High Yielding Oil and Gas Stocks: Are There Signs of Imminent Dividend Cuts?

Description

After recently reported third quarter results, I thought it would be a useful exercise to review the sustainability of some of the oil and gas stocks that currently have high dividend yields. Further to this, what are the signs that investors should look for that would point to imminent dividend cuts?

High Payout Ratio

It's important to look beyond the simple payout ratio (dividends dividend by cash flow) when evaluating dividend sustainability. A better picture of dividend sustainability can be obtained by evaluating the all-in payout ratio (dividends + capital expenditures/cash flow).

The higher the payout ratio, the less sustainable it is. **Bonterra Energy** (TSX: BNE), with a 6.10% dividend yield, and **Baytex Energy** (TSX: BTE), with a 6.20% dividend yield, both have high all-in payout ratios of 125% and 141% respectively. **Crescent Point Energy** (TSX: CPG) has a dividend yield of 6.76% and a payout ratio that is even higher, at 147%.

Twin Butte (TSX: TBE), which has a dividend yield of 8.53%, has seen its all-in payout ratio decline to a more comfortable 80% for the first nine months of 2013 versus over 100% for the last few years.

High Debt Burden

As we all know, the higher the debt burden of a company, the riskier it is. Investors should really start to be concerned when the debt to cash flow ratio hits 1.5x or greater. Currently, Twin Butte has a debt to cash flow ratio of 1.35 times, Crescent Point is at 1.27 times, and Bonterra Energy is at 1.17 times.

Slowing Production Growth

While Bonterra Energy saw increased year-over-year production in the third quarter, quarter-over-quarter production declined 6.5%, reflecting natural gas declines as well as shut in production. While one quarter doesn't necessarily mean we should be concerned, as one-time events happen, investors should keep a close eye on this when evaluating the sustainability of the dividend. And although the company's all-in payout ratio has crept lower and stands at 125% (versus 145% in 2012), this is still an unsustainable level.

Twin Butte on the other hand, reported an 18% increase in third quarter production, which is a very welcome result for investors in the stock. This follows a second quarter disappointment, when production was 3% lower than expected. The decline was caused by extremely wet weather and a prolonged spring break up, as well as problems with the reservoir at the Primate Property, which has been experiencing increased water inflow.

Declining Commodity Price Outlook

This one is obvious and would affect all oil and gas companies. However, the companies with higher payout ratios, higher debt burdens relative to their cash flow, and with slowing production growth will suffer proportionately more.

Bottom Line

A situation where a company has a payout ratio that exceeds its cash flow is not sustainable – especially when paired with already high levels of debt. The high yields are very attractive while they last but investors should watch carefully for signs that it is coming to an end. The more of these signs that are present, the greater the likelihood that the dividend will need to be cut.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:BNE (Bonterra Energy Corp)
2. TSX:BTE (Baytex Energy Corp.)
3. TSX:VRN (Veren Inc.)

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