Why the Pain Is Far From Over for Investors in Penn West Petroleum Ltd.

Description

The bad news doesn't stop for investors in one-time darling of the oil patch **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE). Despite working hard to repair its tattered balance sheet, cut costs, and boost production from its high-quality oil assets, Penn West is set to struggle for some time. It is now facing a range of headwinds that will continue to negatively impact its performance and prevent it from making any meaningful recovery.

Now what?

These headwinds come from a range of sources, but the first and most obvious is sharply low oil prices that are squeezing its margins and cash flow. This is obvious when we take a closer look at its poor first quarter 2015 results, where it failed to meet analyst expectations.

For that period, its netback, a key measure of an oil producer's profitability, plunged by 60% year over year to a paltry $14 per barrel. As a result, cash flow plunged a whopping 58%, highlighting how difficult it is for Penn West to generate sufficient cash flow in the current harsh operating environment in order to meet its financial obligations.

For as long as oil prices remain weak, this will apply considerable pressure to Penn West to continue with its asset divestment program and further cut investments in developing its oil assets.

This then creates another problem for Penn West. As it continues to sell assets, the volume of its oil production will decline further, causing earnings and cash flow to fall. The impact of asset sales on production volumes can be seen in its first quarter results, where oil production dropped by 10% year over year because of earlier asset sales.

With over $2 billion in debt and with $1.8 billion due for repayment between now and 2019, Penn West is under considerable pressure to reduce that debt or face a liquidity crunch. This, along with fears that Penn West could breach its debt covenants, is adding additional urgency to the need to sell more assets.

You see, Penn West has already come awfully close to breaching its financial covenants, and despite renegotiating those covenants, the newly relaxed limits only apply for a short period of roughly one year. As a result, with oil prices likely to remain stubbornly low, coupled with declining production, Penn West has essentially delayed the inevitable.

So what?

Penn West's recent AGM highlighted the distress of investors, particularly with its share price having collapsed, plunging by 75% over the last year. This has left some analysts claiming that it is now an attractively priced levered play on a rebound in crude but I believe the risks are just far too great and outweigh the potential reward available.

Even if Penn West is able to reduce its debt to manageable levels and avoid breaching its financial covenants, its production will have fallen to levels where it won't be able to take full advantage of the anticipated rebound in crude. This means that while it will survive the current harsh operating environment, it is extremely difficult to see it returning to its former glory.

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