Income Investors: This Dividend Stock Belongs in Your Portfolio!

Description

Canadian natural gas prices have not been kind to **Peyto Exploration & Development** (TSX:PEY). To bring you up to speed, gas prices in Canada are at all-time lows thanks to a supply glut stemming from lack of storage and transportation infrastructure.

These record-low gas prices were quite evident in Peyto's second-quarter earnings report for 2018, which say revenues drop 9% to $155 million from last year. However, even factoring in the worst gas prices in history, Peyto's strong competitive position, as the fifth-largest gas producer in Canada, low cash operating costs, and management flexibility mean the industry downturn presents a buying opportunity for income investors looking to for a safe and steady 7% yield.

An ugly second quarter, discounting future prospects

It was obvious even before the earnings came out that Peyto was going to be delivering ugly numbers. Peyto's second quarter of 2018 saw revenues drop 9% year over year, while funds from operations (FFO) fell 14% to $0.70 per share and total production declined over 6% to 549 thousand cubic feet equivalent of gas per day.

However, despite the earnings drop, there were a few bright spots in Peyto's quarter. For example, Peyto proved again in Q2 that it boasted some of the best margins in the business, with cash costs barely rising to $0.89 per share versus $0.84 the year before. Q2 also highlighted the strength of Peyto's management, who had the wherewithal to hedge the majority of gas production at prices well above the market. The result of this foresight was a hedging gain of $53.6 million for the quarter.

Finally, another highlight of Q2 was management's willingness to be flexible in the face of unfavourable commodity prices, which resulted in the delaying the bulk of capital spending to the second half of 2018, when prices are expected to rise. This, of course, bodes well for Peyto's cash flow profile and dividend prospects.

Natural gas prices can't remain low forever

Of course, even with 90% of 2018 production volume fully hedged, Peyto is still heavily dependent on favourable gas pricing. With gas prices in Canada at all-time lows, one has to wonder when producers will get a bit of reprieve. Luckily for the sector, gas prices might turn the corner sooner rather than later. So far, 2018 has already seen production volumes decline across the entire sector, with Peyto and its peers shutting in wells until prices start to normalize.

At the same time, the oversaturation of supply we're seeing now has not been supported by reserve life fundamentals, as the proven reserve life index for North America has remained relatively flat for the past 20 years. This means that even though production has been increasing, reserves have not followed suit, and it is only a matter of time before reserve depletion overcomes the current supply glut. Indeed, North America has the shortest proven reserve life among global peers, at just 11 years, compared to 120 years for the Middle East.

Finally, once we go further out to 2023 and onwards, the low benchmark gas prices in Canada will become less of a factor for Peyto. In July of 2018, Peyto signed a 15-year deal with an Albertan power company to deliver gas directly at higher realized prices than what is offered in the market.

With such low costs and a strong management team at the helm, Peyto is poised to not only weather the cyclical downtown, but it should also prove to be an eventual winner once the supply glut reverses. In the meantime, shareholders will be paid a very good sum for waiting it out.

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