Is Penn West Petroleum Ltd. Headed for Bankruptcy?

Description

The oil rout continues to test whether or not a number of companies in the energy patch are capable of surviving. The market is now doubting whether **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) can make it. Not only did it post a massive $1.7 billion 2014 loss, but it has now flagged that it could breach its debt covenants in 2015. This means the market has essentially priced the company for failure, wiping over 80% off its value during the last year.

Now what?

Penn West finished 2014 with senior debt and total debt of 2.1 times its EBITDA, which is well within its debt covenants, which apply a limit of three times EBITDA for senior debt and four times for total debt.

However, it is likely to breach those covenants later this year.

This is because Penn West has based its 2015 guidance on an average annual price for West Texas Intermediate (WTI) of US$55 per barrel, yet WTI continues to trade at well under US$50 per barrel. I also expect WTI prices to remain at around US$50 per barrel for the remainder of 2015 because U.S. oil production continues to grow, despite oil producers shuttering rigs, and U.S. oil inventories are now at their highest level in 80 years.

If Penn West breaches its covenants it could be forced to file for bankruptcy, or more than likely, it will have to restructure its debt.

Any restructuring means that an accelerated repayment schedule would have to be implemented, and this could include the need for further asset sales. It would also force Penn West to divert much-needed cash flow from investment in developing its oil production to meeting debt repayments. This would further negatively impact production, trapping the company in a spiral of diminishing cash flow.

However, it seems increasingly likely that Penn West won't breach its covenants for the foreseeable future. This is because it has already engaged in negotiations with lenders and they have agreed to relax the existing covenants for the next one-and-a-half years.

The changes to the existing covenants include increasing the limits on senior and total debt ratios to five times EBITDA in exchange for greater rights to assets should the company fail. These changes would include Penn West temporarily granting a floating charge security over all of its property in favour of its lenders on a *pari passu* or equal rights basis.

So what?

Penn West is in a very difficult position, as it is highly dependent upon a rebound in oil prices if it is ever to recover, particularly with the company having abolished its commodity hedges some time ago.

Despite this, I do not believe that it will go bankrupt or be restructured, since its lenders agreed to relax its debt covenants to more manageable levels for the short term. Nonetheless, the risks associated with investing in Penn West are high and the risk-to-reward ratio is mediocre at best, making it a company that all but the most speculative investor should avoid.

CATEGORY

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