Can Penn West Navigate Past These Threats?

Description

Oil and gas companies face a number of threats, which if not navigated correctly, can really destroy shareholder value. In the fourth part of a SWOT analysis of **Penn West Exploration** (NYSE: PWE) (TSX: PWT), I am going to take a closer look at its three biggest threats the company faces in an effort to gain insight into its ability to navigate past them.

Access to customers

One of the biggest threats faced by Canadian producers is access to American refineries. Not only does America use a lot of oil, but Canada already produces two million more barrels of oil per day than its refining capacity. The problem is that there is currently more oil being produced than pipelines can handle, which has caused a discount in the price of Canadian crude oil. That discount is a threat to profitability.

Looking ahead, pipeline companies like **TransCanada** (NYSE: TRP) (TSX: TRP) are working to build a number of pipelines to get Canadian oil to U.S. refiners. The problem is that its massive Keystone XL is currently being tossed around as a political hot potato in the U.S., which is forcing Canadian producers to look at other options to get oil to customers. Penn West, like its peers, is increasingly turning to the rails to get better prices for its oil, it is also directly marketing its oil to refiners to again achieve better pricing. However, if Canadian oil struggles to make its way into the U.S. it could really hurt profitability and cash flow for producers like Penn West.

Shifting investor base

In 2011 Penn West converted from an income trust into a corporation. In the process it lost a portion of its income seeking investor base as its payout was cut. More recently the company was forced again to slash its dividend, this time in an effort to strengthen its balance sheet. Each time the dividend is cut, the company is also cutting loose some of its longstanding investors.

In order for Penn West to deliver strong long-term returns, it needs to build back investor confidence. Right now its investor base is in transition as the company itself continues to transition. One of the company's biggest threats is that it has alienated investors to the point that it will be very difficult for the true value of the company's shares to ever really surface.

Capital constraints

The final threat to Penn West's ability to produce for investors is its balance sheet. It has about three billion dollars in debt, which is about 2.3 times EBITDA. While it's not a worrisome amount, it does limit its options. For example, in addition to slashing its dividend to conserve cash, Penn West also cut its plan to add $300 million to its $900 capital budget this year. Instead it chose to move capital from its Waskada development to its Viking and Cardium plays as it searches for production growth.

That being said, Penn West is looking at all of its strategic options to bolster its balance sheet. One option is asset divestiture. The most likely first asset to exit its portfolio is its 150,000 acre position in the Duvernay. The emerging liquids rich gas asset could fetch a fair price on the market, which would provide Penn West with an abundance of capital. For an example of the value it would unlock, consider that **EnCana** (TSX: ECA) (NYSE: ECA) sold a 49.9% interest in its 445,000 Duvernay acres last year to PetroChina. The company was able to get C$2.18 billion, which included a billion in cash up front and the rest as a drilling carry. A cash deal to exit its position at a rate close to what Encana received per acre would really help alleviate Penn West's capital issues.

Investor takeaway

The bottom line here is that Penn West has a number of threats and weaknesses that it still must overcome. However, I do believe it can do just that because it has a strong foundation as well as a number of opportunities, which should yield solid returns for investors over the long term. If nothing else, I think it's a company investors should put on their radar as it is one worth watching as it continues its turnaround plan.

Fool contributor Matt DiLallo does not own any shares of the companies mentioned. The Motley Fool does not own any shares of the companies mentioned.

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