



Is Penn West Petroleum Ltd.'s Turnaround Doomed?

Description

Significantly softer crude prices are hitting Canada's energy patch hard, with the **S&P TSX Capped Energy Index** – a weighted index of the 58 largest oil companies listed on the TSX – down a massive 21% for the quarter-to-date.

These significantly lower crude prices – their lowest point since 2009 -is applying considerable pressure to those oil companies with troubled operations and weak balance sheets. One company which is being hit particularly hard is troubled intermediate oil producer **Penn West Petroleum Ltd.** (TSX: PWT)(NYSE: PWE).

Once considered the poster child of success for start-up oil explorers and producers, it has now hit particularly rough times, with its share price collapsing a massive 80% over the last five years. Much of this can be attributed to Penn West expanding too quickly, acquiring substandard oil assets and burdening its balance sheet with a massive pile of debt.

This led Penn West to implement a turnaround strategy aimed at reducing debt through the disposal of non-core assets, retaining capital by slashing its dividend and boosting cash flow, but this plan has struggled to gain traction. The tale of woe does not end there with significantly lower crude prices set to derail Penn West's turnaround program and leave the company in an even more vulnerable state.

Let me explain why.

First and foremost, lower crude prices will depress asset prices in the oil industry. As part of its strategic turnaround, Penn West has completed \$1 billion in asset sales, but it still has a further \$1 billion to complete in 2015 if it is to reduce debt further. But in the current environment this may be difficult to achieve. Lower crude prices and a flood of oil assets coming onto the market because of troubled peers also divesting themselves of non-core assets will further depress asset prices.

This will make it increasingly difficult for Penn West to achieve fair prices for the assets it is attempting to sell, impacting its plans to reduce net-debt to a manageable 1.5 times funds flow.

Second, of greater concern, is that significantly lower crude prices will squeeze Penn West's already

thin margins even further impacting funds flow.

For the third quarter 2014, Penn West reported a netback of \$32.51 generated from an average sale price of \$62.84 per barrel with West Texas Intermediate or WTI trading at an average of \$97.31 over the quarter. This netback was one of the lowest among operators in the patch and now with WTI trading 31% lower, it can only fall further despite the hedges Penn West has established to protect itself from weaker commodity prices.

A significant decline in Penn West's netback will also see funds flow weaken, particularly with its funds flow already under pressure from declining crude production because of asset sales.

The end result I believe will be a significant squeeze on Penn West's funds flow which will impact its ability to fund capital expenditures as well as its dividend and operating costs.

For these reasons Penn West is going to be hit hard by such a significant drop in crude prices with it unable to boost oil production to compensate for such lower prices, leaving it struggling to reduce net-debt to affordable levels.

This will place extreme pressure on the company to further reduce expenses and retain capital. Key among them would be to slash its dividend payment, with it now the top yielding dividend in the **S&P TSX 60 Index** with a monster yield of 14%.

In fact I find it quite incredulous that a company in such a parlous state continues to pay a dividend let alone one which gives it the highest yield among Canada's top 60 listed companies. By ceasing dividend payments altogether Penn West would create annual savings of around \$276 million, though this would certainly earn the ire of investors and see its share price punished even further.

While there is certainly some value emerging with its share price testing new lows, Penn West has truly slipped into speculative territory and should only be considered by the most risk tolerant investor.

CATEGORY

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