How Should You Treat This Contrarian, High-Yield Stock?

Description

Natural gas prices have been low. However, some analysts are saying that the oversupply of gas may not be as bad as anticipated, and that if we get a normal winter, we may see some recovery in gas prices.

The problem is that gas producers can't control the gas prices. So, they have to make do with whatever gas prices they're served (or whatever gas prices they have contracted for before). The low gas prices certainly do not work in gas producers' favour right now. That's why low-cost producers should fare better.

Peyto Exploration & Development Corp.'s (TSX:PEY) production mix is about 92% gas, and it is proud to be a low-cost producer. In fact, Peyto focuses its operations on profit and not growth. From 2001 to 2016, Peyto delivered the most profit per dollar of invested capital when compared with nine peers, including three in the United States. In this aspect, it even beat **Canadian Natural Resources**.

Peyto's returns on equity have been positive every single year since 2007. In good years, it had double-digit returns on equity. Not surprisingly, in the last quarter, Peyto had the worst return on equity, but it was still positive at 2.7%.

One of Peyto's biggest problems is that it pays a big dividend. Normally, investors welcome dividends.

However, a humongous yield offered by a commodity stock can spell trouble — specifically, a cut may be on its way.

Peyto stock has declined ~58% in the last 12 months, which almost seems like the market is pricing in the dividend cut. As a result, its yield has been pushed over 9%! The company's December dividend (which was paid on December 15) was intact, but if gas prices stay as low as they are today, the company could cut its dividend next year.

Actually, it would make sense for the company to preserve capital in this harsh environment instead of paying out so much money. And if/when it happens, the market should see it as positive news.

Latest analyst consensus

Over the last 12 months, analysts have reduced Peyto's near-term target. Currently, the Street consensus from **Thomson Reuters** has a 12-month price target of $23.30 per share on the stock, which represents upside potential of +60%.

Contrarian stocks are not for everyone. It's impossible to guess the bottom, and it takes strong belief and willpower to hold on to their shares, especially if the holdings fall much further after you buy them. However, if investors can hold on for the bumpy ride, they could get remarkable gains. Buyers shouldn't expect a quick rebound though. Expect to invest for at least three years.

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