How Will Plunging Crude Prices Affect Monster Dividend Yields in the Patch?

Description

There is a lot of pressure on players in the energy patch, with many of them paying monster dividend yields predicated on ever-rising crude prices. But many are also set to feel the crunch as crude prices slide further south despite supply-side constraints caused by ongoing conflict in the Middle East.

Year to date, West Texas Intermediate has dropped 3%, while Brent's is down 12%. I expect this trend to continue for as long as U.S. light sweet crude production grows and declining economic growth in China and the eurozone causes energy demand to fall. This will apply significant pressure on many of the companies in the patch currently paying sizable yields and any sustained downturn will force many to slash their dividends.

Let's take a closer look at the four largest dividend yields of companies with a market cap of $500 million or greater to see if they are under threat.

Twin Butte Energy Ltd.

Intermediate oil producer **Twin Butte Energy Ltd.** (TSX: TBE) has the honor of having the juiciest dividend yield in the patch at 11% and a total payout ratio of less than 100% that appears sustainable.

Its share price was slammed by the market earlier this year when it released revised guidance, with forecast production 6% lower than originally expected. This was primarily because of higher-than-expected decline rates at its vertical wells, so the company is transitioning to horizontal well drilling, which should see decline rates fall and improve efficiencies.

Twin Butte is also focused on boosting its netback per barrel, which with current softer crude prices will allow it to maintain cash flow in addition to its second-quarter netback of $29.85 per barrel, or a 4% increase quarter over quarter and 14% year over year.

Twin Butte is taking measures to ensure cash flow continues to grow despite softer crude prices, further ensuring the sustainability of its dividend.

Lightstream Resources Ltd.

Troubled intermediate oil producer **Lightstream Resources Ltd.** (TSX: LTS), even after slashing its dividend by 50% in late 2013, takes second place with its dividend yield of 9%. The current dividend appears sustainable with a payout ratio as a portion of net income a conservative 54%.

More importantly for the sustainability of the dividend in an operating environment with softening crude prices ,Lightstream generates one of the best margins or netbacks in the patch, which for the second quarter was $57.49 per barrel.

Furthermore for its 2014 guidance Lightstream has used a conservative average annual price of $95 per barrel for WTI, while expecting oil production to fall slightly as it divests itself of non-core assets.

All of this indicates that it will achieve its guidance and ensures the sustainability of its dividend.

Pengrowth Energy Corp.

Third place is awarded to **Pengrowth Energy Corp.** (TSX: PGF)(NYSE: PGH) for it 7.5% dividend yield, but unlike Twin Butte and Lightstream, there are concerns regarding the sustainability of its yield.

The company has been bleeding red ink over the last six consecutive quarters and reported a net loss for the full-year 2013 and continues to pay a dividend that is greater than funds flow from operations after the deduction of production-sustaining capital expenditures.

Any significant and sustained decline in the price of crude will hit the company hard as it continues to report an unsatisfactory netback, which for the second quarter was a mere $23.86. and if there is a sustained drop in crude prices, it will struggle to maintain its dividend.

Penn West Petroleum Ltd.

The fourth-largest dividend yield of 7% is paid by **Penn West Petroleum Ltd.** (TSX: PWT)(NYSE: PWE). As with Pengrowth, though, there are a number of red flags concerning its sustainability.

The company has been swimming in red ink for some time, reporting a net loss for four out of the last five quarters. While the payout ratio as a proportion of funds flow from operations is a mere 26% since Penn West slashed its dividend after second-quarter 2013, there is a shortfall after allowing for production-sustaining capital expenditures and dividend payments.

Penn West has been funding this shortfall from the proceeds of asset sales, but this obviously can't continue indefinitely. Its options aside from cutting the dividend are to slash capital expenditure, boost production, and try to achieve a higher realized sale price per barrel of crude.

However, that's not likely to happen soon. With existing sustaining capex required to support existing output, production continues to decline as Penn West sells off assets and crude prices are expected to soften further. Essentially the only option for Penn West is to yet again cut its dividend.

While Twin Butte and Lightstream are not the most popular companies on the market due to perceived operational problems, they appear to be on far better footing than either Pengrowth or Penn West. They are more likely to sustain their dividends even if the price of crude falls further, while the latter two will be hard-pressed to do so.

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Date
2025/10/02
Date Created
2014/09/16
Author
mattdsmith