Looking for Income and Growth? Then Invest in This Defensive Energy Name

Description

For those investors who are not completely sold on the idea of oil going higher and staying there for the foreseeable future, I offer up a suggestion that presents with a lower-risk profile that still some really good upside.

Freehold Royalties Ltd. (TSX:FRU) gives investors income and growth through acquisitions, production increases, and continued oil price increases.

While the dividend yield has declined recently due to stock price appreciation, it is currently at 3.74%, which is still a good yield, and the fact is that the dividend has actually been on the rise.

Given that the bias for the dividend is upwards due to rising oil prices, the company's low payout ratio, strong balance sheet, and stated objective to return cash to shareholders, I think that investors getting into the stock now will surely benefit from a higher dividend going forward.

Solid quarter

As a starting point to this section, let's take a look at the company's third-quarter 2017 results that were announced last week.

The third quarter saw a 16% increase in funds from operations, a 56% reduction in debt, and free cash flow of $8.6 million.

Royalty production, which represents over 90% of total production, increased 7%, and with a total of 69 new leases in the first nine months of the year, which is more than double 2016 levels, Freehold is setting up for a very strong end of the year and 2018.

In fact, management increased its production guidance for the year to 12-12.5 million barrels of oil equivalent (boe).

Dividend increase?

With net debt having been reduced to a mere $38.3 million for a net-debt-to-cash-flow ratio of a mere 0.3 times, and a payout ratio of 69%, the question of whether or not management will institute another dividend hike comes to mind.

With oil prices hovering just below the $60 mark, and drilling activity picking up dramatically on Freehold's lands, this leaves me thinking that it is only a matter of time. In the third quarter, Freehold reported drilling on its lands at 144 locations compared to 48 in the same period last year.

For now, management has stated that they remain focused on debt repayment and on acquisitions.

What makes it a defensive play?

Well, the fact that the company's production is royalty-focused (approximately 91% of production) means that this is a lower-risk business model, as the company doesn't pay any of the costs associated with this production.

The company reduces its dividend in difficult times and increases it again when cash flows are stronger, with the goal of keeping its payout ratio in the 60-80% range.

We are now in a period of rising dividend payments, and depending on your conviction on oil prices, this makes Freehold a strong buy.

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karenjennifer