Are Penn West Petroleum Ltd.'s Cuts a Sign of an Impending Oil Rebound?

Description

On Thursday morning **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) announced its capital budget for 2016, and in so doing, painted a very grim reality of the company's future.

We take a closer look below at what this means for Penn West as well as for the sector.

A steep drop

It's no secret that Penn West is in trouble. The company has suffered terribly from the fall in oil prices, which has made its debt load harder to handle. Assets have been sold in response, but of course it's hard to get a decent price in this environment.

So Penn West is clearly backed into a corner, and the company is responding the only way it can: slashing its budget. In 2016 the company plans to spend only $50 million on capital expenditures, a 90% drop from 2015 levels.

As a result, Penn West is anticipating production to total only 60,000-64,000 barrels of oil equivalent per day, down from 77,000 at the end of last year. And despite the cuts, Penn West still may not generate enough funds to cover its capital budget. Based on current strip pricing, the company is projecting funds flow from operations between $0 and 40 million.

A takeover is needed

It's too bad that Penn West is forced to cut production at a time when labour and equipment costs are so low. In an ideal scenario, the company would be taking advantage of this low-price environment to grow production, and then benefit from this growth when prices recover. But this is the reality of having a poor balance sheet.

This also means that Penn West makes a great takeout candidate. If the company's assets were owned by a more stable producer, then perhaps those assets would be used more effectively.

What this means for the industry

Analysts and energy insiders have been predicting an oil rebound for months now, but so far that hasn't happened, primarily because production has been so resilient.

So in an odd way, Penn West provides some hope for the sector. After all, it is not the only energy producer with a poor balance sheet, and if more producers take similar actions, then eventually production will fall more significantly. Only then will we see the price rebound that so many are predicting.

It also serves as a stark reminder: while companies like Penn West have a lot of torque to oil prices, its stock may not be the best way to bet on a rebound. After all, the rebound may very well be caused by production cuts (or even worse, bankruptcies) from these sorts of companies. So you should tread very carefully.

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