

## What Does Penn West Petroleum Ltd.'s Accounting Probe Mean for Investors?

### Description

Earlier this week, **Penn West Petroleum Ltd.** (TSX: PWT)(NYSE: PWE) announced to the market it had identified accounting irregularities stretching back four years and has launched a probe into its accounting practices. These irregularities may have left the company in breach of lending covenants and have seen it initiate discussions with its lenders.

The news couldn't have come at a more critical time for Penn West with the company set to report some solid second-quarter 2014 results as it looks to rebuild its shattered balance sheet, reduce leverage, and grow profitability. Since the news broke, Penn West's shares dropped off a cliff plunging 18%, with the market growing increasingly wary of a company that has over-promised and under-delivered in the past.

But the key question for investors is whether this recent weakness is an investment opportunity.

### How did Q2 2014 shape up?

For the second quarter 2014, Penn West reported crude production declined 2% compared to the previous quarter and a massive 23% compared to the second quarter 2013. However, despite the significant drop in production the proportion made up of higher margin crude liquids remained steady, falling 1% quarter-over-quarter, but rising 2% year-over-year. The key driver of declining production has been the company's asset divestment program, which is a key plank in its restructuring program, with the company ridding itself of non-performing assets and using the proceeds to reduce debt.

Another key plank in the company's restructuring plan is to significantly boost light oil production and focus on becoming exclusively a light oil producer. The primary reason for this is Canadian light crude or Edmonton par trades at a lower discount against West Texas Intermediate than Canadian heavy crude or West Canadian Select.

For July 2014, the average discount of Edmonton Par against WTI was 9.5% while West Canada Select traded at an average discount of 19%. Accordingly, Canadian light oil producers are able to generate more significant margins or netback per barrel of crude produced than heavy oil producers.

But despite this stated goal, both heavy oil and natural gas continue to make up a significant portion of Penn West's production mix, which is impacting the margin it generates per barrel of crude produced.

For the first quarter 2014, Penn West reported a netback of \$36.67 per barrel, which is among the lowest in the patch and significantly lower than light oil producers **Lightstream Resources** (TSX: LTS) and **Crescent Point Energy** (TSX: CPG)(NYSE: CPG), which reported netbacks of \$56.11 and \$52.65 per barrel respectively for the same period.

I am also not expecting to see any significant improvement in Penn West's netback per barrel for the second quarter with heavy crude and natural gas continuing to form a significant part of its production

mix. However, stronger industry-wide fundamentals including higher crude prices will help to boost netbacks across the energy patch.

### **What are the key impacts of the accounting review?**

Essentially the review of the company's accounting policies will see it potentially required to restate its financial statements for the years ended December 31, 2012 and 2013 as well as its quarterly financial statements for the three months ended March 31, 2014 and 2013.

It is expected this will see reported capital expenditures, property, plant and equipment balances, royalty expenses and depletion expenses reduced while increasing operating expenses. The restatements may also require Penn West to reduce capital expenditure guidance and royalty expense assumptions while increasing its operating cost assumptions for its 2014 guidance. Any adjustments to these factors in the current year's guidance would have a negative impact on forecast cash flow seeing it fall.

This will impact Penn West's bottom line, and potentially see the company report another net loss for 2014 following on from its 2013 net loss of \$838 million.

### **Does it affect Penn West's dividend?**

Any reduction in cash flow will also further bring into question the sustainability of Penn West's dividend. Any reduction in 2014 cash flow will place further pressure on the dividend with the company having reported a net loss for the last two consecutive quarters along with a working capital deficit for the last four consecutive quarters. This news couldn't have come at a worse time for investors in Penn West with emerging signs of the restructuring initiatives gaining traction, any increase in costs and reduction in cash flow will impact the company.

It also again brings into the question of just how sustainable the company's dividend really is and with a yield of 6.7% there is plenty of room for another dividend cut by up to 50%. Given the company's need to retain capital this would be a prudent move and still leave Penn West with a juicy yield in excess of 3%.

But I do believe the recent sell down represents an opportunity for patient, risk-tolerant investors who are willing to make a long-term bet on the success of Penn West's restructuring plan.

### **CATEGORY**

1. Investing

### **TICKERS GLOBAL**

1. NYSE:VRN (Veren)
2. TSX:VRN (Veren Inc.)

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