Is This Distressed Oil Stock Doomed or Will it Outperform the Market?

Description

Despite the doom and gloom surrounding the outlook for crude, oil continues to move higher. West Texas Intermediate (WTI) has broken through the US$65-per-barrel mark. There is every sign that it could rise to as high as US$70 per barrel, as a series of geopolitical and economic events curtail supplies and drive greater demand. This has sparked renewed optimism over the outlook for heavily indebted, beaten-down, Canadian heavy oil producer **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH).

Now what?

When oil plummeted to under US$50 per barrel and remained there for a prolonged period, there were fears that Pengrowth would not survive the slump. During the boom years, when WTI was trading at over US$90 a barrel, the company gorged itself on debt, and the sharp decline in cash flow because of weaker oil left it on the brink of collapse.

After commencing an aggressive asset-divestment program, Pengrowth was able to reduce debt to a manageable $610 million by the end of 2017 compared to almost $1.7 billion a year earlier. That reduction also included debt extinguished by the company, because it was able to successfully negotiate with its creditors and restructure a considerable portion during the fourth quarter 2017.

Progress developing the all-important Lindbergh SAGD project continues, and production from what is rated as one of the lowest-cost and most productive SAGD assets is forecast to grow by 3,000 barrels daily to 18,000 barrels by the of 2018.

Nonetheless, despite the significant improvement in Pengrowth's financial position, its share price has weakened significantly to be down by almost 39% over the last year, despite WTI gaining ground to be up by 25%. That is because of the considerable risk still associated with the company.

As part of the debt restructuring, Pengrowth agreed to grant creditors security over its assets. The interest rate on the outstanding notes that mature between 2019 and 2024 also increased by two full percentage points, causing Pengrowth's financing costs to rise at a time when the outlook for crude remains uncertain. The limit on Pengrowth's existing credit facility was lowered to $330 million, reducing the capital available to the company at a time when it would be extremely difficult for it to access credit.

The key risks facing Pengrowth are its looming debt maturities totaling $56 million in 2019 and $118 million in 2020. These will act as a substantial drain on Pengrowth's limited liquidity and cash flow, leaving it vulnerable to another slump in oil, because if WTI drops below US$55 per barrel, then Pengrowth will be incapable of generating sufficient free cash flow to service that debt.

This risk, however, is mitigated by Pengrowth's hedging program, where it has locked in a US$16.80 differential for 17,000 barrels of its Western Canadian Select (WCS) production, covering the output from Lindbergh. It has also hedged another 10,000 barrels of production at an average of ~US$50 per barrel, which will further shield it from any downturn in oil prices.

So what?

Pengrowth is a risky play on higher crude, and its considerable debt coupled with forthcoming debt payments leave it vulnerable to sharply weaker oil prices, especially because of the significant discount applied to WCS.

However, with WTI trading at over $65 per barrel combined with Pengrowth's hedging program, there is every likelihood that it will see a solid increase in cash flow. That will boost its ability to meet upcoming debt maturities, strengthen its balance sheet, and provide additional funds that can be invested in developing its assets. The increasingly positive outlook for oil makes means that this is the most likely outcome for Pengrowth.

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