Is Long Run Exploration's New Dividend Yield Worth the Risk?

Description

Canadian intermediate oil producer **Long Run Exploration** (TSX: LRE) has recently completed the transition to a dividend plus growth company, and is committed to paying a regular dividend and annual share growth. This sees it following in the footsteps of a number of accomplished players in the patch, including light-oil heavyweight **Crescent Point Energy** (TSX: CPG)(NYSE: CPG) and **Whitecap Energy** (TSX: WCP).

But the key question for investors is whether Long Run is capable of effectively executing this strategy, or whether it will fail spectacularly like **Penn West Petroleum** (TSX: PWT)(NYSE: PWE) and **Lightstream Resources** (TSX: LTS).

What is a dividend growth company?

The key premise of a dividend growth company is the payment of a monthly steadily growing dividend that is funded by consistently growing funds flow from operations while continuing to grow the company's core value.

This is typically done through a combination of organic growth and accretive acquisitions. Already, Long Run has indicated it will continue to grow production through a combination of acquisitions and developing existing assets.

Sterling first-quarter results

Long Run is focused on the development, acquisition, exploration, and production of oil and natural gas in the Peace River and Edmonton regions of the Western Canadian Sedimentary Basin. The company has a solid history of growth, with funds flow from operations in the first quarter of 2014 growing a healthy 25% compared to the previous quarter, and a massive 44% compared to the first quarter of 2013.

This solid growth in funds flow from operations can be attributed to growing production and higher realized crude and natural gas prices. Crude production, despite falling 5% quarter over quarter, shot up a healthy 8% year over year to 25,613 barrels of oil daily, allowing Long Run to take full advantage of the spike in oil prices during the same period.

The company's core profitability continues to grow, with its operating netback for the first quarter up a spectacular 35% quarter over quarter and 31% year over year to $36.55. This is one of the lower operating netbacks in the patch, being significantly lower than Lightstream's $56.11, Crescent Point's $52.65, Whitecap's $45.80, and Penn West's $36.67, but I expect this netback to continue growing as production operations mature.

Drilling success rate is 100%

Long Run is also enjoying considerable exploration and development drilling success; it has a drilling success rate of 100% for the quarter after drilling almost 48 wells.

The company also acquired further liquids-rich natural gas assets in the Cardium and Deep Basin areas of Alberta, which are located close to its existing properties, for $225 million. In 2014 alone Long Run expects to drill five wells on the properties that form part of this acquisition. This acquisition provides further opportunity for production growth while allowing Long Run to leverage its existing assets located nearby.

Even more promising for investors is management's promise to increase the monthly dividend payment by 5% once the deal is completed in late May or early June of this year. This will see Long Run paying a monthly dividend of $0.035 per share, giving it a very tasty yield of just over 7%.

After the increase, the dividend will represent a mere 19% of funds flow from operations, making it appear sustainable at this time. This yield is also one of the more attractive yields in the patch and is higher than Whitecap's 5%, Penn West's 5.6%, Crescent Point's 6.2%, and Lightstream's 6.5%.

Proceed with caution

But despite the attractive dividend yield, investors should still show some caution, as the company's operations have not reached the degree of maturity of Crescent Point's or Whitecap's and its management does not have the proven track record displayed by those companies.

Another worrying aspect of Long Run's operations is that a significant portion of its production is made up of dry natural gas, which has a lower margin and far more volatile prices than crude or natural gas liquids. For the first quarter of 2014, crude made up 50% of total hydrocarbons produced whereas natural gas liquids made up 6%, and the remaining 44% was composed of dry natural gas.

In contrast, higher-margin crude makes up more than 80% of the total hydrocarbons production of companies such as Crescent Point, Whitecap, and Lightstream Resources. This allows those companies to generate significantly higher profit margins from their operations as highlighted by higher operating netbacks, leaving them less reliant on volatile natural gas prices.

For many of the reasons discussed above, Long Run does represent an interesting opportunity for income-hungry investors. But the company is not without risk, primarily due to the lack of maturity of its operations and the fact that a significant portion of its production is made-up of lower-margin natural gas.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:VRN (Veren Inc.)
2. TSX:WCP (Whitecap Resources Inc.)

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