What Does the Latest News Mean for Pengrowth Energy Corp. (TSX:PGF)?

Description

It's been a tough year for investors in the once deeply troubled **Pengrowth Energy Corp.** (TSX:PGF). Since the price of crude collapsed in October 2018, the stock has been heavily marked down by the market. It's now down by a whopping 52% year to date. While there was once considerable optimism surrounding the outlook for Pengrowth in an operating environment where West Texas Intermediate (WTI) was trading at over US$60 a barrel, substantial pessimism is emerging.

The short-term outlook for heavy oil has improved

This is also being driven by the deep discount applied to Canadian crude blends, notably Western Canadian Select (WCS), the benchmark price for bitumen and other forms of heavy oil. While WCS prices surged after the government of Alberta imposed mandatory production cuts, there is no guarantee that they will remain firm over the long term.

The initial cuts totalling 325,000 barrels daily will only remain in place until the localized supply glut that has emerged in Western Canada has drained and there is sufficient exit capacity on Canada's pipeline network to boost prices. It is anticipated that this will take around three months, and they will then be reduced to around 95,000 barrels daily for the remainder of 2019.

The key problem with this strategy is that it doesn't address the core underlying issue, the conspicuous lack of pipeline capacity to ship Canadian crude to crucial U.S. refining markets. If transportation bottlenecks remain, which is highly likely given the long lead times to build new pipelines, and Canadian oil producers ramp up production to take advantage of higher prices, then the same issue will emerge once again.

Production is growing and costs are falling

The recent substantial narrowing of the differential between WCS and WTI will be highly beneficial for Pengrowth because of growing production from its flagship Lindbergh SAGD asset. For the month of October, its output averaged 18,350 barrels daily, which was 16% greater than the previous month.

This strong growth places Pengrowth on track to meet its full year 2018 guidance, which includes an average of 16,500 barrels daily over the year from Lindbergh. It also means that it can achieve its 2019 production guidance, where it anticipates that Lindbergh will produce on average 17,750 to 18,250 barrels daily over the course of the year. This growing production will help to offset the revenue lost from weaker oil, while the significantly narrower differential between WCS and WTI will boost earnings and profitability.

Pengrowth's focus on reducing costs will further boost profitability. For the third quarter 2018, Lindbergh's operating and transportation costs fell by 6% year over year to $12.92 per barrel, thereby highlighting the considerable profitability of that operation with WCS trading at $40.42 a barrel.

The company also has a hedging strategy in place that's designed to minimize the financial impact of weaker oil prices. During the third quarter, because of oil's unexpected rally that saw WTI average US$69.50 per barrel over that period, Pengrowth incurred a loss of $23 million due to those commodity risk management contracts. However, those hedges will now help protect Pengrowth's earnings because WTI has plunged to below US$46 per barrel and it appears that it could fall further because of fears of a growing global supply glut.

Nonetheless, the latest OPEC production cuts that saw the cartel and its allies agree to reduce their oil output by 1.2 million barrels daily will take effect in January 2019. This should go some way to rebalancing global energy markets, thereby giving the price of crude a healthy lift. And that, along with a significant reduction in the discount applied to WCS, bodes well for Pengrowth's profitability and earnings over the short term.

Is it time to buy Pengrowth?

The short-term outlook for Pengrowth is more positive than the market's reaction indicates. The latest sell-off sees the company down by 35% over the last month — roughly triple the decline posted by WTI — has created an opportunity for risk tolerant contrarian investors to boost their exposure to crude.

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