Why Shares of Penn West Petroleum Ltd. Could Plunge Further

Description

Life has not been fun for shareholders of **Penn West Petroleum Ltd.** (TSX: PWT)(NYSE: PWE) in recent years. Over the past 36 months, the shares have plummeted by 84%.

But now, the company is starting to look tempting to some people. Institutional investors have bought some shares. So have insiders. Should you follow suit? After all, the dividend now yields nearly 20%.

Well, not so fast. To understand why, we need to look at the company's strategy, its dividend, and what happens if that payout is cut.

How did we get here?

Penn West has been one of the Canadian energy sector's worst performers for a number of years. The company's current problems can be traced back to 2008, when it acquired Canetic Resources Trust for $3.6 billion.

Unfortunately, the acquisition left the company with a massive debt load. As a result, the company has been selling assets (sometimes at a bargain) in order to fund its capital spending and dividend. This year, the news got worse, thanks to a $400 million accounting restatement. The crash in oil prices has added further pain.

So where does the company stand now?

To answer this question, let's look at the Penn West's long-term plan, released on Monday, November 17. According to the presentation, the company plans to keep selling assets in order to fund the dividend and pay down debt. Ideally its debt-to-cash flow ratio would approach 1.5 times by 2016.

Unfortunately, the assets to be sold are mainly non-producing. This should be a major red flag. Remember, Penn West wasn't able to get a fair price when selling producing assets at the beginning of the year. And in today's environment, it will be tough to get a fair price for non-producing assets.

Making matters worse, oil prices have collapsed since Penn West made that presentation. At the end of the presentation, you can see the company assumes an oil price of US$87.50 per barrel for 2015. We now know that this is far too optimistic.

So what happens now?

Well, we don’t know exactly. The company has stated that at sub-$75 oil, capital spending would be reduced. Otherwise, we haven’t heard any revision to its long-term plan. But it looks like any update must involve a dividend cut.

And a dividend cut will likely cause the share price to collapse. Why? Well, roughly 80% of shareholders collect their dividend in cash, even though there’s a 5% incentive to receive the payout in additional shares. In other words, most shareholders aren’t interested in holding more Penn West stock – they only want their cash payout. And if this payout is cut, these shareholders could bail en masse. This is what happened when **Canadian Oil Sands** cut its dividend just a few days ago.

So at this point, you should wait a very long time before buying Penn West shares. And if you hold the stock, you can claim some tax benefits for this year if you cut your losses now.

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