Why Penn West Petroleum Ltd's Dividend Should Go to Zero

Description

As oil prices slide, investors are learning a very difficult lesson: Never buy a stock just for the dividend. Nowhere is this more true than at **Penn West Petroleum Ltd.** (TSX: PWT)(NYSE: PWE). The embattled oil producer has not yet cut its dividend, but with a yield of more than 20%, the market clearly believes the payout is unsustainable.

And it looks like those fears are well-reasoned. In fact, the company should probably cut its dividend to zero. Below we take a look at why.

Bleak times

Even before oil prices plunged, Penn West was struggling badly. Unwise acquisitions and operational problems were stretching the company (and its balance sheet), forcing it to scale back, mainly by selling assets. The dividend was cut by nearly 50% in 2013.

Looking ahead, the company hopes to reduce its debt load to 1.0 to 1.5 times cash flow sometime in 2016. This would be done partly through asset sales, quite a challenge since many of these assets are not yet producing any oil.

At least that was the story back in mid-November, before oil prices went into total free-fall. In fact, that assumed that the American oil price would be US$87.50 next year. This assumption now would be wildly optimistic.

With oil prices so much lower, not only will cash flow be lower, but these assets will be even more difficult to sell. Unfortunately, Penn West has provided no updates since mid-November.

The dividend is far too high

Even for a thriving company, Penn West's dividend would likely be too high. For a struggling company, the payout is simply off the charts.

To put this in perspective, Penn West earned roughly $0.49 per share in free cash flow through the first nine months of this year. This was barely enough to cover $0.42 per share in dividends. During this time, American oil prices averaged roughly US$100. Today, that number is less than US$60. Making matters worse, production is declining, meaning that cash flow will come under further pressure. The dividend will then be that much more of a burden.

Why not zero?

The company's management team is under enormous pressure to keep the payout as high as possible. After all, many investors hold the shares simply for the dividend, and if it is cut more than expected, the share price could crumble.

But if Penn West doesn't cut its dividend enough, then its debt reduction targets will be impossible to reach. And investors will simply assume that another cut is coming. Put another way, let's suppose that Penn West didn't have a dividend at all. Would it introduce a payout, even a modest one? The answer is of course no.

Here's the important thing: no matter what the company does, it's going to get ugly. And you don't want to be a part of it.

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