Can Penn West Petroleum Ltd. Survive?

Description

There has been considerable conjecture among analyst regarding whether or not deeply troubled upstream energy company **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) can survive low oil prices. The company is heavily indebted and faces a range of headwinds that could derail management's plans to stave off bankruptcy until oil prices rebound.

Now what?

Key among Penn West's problems is its mountain of debt. During the boom years, it gorged itself on debt that was used to acquire a range of oil assets–many of dubious quality. As a result, Penn West now finds itself burdened with $1.9 billion in long-term debt in a difficult operating environment where the viability of its operations is questionable.

For these reasons, Penn West was able to renegotiate its financial covenants in 2015 in order to obtain some relief. This saw its senior debt and total-debt-to-EBITDA ratios lifted to 5:1, but only for a temporary period; they are set to revert to their original levels by the end of 2016.

However, all this essentially did was kick the debt can further down the road because management at the time were overly optimistic that oil prices would have recovered by now. This has not occurred and leaves Penn West in danger yet again of breaching these covenants, despite having completed $800 million of asset sales in 2015, the proceeds of which were used to repay debt.

You see, by the end of the second quarter 2016, both covenants fall to a ratio of 4.5:1 and then to 4:1 after the third quarter. With Penn West's senior debt and total-debt-to-EBITDA ratios now being 4.6, those covenants must be renegotiated yet again, and this comes at a cost. These costs include temporarily granting floating security over all of its property to its lenders, reducing its dividend, making further asset sales, and paying higher financing costs.

Now in a desperate measure to avoid breaching these covenants, Penn West is looking at other alternatives to accelerate its debt repayments, including monetizing $50 million in positive value from its foreign exchange hedges.

Another of Penn West's problems is that despite savagely cutting costs, it still has particularly high cash costs of $20.49 per barrel. These are higher than many of its peers, such as **Crescent Point Energy Corp.** and **Pengrowth Energy Corp.,** which have cash costs of US$17.30 and US$17 per barrel, respectively.

This highlights that Penn West is struggling to generate a decent margin from its oil production in an operating environment where West Texas Intermediate (WTI) continues to trade at about US$40 per barrel. The margins it is able to generate are also being squeezed by the discounts to WTI that apply to Canadian crude blends. Western Canada Select, or heavy crude, currently trades at a 33% discount to WTI, whereas as Edmonton mixed sweet or light oil trades at a 10% discount.

Then there is the issue of declining oil production, which is impacting revenue. For 2015, output fell by 17% year over year, and it is expected to fall yet again in 2016 by a massive 23%. This can be attributed to the savage cuts made to capital expenditures and ongoing asset sales.

So what?

Penn West has its work cut out if it is to survive, and there are signs that if crude falls further and/or remains weak for a sustained period, the time may come where the company will be forced to aggressively restructure. These types of restructures typically leave little to no value for shareholders, which, in conjunction with the current market conditions, highlights just how risky an investment in Penn West is.

CATEGORY

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Date
2025/10/01
Date Created
2016/03/18
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