# Will Obsidian Energy Ltd. (TSX:OBE) Ever Unlock Value for Investors?

## Description

Intermediate upstream oil producer **Obsidian Energy Ltd.** (TSX:OBE)(NYSE:OBE), which emerged from the near failure of Penn West Petroleum Ltd., has failed to rally despite the higher oil. While the North American benchmark West Texas Intermediate (WTI) has gained around 15% for the year to date, Obsidian has seen its market value plunge by almost 23%. This has led to considerable speculation that Obsidian is a deep-value investment opportunity that offers considerable upside.



**Now what?**

After divesting a considerable number of operations, including US$1.1 billion in assets by mid-2016 and the further sales since then, Obsidian whittled its long-term debt down to $408 million by the end of the second quarter 2018. This is a manageable 2.6-times operating cashflow and saw Obsidian finish the quarter with its debt ratios within the covenants set by its lenders.

The sale of a wide-range of assets caused oil reserves and production to decline sharply.

Obsidian is focused on maximising the potential of its remaining Peace River, Cardium, Deep Basin and Alberta Viking acreage. Overall second quarter production fell by 6% year over year to 28,697 barrels daily, although this can be attributed to the sale of legacy assets, which were producing 2,200 barrels per day.

After eliminating the contribution of Obsidian's non-core assets the driller's oil output for the second quarter rose by 5% compared to the same period in 2017**,** to 26,557 barrels daily. That's a good sign for a company that has failed to effectively boost its oil output since selling a vast swath of its developed oil assets. This increase can be attributed to its wells in Alberta's Deep Basin play, which were drilled during the second half of 2017, coming online to contribute 1,541 barrels daily for the quarter.

Disappointingly, despite significantly higher average oil prices over the quarter compared to a year earlier Obsidian's netback – a key measure of operational profitability – plummeted by 7% to $16.51 per barrel produced.  This occurred regardless of a notable decline in operating costs, which were down by almost $2 a barrel, thereby more than adequately offsetting higher transportation expenses.

The primary culprit for this was the significant loss incurred because of Obsidian's commodity hedging contracts.

You see, like many other upstream oil producers which are dependent on higher oil to be profitable, Obsidian's management expected weaker oil over the course of 2018 and that WTI could fall once again to under US$50 barrel.

As a result, management expected WTI to average US$55 per barrel during 2018 and accordingly established a series of risk management contracts to minimise the impact that weaker oil would have on its finances. This was particularly important because it would ensure that Obsidian generated sufficient operating cash flow to fund its development activities and meet debt repayments.

Because WTI has unexpectedly rallied substantially since those hedges were established**,** Obsidian has incurred a loss of $50 million for the second quarter compared to a gain of $30 million a year earlier. This loss has been recorded against its net earnings and was key driver of not only a weaker operating netback, but also Obsidian's $96 million quarterly loss.

A large portion of those risk management contracts will unwind at the end of 2018, and if oil remains firm, which is likely, then that will give the driller's profitability a solid boost. Increased spending on Obsidian's assets to ramp up drilling and development activity coupled with a focus on reducing expenses will further lift Obsidian's bottom line.



**So what?**

While management has done a fantastic job pulling the company back from the brink, there are still considerable risks associated with its operations because of their lack of maturity. Clearly, in an environment where oil is rising, Obsidian will unlock value for investors, but the unproven nature of its operations means there are far more attractive stocks for investors seeking exposure to oil.

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mattdsmith