Does Crescent Point Energy Still Have Room to Run?

Description

For some time I have been a huge fan of **Crescent Point Energy** (TSX: CPG)(NYSE: CPG). Not only does the company continue to pay a monster dividend yield of just under 7%, but it also continues to exhibit solid growth potential. However, I am not certain whether I agree with a number of analysts who are now claiming that the stock has significant space left to run, with some claiming its shares could appreciate by up to 49%.

The majority of these claims centre on Crescent Point's acquisition-focused business model, which continues to see oil reserves and production grow along with its extensive existing crude reserves, but there are a range of issues that investors need to consider before taking the plunge into one of the patch's most successful companies.

Rewards investors through a dividend plus growth operating model

One of the most attractive aspects of Crescent Point for investors is its monthly dividend, with a yield of almost 7%, which is one of the highest in the patch. However, this yield has for some time raised a number of questions among the investment community as to whether it is sustainable.

This is because if its dividend payout ratio is calculated using the standard method of dividends paid divided by net income, it has a payout ratio of 500%, suggesting that over the long term that it is unsustainable. However, when cash flow from operations is used in place of net income, this ratio drops to a very sustainable 54%.

The second methodology is superior to the first because oil exploration and production is a capital-intensive business where cash flow is king. In addition, net income includes a range of non-cash items that can distort the payout ratio.

However, a worrying trend is that once capital expenditures for the development of existing assets are deducted from operational cash flow, a key requirement to sustain production, the payout ratio is once again well over 100%, and thus too high to be sustainable. This consistently leaves Crescent Point with a working capital deficit quarter after quarter. This deficit needs to be funded either through increased cash flow, by taking on further debt, or both.

Growing net debt

As a result, Crescent Point's net debt continues to rise quarter over quarter. For the first quarter of 2014, net debt grew 10% compared to the previous quarter and 18% in contrast to the equivalent quarter in 2013. Despite this reliance on debt to fund its working capital and accretive acquisitions, Crescent Point has a relatively low level of leverage. It has net debt of 0.3 times equity and 1.8 times operating cash flow, which is lower than many of its peers, highlighting the strength of its balance sheet.

What does all of this mean for investors?

Crescent Point must continue growing cash flow by growing its oil production. To date, the company has been able to successfully do this by making a series of accretive light oil acquisitions and further developing existing oil assets. As a result, for the first quarter of 2014 oil production shot up 2.3% quarter over quarter and a healthy 11% year over year.

There are also signs that Crescent Point will continue to successfully grow crude production, and hence cash flow, with its recent acquisition of CanEra Energy. This has allowed Crescent Point to issue a new full-year guidance that saw oil production grow a healthy 5%, and cash flow 6%, compared to the previous guidance.

But the high dividend yield, coupled with a payout ratio of greater than 100% of operating cash flow after the deduction of capital expenditures, highlights that Crescent Point is focused on delivering value for shareholders through dividend payments rather than reinvesting cash flow to further develop existing assets. It also indicates the risks the company faces should appropriate acquisitions dry up or the price of crude suffer a significant fall.

For all of these reasons, while I expect Crescent Point's share price to continue appreciating in value for as long as crude prices continue to rise, I don't expect to see any significant appreciation for the foreseeable future, with the company rewarding investors through its dividend rather than capital growth.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:VRN (Veren)
2. TSX:VRN (Veren Inc.)

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