3 of the Energy Sector’s Safest Dividends: PrairieSky Royalty Ltd, Bonterra Energy Corp, ARC Resources Ltd

Description

Dear Fellow Fools,

Yesterday, **Pacific Rubiales** (TSX:PRE) became the latest in a long line of TSX-listed energy producers to cut its dividend.

Seemingly, Mr. Market had its suspicions that a cut was on the way as the company’s shares actually climbed after the announcement was made. This after declining by 86% over the past 6-months.

Ooof!

Unfortunately, this same painful story has played out over and over again amongst energy producing companies across all markets. An indication that many were woefully unprepared for the decline in the price of oil that has occurred.

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Though many companies were paying out dividends as though oil would stay in the neighborhood of $100 per barrel forever, there were a few good apples in the bunch that had a more realistic approach.

In this week’s Take Stock, we’re going to share the names of a few companies that at least appear to have the capacity to maintain their current payout, for a while anyway.

A word of caution though: If oil stays at its current level for the next couple of years, all bets are off.

First things first

Before we get to the companies, let me give a brief explanation of where a dividend comes from. Make that, “supposed” to come from.

It’s really quite simple. Dividends are meant to be paid out of any excess cash that a company has lying around after it’s taken care of re-investing in the business and tending to other financial obligations. In my mind, the best way to measure a company’s ability to pay a dividend is to calculate a metric known as “free cash flow”.

Free cash flow is calculated by subtracting a company’s capital expenditures from its cash from operations, two metrics that are found on the (underappreciated) statement of cash flows. If a company is consistently generating free cash flow, there’s reason to believe it’s able to sustain an annual dividend.

Plenty of company’s share this characteristic. Very few of them, however, are energy producers, which has always made me scratch my head as to why so many energy producers payout a dividend. These are cash hungry businesses that have to constantly be reinvesting in new projects to ensure their production levels are maintained. It’s rare that, after all of this investment is complete, there’s excess cash laying around to payout to the company's shareholders.

Enough with the lesson

Let's get on to those three companies that are at least linked to, if not directly responsible for, the production of energy and appear able to continue weathering the storm and maintain their current payout:

(Note – one thing you'll notice, none of them offer a yield of 29% like Pacific Rubiales did before it took its medicine and eliminated its dividend.)

PrairieSky Royalty (TSX:PSK)
Current Yield: 4.3%

If there's an energy-related entity that's well suited to paying a dividend, this is it. PrairieSky owns royalties and is paid by producers that want to drill on its land. No capital expenditures, no re-investing to maintain production. The cash that this company brings in is almost entirely "free." In 2014, PrairieSky's cash from operations totalled $317 million and total dividends equalled $141.4 million. Even if there's less drilling on its land – an entirely foreseeable event – there's a sizeable enough buffer between the cash coming in and the dividend going out to absorb even a reasonably material slowdown.

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Bonterra Energy Corp. (TSX:BNE)
Current Yield: 4.8%

Bonterra is a traditional energy producer (vs. PrairieSky) and has already "adjusted" its dividend to reflect the current reality. And historically, they have been entirely guilty of not having enough free cash on hand to cover the dividend.

What gives me some hope that the new dividend is sustainable (again, provided oil doesn't languish at current levels indefinitely) is the balance sheet. The company appears to have balance sheet capacity to endure the current storm and maintain the adjusted dividend. In fact, Bonterra has utilized this financial strength to recently acquire oil and gas assets – a potentially prudent move. Relying on the balance sheet to support the dividend is not an ideal scenario by any stretch, but relative to many in the space that don't have this same financial strength, Bonterra looks good.

ARC Resources (TSX:ARX)
Current Yield: 5.2%

ARC offers a similar scenario as Bonterra. This is a company that historically has not generated enough free cash to support a dividend. However, the company's relatively strong balance sheet gives it a leg-up on much of the space. If there's more trouble ahead, others are likely going to feel it before ARC, thanks to the financial insulation that the company's balance sheet provides.

Though ARC has not embarked on any acquisition activity in recent months, an equity issue back in January put it in position to perhaps prey on others that are in a less secure financial position.

There's more

As you can see, even the “best of the best,” so to speak, of energy producers aren’t ideally suited to paying a dividend.

Which is why it’s important to realize, if it’s energy dividends you’re after, there’s more ways to play than just focusing on company’s directly tied to production as these three are.

Our *Stock Advisor Canada* team (of which I head up) has made **several energy-related, dividend paying recommendations**, and though the share prices have fallen along with the entire industry, we’re as confident as can be that the dividends they offer are sustainable.

We’re talking about companies that serve as the “pick-and-shovels” of the industry and are therefore less dependent on the specific price of the commodity for support. It’s more about activity levels for these entities.

In a recent interview on BNN *Stock Advisor Canada* analyst Taylor Muckerman actually discussed two of these dividend-paying, energy-related recommendations. Take a couple minutes and have look/listen….

The companies that Taylor discusses, though, are just two of the five energy-related recommendations (out of a total of 32) that we’ve made. In fact, these are the two lowest yielding of the bunch.

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And to get the names of the other three (as well as access to all of our recommendations), all you have to do is **click here now** and take advantage of **one of our most significant discounts ever (75% off!)** .

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To your wealth,

Iain Butler, CFA
Chief Investment Adviser, Motley Fool Canada

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2. TSX:BNE (Bonterra Energy Corp)
3. TSX:PSK (PrairieSky Royalty Ltd.)

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