Is Surge Energy Inc.'s 14.5% Dividend Safe?

Description

Energy stocks are drowning — in a sea of $50 oil.

When crude was trading in triple-digit territory, life was good in the energy patch. Producers had a virtual licence to print money. But now that oil has plunged 40% in just a couple of months, the industry is feeling the pinch.

It doesn't take a PhD to figure this out — producers are earning less money on every barrel of crude they haul out of the ground. As a result, these companies could soon be forced to cut spending, slash dividends, and abandon buyback programs.

Case in point: **Surge Energy Inc** (TSX: SGY). Since late August, shares are off more than 50%, making it one of the worst performers on the Toronto Stock Exchange. And given that the stock now sports a dividend yield north of 14%, it's becoming obvious that the current payout is no longer sustainable.

Can Surge Energy keep the dividends coming?

Income investors have long adored Surge Energy. It was an early adopter what's called in the business the 'growth-plus-yield' model. The company aimed to deliver respectable 5% to 10% growth combined with a sensible dividend and a strong balance sheet.

The secret to the business's success hinged on finding assets with low decline rates. Oil well output falls over time. Firms with higher decline rates have to reinvest almost all of their cash flow just to maintain output. However, because production at the company's wells fell so slowly, Surge would have plenty of cash flow left over to lavish shareholders with dividends.

At least, that was the theory. The model worked well when oil was above US$100 per barrel. But at current prices, investors are wondering if Surge can earn enough cash to keep the lights on.

Chief Executive Officer Paul Colborne remains committed to the payout. "We've cut costs on our operating expenses," Colborne told Bloomberg in a Nov. 13 phone interview. "It's exciting because that makes our dividend more and more resilient."

Surge has a few points working in its favour. The company has a $270 million bank credit line. Before oil started plunging, Surge had locked in prices for some of its future production. And if executives need to conserve cash, they can always cut back on capital spending further.

Yet in spite of management's best efforts, the math at Surge no longer works. Oil prices are falling faster than analysts can revise their estimates. But based on consensus numbers compiled by Reuters right now, the firm is expected to earn $0.37 per share over the next year.

However, today Surge pays investors $0.60 per share in distributions annually. That's a whopping 162% of earnings. Even if you focus on cash flow, the business is not generating enough money to fund the current dividend program.

Is it time to bail on Surge Energy?

The numbers no longer work at Surge Energy. Unless oil prices rally sharply from here, the company could be forced to cut its dividend by at least 50% or more.

CATEGORY

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1. TSX:SGY (Surge Energy Inc.)

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rbaillieul