Is it Time for Pacific Exploration and Production to Turn Off the Lights?

Description

The sustained weakness of oil prices continues to weigh heavily on oil stocks. Consulting firm Deloitte estimated that up to one-third of all oil companies could go bankrupt this year. It now appears that the rout in crude has claimed its next victim: deeply troubled Latin American-focused oil company **Pacific Exploration and Production Corp.** (TSX:PRE).

The company carries an unmanageable debt burden and is battling to shore up its balance sheet in the harshest operating environment the oil industry has experienced in almost a decade. The latest news indicates that Pacific Exploration is now headed for bankruptcy.

Now what?

Pacific Exploration has been struggling to remain profitable in the current harsh operating environment because of its high variable costs of production; it has cash costs of US$27 per barrel, which are far higher than many of its peers. These, along with markedly lower oil prices, are causing its financial position to deteriorate.

The key threat to Pacific Exploration's survival is its massive US$5.4 billion in debt.

This debt, in conjunction with deteriorating cash flows, has made Pacific Exploration struggle to shore up its overleveraged balance sheet, meet debt repayments, and avoid breaching its financial covenants.

It attempted to do this by selling a range of assets, including its interests in a number of oil pipelines in Colombia. This has not been successful because weak oil prices weigh heavily on asset prices, making it a buyers' market.

As a result, Pacific Exploration has already breached a number of its financial covenants and has elected to defer US$66 million in interest payments in the hope that it could restructure its debt in order to survive. It placed itself on the market and is considering buyout offers; **EIG Global Energy Partners** offered US$4.1 billion for its senior bonds.

However, EIG has withdrawn that offer because of growing concerns over the outlook for crude and Pacific Exploration's deteriorating financial condition.

Now with the clock fast running out on the grace period for the US$66 million interest payment, bondholders could agree to give Pacific Exploration more time to negotiate a deal, but they could also demand immediate payment and force the company into bankruptcy.

As a result, it appears that Pacific Exploration will be unable to continue**.**

So what?

This is a stark reminder of just how dangerous debt can be because oil companies are beholden to volatile commodity prices. It also highlights the dangers facing other heavily indebted oil companies such as **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) which is struggling not to breach its financial covenants.

In 2015, Penn West was able to renegotiate its covenants, lifting the total-debt-to-EBITDA ratio to 5:1, but only for a temporary period; it reverted to its original level by the end of 2016. This was done with the hope that oil prices would recover during that period, but this has not occurred. Penn West is still struggling to survive with its debts totaling more than $1.9 billion.

The predicament that Pacific Exploration now finds itself in illustrates the very real risks investors face when betting on a recovery in crude by investing in troubled energy stocks.

CATEGORY

1. Energy Stocks
2. Investing

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1. TSX:FEC (Frontera Energy Corporation)

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