Is Sub-$50 Oil Going to Send Penn West Petroleum Ltd. to Bankruptcy?

Description

Thanks to the recent decline in the price of crude, shares of Canada's energy giants have been plunging over the last month.

One of the worst hit has been **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE), which investors generally view as one of the weaker players in the sector. Since shares flirted with a high of $3 in April, they've taken a nearly 50% haircut, sinking to as low as $1.50 each. They've recovered recently to current levels of $1.68.

It isn't just the weak price of crude that's affecting Penn West. The company's other problems have been well documented. It's wallowing in debt, brought upon by the previous management team's habit of acquiring assets without any real plan. It also dealt with an accounting scandal about a year ago, which sure doesn't help investor confidence.

But it's also taking steps in the right direction. The new management team swiftly fixed the accounting issue, and retrained staff in an attempt to make sure something like that doesn't happen again. It has also been selling off assets to pay down the debt, and has even been getting good prices for them. The company has even recently instituted a hedging program as a way to reduce price risk in the future.

The decline in the Canadian dollar has been both a positive and a negative for Penn West. Because of the decline, the price of oil in Canadian dollars isn't nearly as bad as it is in U.S. dollars. That, combined with other cost savings it has been able to create, makes the future look at least a little better.

The bad news about the weakness in Canada's currency is that Penn West's debt is mostly denominated in U.S. dollars. So, even though it's making progress and paying back some of the debt, the amount owing goes up when converted back to Canadian.

And finally, the company has also gone to its lenders and negotiated better terms on its debt, including upping the total debt-to-EBITDA ratio tolerated by lenders before it would force the company to breach its covenants. This agreement came with a few conditions, like slashing the quarterly dividend to a penny per share and a requirement to sell a certain amount of assets, but these are things the company would have done anyway.

Still, even after making these positive changes, the investment thesis on Penn West is still relatively simple. As goes crude, so will go Penn West.

The future of crude

One thing is for certain. At $48 per barrel of crude, Penn West cannot survive forever. The weight of its debt will eventually crush it if there isn't a meaningful improvement in oil.

The issue is how long Penn West can survive in a scenario where crude doesn't recover. I don't have a crystal ball–so take this with a huge grain of salt–but I can't see it being able to stick it out for any longer than the end of 2016 if crude remains at today's level. At that point, lenders are going to start getting very nervous.

Which means that investors who get in now are betting on an improvement in the crude market in the next 18 months. For Penn West to survive, it needs oil to improve from the current price. It's that simple.

In the short term, the crude market doesn't look great. North American inventory continues to flirt with records. OPEC hasn't cut production like many people predicted it would. And Iran will soon be free to market its crude freely.

But over the long term, there is light at the end of the tunnel. Lower prices means no new wells will get drilled. And demand should keep on ticking up as the developing world continues to expand. There's an argument to be made that folks bullish on oil should be cheering lower prices, since that will flush excess production out of the system.

Penn West is risky, there's no doubt about that. But the stock is cheap enough that it could be a real winner if it survives the low price in crude.

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