I Just Sold My Penn West Petroleum Ltd. Shares: Here’s Why

Description

Since the latter part of 2014 I’ve been singing the praises of **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE).

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After years of mismanagement–including a minor accounting scandal–the company finally had competent oil industry vets in charge.

Insiders were buying shares like crazy when the price of crude first began its free fall back in 2014. The company was actively reducing debt by selling non-core assets–a tactic I figured would be enough to get the company’s balance sheet healthy. And from a book-value perspective, the stock looked ridiculously cheap. When I was buying, tangible book value was approximately $10 per share.

It looked to me that Penn West was a very typical value stock. All the company needed was for the price of crude to cooperate, and it would start to recover. Either that or management would make the decision to sell to somebody with much deeper pockets. Penn West has plenty of reserves compared to its current production, which is usually what the big players in the sector look for.

Alas, it was not to be. Crude continued to crater in 2015 and is currently trading for about $32 per barrel. Penn West has done everything it can to weather the storm, including selling off more non-core assets, slashing its dividend, and negotiating with bondholders to relax the covenants on its debt. It also instituted a hedging program with the goal to lock in prices for between 25% and 40% of its crude production.

These are all smart moves. But at the same time, my investment in Penn West came down to one simple fact: at $32 per barrel of crude, there’s no way Penn West can survive over the long term.

Too many problems

Penn West’s recovery hinges on two things it can’t really control: the company needs crude to recover and it needs to be able to sell assets to pay down the debt.

There’s little indication that oil is about to go much higher. Saudi Arabia and other OPEC members have no desire to turn off the taps. These countries see the bankruptcy of Penn West (and dozens of other producers like it) as their way of breaking North American producers. Once this extra production leaves the market, prices should return to higher levels. But this could take years.

The issue is that hardly any production is leaving. Companies are getting by because costs have come down considerably. Layoffs and wage cuts across the sector makes drilling cheaper than it's been for years. Lower fuel costs are helping as well, especially in the oil sands.

Besides, a company like Penn West can't just shut down, even though it might be prudent to do so at this point. It needs to generate all the cash flow it can to pay the interest on the debt. The hope is for asset sales to cover the debt that's coming due in 2016, but it's going to be tough to get a good price for these assets when most of the rest of the sector is contracting, not expanding.

The other big issue is the decline in the Canadian dollar. Although Penn West has raised nearly $1 billion by selling off spare assets, its total debt has actually gone up in the last year, rising from $2.19 billion to $2.25 billion. The reason? Most of it is denominated in U.S. dollars and then converted back to Canadian. Net debt should improve to approximately $2 billion thanks to a couple of more recent asset sales, but Penn West still owes too much.

The company has more than $500 million in debt due by the end of 2017, which is evenly split between 2016 and 2017 maturities. Without further asset sales, Penn West would be forced to use its bank facility to refinance the debt. With $600 million left as a borrowing limit the company could, in theory, be fine. But then it has no further credit available. That's it.

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All this combined with the danger of Penn West losing its listing on the New York Stock Exchange made me sell my shares at a loss. I'd rather get some of my capital back and put it to work than continue to watch a story I think will inevitably end in bankruptcy.

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