Buy This 9% Yield to Profit From Higher Oil

Description

The last five years have been tough for energy investors. After a brief glimmer of hope toward the end of 2018, where crude rallied sharply to see the international benchmark Brent peaked at a multi-year high over US$85 a barrel, it has pulled back sharply because of a growing global supply glut. This latest price collapse, which was predicted by a few pundits, including analysts at the Russian Finance Ministry, has hit energy stocks hard.

Energy Select Sector SPDR Fund, which offers exposure to the U.S oil industry and some of the world's largest oil companies, has lost 7% over the last year. Globally diversified Canadian upstream oil producer **Vermilion Energy** (TSX:VET)(NYSE:VET) has been hit even harder, losing 28% over the same period compared to Brent drifting lower by a mere 3%. This has created an opportunity for investors to acquire a high-quality energy stock at an appealing valuation.

Internationally diversified portfolio

Vermilion owns and operates a broad portfolio of oil and natural gas assets located across North America, Europe, and Australia. It has net oil reserves of 270 million barrels, which are 45% weighted to light and medium crude.

Vermilion's full-year 2018 production is expected to come in at the upper end of its revised annual guidance, where it anticipated average daily production of 86,000-90,000 barrels daily. At its upper end, this is 32% greater than the 68,021 barrels daily reported for 2017. That solid growth was supported by a range of acquisitions made over the course of 2018, including the $1.4 billion purchase of Spartan Energy, as well as by Vermilion's drilling program. For those reasons, the driller's oil reserves will also expand, further bolstering its market value.

The company is forecasting that 2019 production will grow by up to 18% year over year to somewhere between 101,000 and 106,000 barrels daily. This will allow Vermilion to take full advantage of higher oil with analysts predicting that Brent will average around US$70 a barrel over the course of 2019.

An important aspect of Vermilion's operations, which supports its profitability and gives it an advantage over many exploration and production companies operating solely in North America, is its ability to access international Brent pricing. The international benchmark oil price trades at a premium to the North American benchmark West Texas Intermediate (WTI), which is currently over US$8 a barrel.

Because of its ability to access Brent pricing — along with a focus on controlling costs — Vermilion has reported some impressive netbacks. For the third quarter 2018, it reported an operating netback of $34.85, which was higher than many drillers operating solely in Canada. It also has a long history of delivering top quartile netbacks.

The diversified international nature of Vermilion's hydrocarbon assets and oil production, which sees only 54% of its oil output coming from Canada, minimizes the impact of the volatility and discounts associated with Canadian oil prices. Until the government of Alberta announced mandatory production cuts in late 2018, Canadian heavy and light oil prices were trading at record discounts to WTI, which was substantially impacting the financial performance of many Canadian upstream oil producers.

Juicy dividend

No analysis of Vermilion is complete without coming to grips with its huge dividend yield of almost 9%. Vermilion is one of the few upstream energy companies not to eliminate its dividend when it became clear that sharply weaker oil was here to stay for a sustained period.

In fact, the driller maintained its monthly dividend at the pre-slump level of $0.215 per share and even hiked it in early 2018 to $0.23 per share, despite Brent trading at lower than US$30 a barrel in early 2016.

While some pundits have voiced concerns that the dividend may not be sustainable, that doesn't appear to be the case. For 2017, net dividends paid as a proportion of funds flow from operations was a very manageable 33%, and it is expected to remain at around that level for 2018 because of growing production driving higher funds flow.

Another reason for the sustainability of Vermilion's dividend is its solid balance sheet. The driller finished the third quarter 2018 with considerable liquidity totaling $24 million and long-term debt of $1.8 billion, which is around a manageable 2.2 times Vermilion's funds flow from operations. According to the driller's estimates, its dividend, sustaining capital, and growth expenditures are covered if WTI averages US$50 a barrel over the course of 2019, which is likely given OPEC's production cuts and declining production from Venezuela.

Why buy Vermilion?

A solid balance sheet, growing production, internationally diversified petroleum assets, and monster dividend yield of almost 9% makes Vermilion one of the most attractive stocks to play higher oil. Those reasons combined with it being heavily sold off since late 2018 make now the time to acquire Vermilion.

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