



Is Penn West Petroleum Ltd. on the Brink of Bankruptcy?

Description

The sell-off in the energy sector has hit just about every company hard. But it may have hit **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) the hardest.

Penn West's issues started way before the most recent oil crisis. You could argue that the company first goofed back in 2007, when it merged with Canetic Energy. Previous management then used the new company's clout to borrow aggressively and buy assets across the globe. Execution suffered, and today many of those acquisitions are disappointments.

Once the old management team was out, the new guys in charge discovered another problem. The company's finance team had been listing operating expenses as capital expenses, in a pretty obvious attempt to goose cash flow. To their credit, the new management team immediately disclosed it to shareholders, and pledged to clean up the company's accounting.

The accounting wasn't the only thing improving. The company started focusing all new drilling in areas that were more profitable, cutting staff and becoming more efficient at the same time. Management sold off more than \$1 billion in non-core assets, getting rid of land acquired during the binge of 2007-12.

The company's turnaround was working, at least until the price of oil fell off a cliff.

Now, things are looking pretty bleak. Although the company has been aggressively paying down its debt over the last year, there's still more than \$1.8 billion worth of it remaining on the balance sheet. As an unhedged producer and perceived weak link, the stock suffered alongside oil, falling more than 80% in the last six months.

Ouch.

The company cut the quarterly dividend from \$0.14 per share, all the way down to \$0.02 back in December, based on low energy prices. It also cut its capital budget as well, choosing to invest only in projects that were viable at lower prices. Production is expected to be pretty much flat this year compared to last, but 2016 production could be an issue. Conventional oil companies need to continuously drill new wells to keep production up.

Just in case this wasn't enough, the company was hit with another piece of bad news last week. Management disclosed that it had entered into negotiations with its lenders. Essentially, Penn West has to keep its EBITDA at or above 3x its current debt level, or it will technically be in default. If oil persists at below \$50 per barrel, Penn West will breach this covenant.

This may look like terrible news on the surface, but in reality it isn't so bad. Not only is management being prudent by discussing it with lenders before the event actually happens, but the company has actually disclosed it to investors. Ever since he's taken over, CEO Dave Roberts has done a terrific job of keeping shareholders in the loop.

Think of it this way. When a bank lends against a house, the last thing it wants to do is take over the house. It's expensive, time consuming, and then the bank needs to sell it. A borrower who is still happy to pay the interest on that house can likely work a deal out with the bank.

It's the exact same scenario in the oil patch. Penn West has a book value of \$11.11 per share, or approximately \$10 per share if you take away the company's intangible assets. The value of the company's debt is approximately \$1.8 billion, which works out to \$3.70 per share. There's plenty of collateral there, even in a down market. But that doesn't mean bankers want to sell those assets, especially now.

At \$50 per barrel, Penn West isn't in good shape. The paltry dividend is likely toast, and it can barely afford to pay the interest on its debt based on its latest capital budget. If oil stays weak until the end of 2015, the company could be in danger of actually defaulting on its debt.

But, if you're a believer in the price of oil recovering in 2015, this stock could soar. It may be a bumpy ride, but I think if oil is at \$65 by the end of the year, Penn West's shares will be up substantially. It's a risky stock, but there's plenty of upside if oil cooperates.

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1. Energy Stocks
2. Investing

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