Will Penn West Petroleum Ltd. Dig Itself out of its Financial Hole?

Description

Penn West Petroleum Ltd. (TSX:PWT)(NYSE:PWE) reported fourth-quarter results on Wednesday, and they were ugly to say the least. The company posted a loss of $1.6 billion for the quarter, or $3.20 per share. Funds flow per share came in at just $0.01, well short of the $0.07 average analyst estimate. The company's Canadian-listed shares fell by more than 10% on the news.

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And there's an even bigger problem: Penn West's balance sheet. We'll take a closer look and try to determine if the company's debt load is too onerous to overcome.

A mountain of debt

Even before oil prices began to plunge, Penn West was struggling with its balance sheet mainly due to an over-acquisitive history and operational missteps. So when oil prices fell, it put a serious strain on the company. It's no wonder the shares have fallen by 95% in the past five years.

To deal with the problem, Penn West has sold off nearly $2 billion worth of assets since the second quarter of 2013. But it hasn't been enough.

Penn West's debt is equal to 4.6 times earnings before interest, taxes, depreciation and amortization (EBITDA). This is a big problem, because a covenant states that this ratio cannot go above five. Making matters worse, the maximum ratio drops to 4.5 after the second quarter is over. The company has acknowledged that unless oil prices recover sharply, these covenants must be renegotiated.

Renegotiating covenants

It looks like Penn West will have to renegotiate its debt covenants, and this is actually something the company has done before. At the beginning of last year, Penn West convinced lenders to raise the maximum debt-to-EBITDA ratio from three to the current five.

But this did not come for free. In exchange for relaxing covenants, Penn West's lenders forced the company to reduce its dividend. Penn West also had to agree to higher interest rates as its debt level increased. Finally, the company had to agree that any funds from asset sales had to go towards debt reduction.

The verdict

There is very little in the energy sector that can be predicted with certainty. But we can be reasonably be sure that Penn West will renegotiate its covenants. We just don’t know what it’s going to cost the company. After all, the dividend has already been lowered to zero, so that’s one less carrot that can be dangled in front of the lenders.

Of course, Penn West’s fate will be determined by oil prices, and given the company’s current situation, it has as much to gain as any other company from an oil rebound.

There’s another possibility: Penn West could get taken out. Such an outcome would make as much sense as ever, since an acquirer wouldn’t have to renegotiate any covenants. Thus there’s a possibility for a win-win situation.

But if you’re thinking of investing in Penn West, make sure you commit a very small amount of money–certainly no more than you’re willing to lose. This remains one of the riskiest options in Canada’s energy patch.

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