Is Canadian Oil Sands Ltd.’s 14.1% Dividend Safe?

Description

A few weeks ago, I heard from a friend who had purchased shares of **Canadian Oil Sands Ltd** (TSX: COS).

He figured the company – which owns a stake in the massive Syncrude oil sands project – would be a great long-term investment. He backed up the truck and bought the stock in November “for the high yield”, which at the time was about 12%.

The supersized yield apparently didn’t faze him, but it should have. What happened next underscores the most important lesson of dividend investing: stocks with big yields often come with big risk.

On December 4, citing the impact of falling crude prices, Canadian Oil Sands announced plans to cut its quarterly dividend 42% to 20 cents per share. That sent shareholders fleeing.

It’s not the first time investors have been seduced by a big yield. **Baytex Energy Corp** and **Trilogy Energy Corp**, to take two recent examples, have both sported hefty payouts. However, last week Baytex slashed its dividend by 58%. Trilogy was forced to eliminate its dividend entirely.

These cuts should not have shocked anyone. In the face of lower oil prices, energy producers need to conserve cash. The scary part is, another dividend cut could be looming at Canadian Oil Sands.

Cash flow is the most obvious concern. Assuming oil prices at around US$75 per barrel, the company is expected to generate $0.35 per share in free cash flow. However, the firm’s dividend currently stands at $0.80 per share annually.

Those numbers don’t add up. The firm cannot maintain both its current dividend and keep the balance sheet intact. Even if management were to cut the dividend in half once again, the company’s payout would still be beyond its means.

This would be bad enough. However, business continues to deteriorate. Oil prices are in free fall,sitting at US$55 per barrel at the time of this writing. And on Monday, the company announced anoutage at the Syncrude sour water treater.

The news could not have come at a worse time. The project’s production is now expected to come in well below management’s guidance. All of which means the business will be generating much less cash than expected.

If oil prices don’t rebound soon, income investors should be prepared to see their dividend payments cut once again. Personally, to protect the balance sheet, I would like to see the payout eliminated altogether. However, that might send too many income-focused shareholders running for the exits.

That is, if they haven’t exited already.

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Date
2025/10/01
Date Created
2014/12/18
Author
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