Should Canadian Natural Resources Limited Cut its Dividend?

Description

While many energy companies have either reduced their dividends or completely eliminated them, **Canadian Natural Resources Limited** (TSX:CNQ)(NYSE:CNQ) seems intent on growing its payout. Shares have provided 15 consecutive years of dividend increases with its latest $0.92 annualized dividend declared this month. As we'll see, maintaining its payout (costing roughly $1 billion in cash per year) doesn't come without downside.

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Cost cutting is hitting production

Last year, management cut capital expenditures by roughly 25% to $3.9 billion. For 2016, it anticipates cutting it further to around $3.7 billion. Lower project spending is starting to hit production levels. This year management anticipates output of 809-868 mboe per day compared to 2015 levels of 852 mboe per day. Production will likely come in lower this year. The company only has 5,713 mboe of proved reserves left (18 years at current production), so spending can only stay low for so long.

Management has been promoting its Horizon project, which should come partially online this year. Still, it will take until 2017 until full production is reached (80 mboe per day). The company estimates that wrapping up the project should cost $2 billion this year and $1 billion next year. When finished, Canadian Natural Resources will only need to spend $2.6 billion in 2018 to keep production flat.

High leverage is starting to weigh on shares

Last month, **Moody's** downgraded Canadian Natural Resources's debt to one level above junk status.

"The downgrade of Canadian Natural Resources to Baa3 reflects its diminished cash flow and very high leverage in the currently weak commodities price environment," said Terry Marshall, Moody's senior vice president. "Leverage is further negatively impacted by the significant debt funded capital being incurred through 2017 to complete the Horizon expansion."

Moody's anticipates negative free cash flow of about $2 billion in 2016 with the additional hurdle of two debt maturities totaling US$750 million.

However, things may not be that dire. The company's liquidity position remains strong with $30 million in cash and $3.8 billion in committed lines of credit. Leverage, while elevated, is still well within the firm's debt covenant limits. Even Moody's admits that by 2018 it "expects the company to generate positive free cash flow and exhibit substantially improved leverage."

Will oil recover by 2018?

While negative free cash flow is probable over the next year or two, Canadian Natural Resources is actually in a decent position from 2018 onward. By then, limited capital expenditures and a boost in production should help shore up its finances.

The biggest potential contributor, however, is higher oil prices. Assuming $45.50 a barrel oil in 2018, the company should produce $2.1 billion in *excess* cash flow after dividends and capital expenditures are taken into consideration. That's a pretty good cushion considering oil could rebalance to a level much higher than that.

If you're worried about the company's yield considering low energy prices, you can rest easy if you're in it for the long haul.

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