3 Champions From the Patch Yielding Over 6%

Description

Canada's oil patch is shaping up to be a gold mine for investors. Higher crude prices and narrowing price differentials for Canadian crude blends compared to West Texas Intermediate are driving higher funds flow from operations, margins, and profitability among its players.

This is creating further support for the dividend growth model utilized by a number of players in the patch to attract and reward loyal investors. Central to this model is a regular steadily growing dividend with a high yield supported by increasing cash flow from operations. Typically this is centered on growing the company's core assets — its oil reserves — as well as production through accretive acquisitions and organic growth.

There are now a number of players in the patch paying dividends with yields well in excess of 6%; they also have appreciating share prices as their oil reserves, production levels, and cash flows continue to grow. But when seeking income-generating companies in a capital-intensive industry subject to a range of risks, it is important to find those with sustainable dividend payments and sufficient size to weather any downturn in crude prices.

So let's take a closer look at three companies from the patch with market caps over $1 billion and yields in excess of 6%.

This newcomer to the patch pays a hefty dividend yield

A relative newcomer, light oil producer **Surge Energy** (TSX: SGY) pays one of the highest dividend yields in the patch at just over 8%, making it a compelling addition to any income-focused portfolio.

More compelling is that such a massive dividend yield appears sustainable, with Surge having an all-in sustainability ratio of 89% and its funds flow from operations continuing to grow. This is a key measure of an oil producer's performance.

For the first quarter of 2014, Surge's funds flow from operations grew a stunning amount compared to the previous quarter and 109% compared to the equivalent quarter in 2013. This was because crude production jumped a stunning 23% quarter over quarter and 56% year over year. Two other drivers were higher realized crude prices and a significantly higher operating netback, which shot up 24% quarter over quarter and a monster 49% year over year.

Even more compelling is that Surge maintains an all-in payout ratio of less than 100% while paying a monster dividend yield with no dividend reinvestment plan in place. This removes the dilutive effect such a plan has on existing investors, particularly those who elect to take their dividend in cash.

This light oil heavyweight continues to deliver for investors

Crescent Point Energy (TSX: CPG)(NYSE: CPG) has been talked about relentlessly by analysts, but it is hard to resist in any income-focused share portfolio. It has become a perpetual favorite with investors because of its consistent dividend payments, dividend yield in excess of 6%, and consistently strong operational performance.

Much of this can be credited to the company's management team, which is one of the best in the patch, having identified a number of accretive acquisitions over the last few years that have grown the company into a light oil titan.

But there is growing concern in the investment industry regarding the sustainability of Crescent Point's dividend and the dilutive impact of its dividend reinvestment plan on investors. Right now, Crescent Point's dividend yield as a proportion of net income is clearly unsustainable at well over 300%, but as a portion of funds flow from operations it is a sustainable 50%.

However, after capital expenditures have been deducted from funds flow from operations, this ratio moves to well over 100%, creating a working capital deficit, which is funded with debt. This means Crescent Point's level of debt creeps up each quarter.

Another issue is the DRIP, which is diluting the share holdings of other investors, causing Crescent Point's total share float to grow by over 23% since the second quarter of 2012.

While this is not overly significant, it does highlight that investors, particularly those who take dividends in cash, may see the value of their investment return drop significantly if Crescent Point is unable to continue growing crude production and funds flow from operations.

Will this intermediate oil producer's turnaround strategy work?

After gorging itself on debt to fund marginal acquisitions and an unsustainable dividend payment, intermediate crude producer **Pengrowth Energy** (TSX: PGF)(NYSE: PGH) found itself in trouble. Debt was spiraling out of control and cash flow, along with funds flow from operations, started shrinking, leaving it vulnerable to a downturn in crude prices.

As a result, management implemented a turnaround strategy aimed at conserving capital and rebuilding its shattered balance sheet, a key part of which was slashing the dividend by almost 50%. But this still left Pengrowth with a tasty dividend yield in excess of 6%. With the turnaround strategy starting to unlock value, it appears that Pengrowth's monster yield is approaching sustainability.

The dividend as a proportion of funds flow from operations is a very sustainable 45%, while funds flow from operations continues to grow, enhancing this sustainability. For the first quarter of 2014, it shot up a healthy 32% compared to the previous quarter despite falling crude production caused by the divestment of non-core producing oil assets. Another sign of the growing sustainability of Pengrowth's dividend is that the profitability of its oil production continues to grow, with its operating netback jumping a stunning 43% compared to the previous quarter and 20% year over year.

All three players in the patch offer investors very tasty dividend yields and the security that comes from investing in a larger company with more mature operations. While there may be a question mark hanging over the sustainability of Crescent Point's and Pengrowth's dividends, the management teams of both companies are working hard to ensure that funds flow and operating netbacks continue to grow, making them a compelling investment for income-hungry investors.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:VRN (Veren)
2. TSX:SGY (Surge Energy Inc.)
3. TSX:VRN (Veren Inc.)

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