Will Lower Crude Prices Threaten Talisman Energy Inc.'s Dividend?

Description

Softer crude prices have hit diversified global oil explorer and producer **Talisman Energy Inc.** (TSX: TLM)(NYSE: TLM) hard, with its share price plunging 45% over the last three months. This now leaves it with a dividend yield of 5%, the sixth highest in the **S&P TSX 60 Index**. But with a payout ratio in excess of 100%, coupled with one of the lowest netbacks in its industry – a mere $25.06 per barrel for the third quarter 2014 – I believe the dividend is under threat.

Let me explain why.

1. Talisman's myriad problems can be attributed to the low quality of a significant portion of its oil assets.

Among these, the most questionable are its North Sea assets, which continue to drag down the company's overall performance. These assets are among its least productive assets and have some of the highest operating and royalty costs of any of Talisman's assets. For the third-quarter 2014 royalties and operating costs came in at $52.33 per barrel or 57% higher than its U.S. assets.

This makes them a key reason for the particularly low netback, which leaves Talisman especially vulnerable to lower crude prices and weaker industry fundamentals.

2. Production and cash flow growth remains flat.

This is primarily because of its asset divestment program with the company focused on selling its non-core and lower quality assets, while investing in its higher quality assets. But to date, while it has made some significant progress with this divestment program it is still burdened with a range of lower quality higher decline rate assets, which are unattractive to potential buyers.

These assets possess high decline rates, meaning Talisman has to continue injecting significant capital to develop those assets in order to maintain oil production. This makes them a significant financial burden, and with cash flows set to plunge because of weaker crude prices, it will be increasingly difficult for Talisman to maintain the required capital expenditures to sustain production.

3. Talisman remains heavily indebted.

Despite the company divesting itself of $721 million of assets over the last year and a half, the proceeds of which were used to reduce its mountain of debt, it is still carrying net debt of US$4.5 billion. This amounts to 2.4 times its operating cash flow and a debt-to-equity ratio of 0.56. Such a high level of debt reduces the company's operational and financial flexibility, while leaving it burdened with considerable financial obligations including annualized interest costs of over $300 million.

These financing costs will essentially remain unchanged, until Talisman is able to fund further debt repayments or restructure its debt. This means they will have a severe ongoing impact on Talisman's cash flow, particularly with it set to fall on the back of significantly softer crude prices. The end result will be less cash flow available to meet other financial obligations including dividend payments and production sustaining capital expenditures.

When accounting for all of these issues, the end result could be a cash crunch caused by softer crude prices, declining cash flow, and falling production, forcing Talisman to cut expenses — including the dividend — in order to preserve capital. I believe this makes Talisman dead money for investors and an energy company to be avoided.

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