Oil's Sustained Rally Is a Boon for This Beaten-Down Energy Stock

Description

It has been a painful few years for investors in heavy oil producer **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH). Oil's sustained rally couldn't have come at a better time for the company, particularly with the North American benchmark West Texas Intermediate (WTI) trading at over US$66 per barrel, buoyed by geopolitical unrest in the Middle East.

Now what?

Over the last month, Pengrowth's shares have rallied by an impressive 12% because of firmer crude, and there is every sign that it will continue to appreciate for as long oil remains firm.

You see, Pengrowth has barrels of oil reserves valued at $2.1 billion, which equates to $3.01 per share after applying a 10% discount in accordance with industry methodology. This is more than three times higher than its last price, even after Pengrowth's latest rally is accounted for. That emphasizes the considerable potential upside available to investors.

Nonetheless, investing in Pengrowth is not without considerable risk. The upstream oil producer entered the prolonged slump in crude with a heavily indebted balance sheet that saw it extremely vulnerable to collapse if WTI remained below US$50 per barrel for a protracted period.

The company, however, has gone a long way to mitigating this risk. Firstly, Pengrowth moved to divest itself of non-core assets, the proceeds of which were used to reduce a significant portion of its debt. During 2017 alone, it reduced that debt by a remarkable $1.1 billion, and Pengrowth has no material debt maturities until 2020 when $118 million falls due. That gives it sufficient time to benefit from higher WTI and rebuild its coffers to meet those debt repayments.

Secondly, management restructured the company with a focus on significantly reducing costs. That saw Pengrowth substantially reduce its operational footprint with the oil producer focusing on growing its most profitable and highest-quality operation, which is the Lindbergh SAGD project. This has helped to boost margins, seeing Pengrowth report an impressive netback of $24.89 per barrel for the fourth quarter 2017.

The Lindbergh operation offers considerable cash flow torque to higher oil prices. Pengrowth has estimated that if WTI reaches US$70 per barrel, it could generate up to an additional $69 million in field operating cash flow than when WTI was at US$60 a barrel. That would leave it flush with funds to meet the looming $56 million debt repayment due in 2019.

Finally, Pengrowth has established a hedging program aimed at limiting the short-term downside should oil pull back. While in the current environment, it appears that crude won't pull back any time soon, it is still a risk that needs to be managed primarily because of the considerable expansion in U.S. oil production. That program has established a minimum price of just under US$50 per barrel for 10,000 barrels daily of production, which will cover a large portion of Pengrowth's Lindbergh output.

So what?

Pengrowth is admittedly a high-risk play on firmer oil, but with growing signs that US$60-65 per barrel WTI is here to stay the risk/reward equation is tilting firmly in the favour of investors. This becomes especially apparent when considering the quality of the Lindbergh asset, the fact that Pengrowth has been able to restore its balance sheet, and that the net present value per share of its oil reserves is more than three times its price.

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mattdsmith