



## Penn West Petroleum Ltd.: a Lesson on How Dangerous Debt Can Be!

### Description

It has been a tough time for investors in beleaguered oil producer **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE), with the company paying for a multitude of its sins in almost every way imaginable. Not only did it gorge itself on debt to acquire marginal assets that have fallen significantly in value since oil prices crashed, but it wound down its oil hedges at the worst possible time, leaving it extremely vulnerable to the oil crash.

In fact, the sharp collapse in oil almost took Penn West to the brink of bankruptcy, but it recently renegotiated its financial covenants and completed further asset sales, so it appears to be on the path to recovery. Some analysts are now claiming that it is a speculative play on a rebound in oil prices.

### Now what?

While these events are positive news for investors they have done very little to change the long-term outlook for the company with the risk-reward equation certainly not skewed in favour of investors for two key reasons.

Firstly, the renegotiation of its financial covenants, while giving it some breathing space, really only kicks the proverbial debt can.

You see, while it has successfully negotiated with its lenders to significantly relax its financial covenants, those measures start to unwind in June 2016 and end in December of that year. At that time, they will return to their original levels, and unless there has been a serious uptick in the price of oil by then, Penn West will find itself back to where it was. It will potentially be in a position to breach those covenants.

Secondly, asset sales, while providing much-needed funds to pay down its debt burden, are eroding oil production.

One of the key problems Penn West is facing is that every time it sells an asset, its oil output declines. This has a marked impact on revenue and cash flow that it can ill afford in a harsh operating environment dominated by discernibly softer oil prices.

This can be seen in its first-quarter 2015 results, where total output declined by 15% year over year, which, in conjunction with softer crude prices, meant funds flow declined by a very worrying 58%. Penn West has already earmarked up to roughly another \$1 billion in asset sales.

The long and short of it is that this trend can only continue, with a range of indicators signalling that sharply weaker oil prices are here to stay.

These factors, along with Penn West having wound down its hedges when oil prices were high, have left it extremely vulnerable to the deepest oil rout since the global financial crisis.

### **So what?**

Despite a number of analysts now taking an optimistic view of Penn West, I don't believe that this is truly warranted because the risk far outweighs the reward. Because oil prices are set to remain soft for longer than expected and Penn West's renegotiated financial covenants expiring in late 2016, the risk of Penn West breaching those covenants returns.

Furthermore, declining oil production because of asset sales only magnifies this risk, while also causing its cash flow and bottom line to shrink even further, leaving little cash available for investments in developing its assets in order to grow production.

### **CATEGORY**

1. Energy Stocks
2. Investing

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1. Editor's Choice

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mattdsmith

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