Is Another Dividend Cut Looming for Canadian Oil Sands Ltd.?

Description

The carnage in the energy patch continues with a number of energy companies forced to cut their dividends. One of the biggest so far is **Canadian Oil Sands Ltd.** (TSX: COS). It was only earlier this month that it slashed its dividend by 43% to $0.80 per share annually. But with crude prices having dropped further since then, there are growing fears among a number of analysts that Canadian Oil Sands will have to cut its dividend yet again.

Let's take a closer to see whether the new dividend is sustainable in the current operating environment.

Is the revised dividend sustainable?

A key test of dividend sustainability is to calculate the payout ratio, which is traditionally done by dividing total dividend payments by net earnings, with any ratio over 100% deemed to be unsustainable. If we use the consensus analyst estimate for Canadian Oil Sands' 2015 earnings of $0.50 per share, it has a dividend payout ratio of 160%, which clearly is not sustainable.

But I don't believe this provides an accurate picture, with Canadian Oil Sands operating in a cash-intensive industry. This is because net earnings is calculated using a number of non-cash items, and since dividends are cash flows it makes better sense to use cash flow rather than earnings.

If we take Canadian Oil Sands' projected 2015 operating cash flow of $730 million and deduct forecast capital expenditures of $564 million, there is free cash flow of $166 million or $0.35 per share for the year remaining. This is significantly lower than the annual dividend of $0.80 per share that Canadian Oil Sands has committed to paying, with a funding shortfall of $223 million.

In order to fund that shortfall, Canadian Oil Sands could take on more debt, divest itself of assets, or raise equity. But all three are particularly unappealing options in the current turmoil-ridden environment, even more so when its mountain of debt, with net debt totalling $1.7 billion, is considered.

How will lower crude prices impact the dividend?

Of even greater concern is that Canadian Oil Sands has predicated its 2015 financial outlook on an assumed price for West Texas Intermediate or WTI of US$75 per barrel, which is 36% higher than the current price. It is also higher than the price assumptions used by many of its peers, which range between US$60 and US$70 per barrel.

In fact, there are a range of signs that crude prices won't rebound anytime soon. This includes the Saudis' determination to maintain their current level of production despite significantly softer global demand. It will take considerable time for U.S. shale oil producers to wind down uneconomical crude production, meaning global oil supplies will not decline anytime soon.

Finally, the short-term global economic outlook remains pessimistic with fears that the Eurozone may slip into another recession and industrial activity along with construction in China will continue to slow.

This will drive lower demand for oil seeing the supply glut continue, keeping crude under $70 per barrel for the foreseeable future. Each of these factors is being factored into crude prices with December 2015 WTI futures currently trading at just under $60 per barrel and December 2016 WTI futures at $65 per barrel.

If the price of WTI averages $65 per barrel over the course of 2015, then based on Canadian Oil Sands' own calculations, its operating cash flow will fall by $270 million to $460 million. This is significantly less than the current forecast capital expenditure and would leave it with a significant shortfall if it elected to maintain the dividend payment.

What does the future hold?

It is extremely difficult to see how Canadian Oil Sands can sustain its dividend even after slashing it by 43%. Its forecasted free cash flow is insufficient to meet dividend payments and significantly lower crude prices set to erode the basis of its 2015 forecast, clearly leaving only one other choice — yet another dividend cut.

CATEGORY

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