in developing its Viking acreage. That means it could be some time before the full potential of that asset is fully realized.

For these reasons, it is difficult to see Penn West being capable of unlocking considerable value for investors.

While its Cardium acreage is unquestionably a high-quality asset, if WTI remains under US$45 per barrel, then Penn West will be unable to develop that acreage as planned.

You see, its five-year plan to develop that asset is reliant on WTI averaging US$55 per barrel, which appears unlikely in the current operating environment — for at least the foreseeable future, anyway. That will put a serious dent in its planned cash flow, further constraining investments in the drilling and exploration activity needed to develop its core assets.

So what?

Penn West may have gone a long way to improving its outlook, but there is still considerable drilling and exploration work that must be completed before it is capable of truly unlocking value for investors. Because those activities are solely reliant on the company being able to self-fund its capital program, the recent decline in oil brings into question its ability to complete them.

For these reasons, Penn West remains a questionable choice for investors seeking to make a bet on higher oil.

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