Will Pengrowth Energy Corp. Be the Next Company in the Patch to Slash its Dividend?

Description

The carnage in the energy patch continues unabated with crude prices continuing to fall with the price of West Texas Intermediate or WTI at its lowest point since early 2009. This has forced a number of companies in the patch to brace themselves for a difficult 2015 and take a knife to dividends and capital expenditures. It is now leaving investors and analysts asking the $64 million question, which company will be the next to slash its dividend?

I believe it will be **Pengrowth Energy Corp.** (TSX: PGF)(NYSE: PGH), which after seeing its share price plunge a massive 38% over the last three months, now sports a monster 13% yield. This is despite some analysts claiming its dividend is sustainable because of its hedging program, which sees 77% of its remaining 2014 oil production hedged at $95 per barrel, 63% of 2015 production at $94 per barrel and 33% of 2016 production at $95 per barrel.

Let me explain why.

First, Pengrowth remains burdened by a mountain of debt totalling $1.7 billion.

Even after accounting for cash on hand, this leaves it heavily leveraged, with net debt at the end of the third-quarter 2014 equal to 2.7 times its trailing 12 month operating cash flow. Of greater concern is that it remains free cash flow negative and has been so for the last five straight quarters. It continues to bleed red ink, having reported a net loss for four out of five of those quarters.

For these reasons it is difficult to see how Pengrowth's dividend is sustainable before the impact of significantly lower crude prices is accounted for.

Second, the outlook for crude remains bleak particularly over the short to medium term.

The Saudis have said they will continue to maintain production at current levels and continue aggressive price-cutting as a means of regaining market share. Meanwhile, even with WTI below the breakeven price for many U.S. shale operators, it will take some time for them to wind down uneconomic operations, causing U.S. production to remain unchanged.

The weak economic activity in a number of emerging economies, China and Western Europe is causing demand for crude to decline, which in conjunction with growing supplies will only cause the supply glut to worsen, placing further downward pressure on crude prices. As a result this now sees many analysts forecasting an average WTI price of around US$60 to US$65 per barrel for 2015.

Finally, Pengrowth continues to operate with relative thin margins.

Even with WTI averaging US$108.97 per barrel for the nine months ending September 30, 2014, it has only reported a meagre netback of $26.17 per barrel. This leaves little room to absorb the significant drop in crude prices we have already witnessed.

Based on Pengrowth's own third-quarter price sensitivity analysis and accounting for its existing price hedges and a forecast WTI price of US$80 per barrel, each $1 per barrel decline in price reduces its estimated 12 month funds flow by $3.8 million. If we assume it is likely that WTI will average $65 per barrel for 2015, then Pengrowth's funds flow will be around $443 million or $0.84 per share, which is 11% lower than the lower end of its 2014 fund flow guidance.

With Pengrowth already struggling to be free cash flow and net earnings positive, such a significant drop in funds flow can only further impact the sustainability of its dividend.

It is difficult to see how Pengrowth has been able to previously maintain its dividend. With crude prices expected to remain low for the foreseeable future, it only makes sense for it to cut its dividend to a more sustainable level. This is particularly the case, with Pengrowth being heavily leveraged and committed to continuing development of its Lindbergh thermal project, which requires further considerable capital expenditures for completion.

CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing

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