Is It Better to Ignore Big Dividend Energy Stocks?

Description

Dividends are great sources of returns. However, dividends from energy stocks may not be reliable because of volatile energy prices.

Energy companies cannot control the energy prices they get. Rather, energy prices are controlled by changes in supply and demand. When global economic growth is expected to slow, demand for energy is expected to decrease, and energy prices drop as a result.

Given the volatility in their profitability, it may be better to ignore energy stocks that offer big dividends. After all, many end up cutting their dividends in troubled times, which trigger huge sell-offs in their shares.

That said, we can’t use a wide brush to paint the whole energy sector. Instead, we must study each company individually. Here’s an example of an outperforming energy stock that doesn’t pay a dividend and a big-dividend energy stock.

Parex Resources stock simply outperforms

It’s amazing how **Parex Resources** (TSX:PXT) has outperformed its peers and the market by a wide margin. Since 2010, the stock has delivered total returns of about 19% per year, despite not paying a dividend.

As an oil-weighted producer in Colombia, Parex enjoys the Brent premium pricing. Its recent net margin was sky high at 47.2%. Additionally, its balance sheet is very strong. In the first quarter, it had only US$1.5 million of long-term debt compared to the US$60.5 million free cash flow it generated for the quarter. Its cash and cash equivalents have also increased every year since 2015 to nearly US$433 million at the end of Q1.

The stock looks cheap, too. At about $21 per share at writing, it trades at about six times earnings and less than four times cash flow. Analysts from **Thomson Reuters** have a mean 12-month target of US$22.40 per share on the stock, which represents 38% near-term upside potential to above CAD$29 per share using a more conservative foreign exchange of US$1 to CAD$1.30.

TORC's big dividend

TORC Oil and Gas (TSX:TOG) is a dividend-paying energy stock, but it has not been smooth sailing for its dividend. The company website shows a dividend history that extends back to 2013, including a dividend cut in 2016.

TORC is a better-managed company than many other oil and gas producers, though, as it was able to increase its dividend by 13.6% this month. The dividend appears to be safe, as its Q1 payout ratio was 84%.

Assuming a WTI oil price of US$55 per barrel, TORC estimates a payout ratio of 80%, while the WTI oil price currently trades solidly above that level at US$59 per barrel. However, investors certainly don't want the WTI oil price to fall through US$50 per barrel for long, and if it does, they hope that it rebounds fairly quickly because a WTI oil price of US$50 per barrel implies a payout ratio of 97% for the company, and that's cutting it very close.

At $4.35 per share as of writing, TORC offers a juicy yield of 6.9%. While the big dividend is enticing, investors should prioritize on price appreciation. Analysts from Reuters have a mean 12-month target of $7.67 per share on the stock, which represents 76% near-term upside potential.

Foolish takeaway

It's better to prioritize on (capital preservation and) price appreciation over big dividends when it comes to oil and gas producers. Since 2010, in which no-dividend Parex delivered returns of 19% per year, big-yield TORC delivered total returns of -10% per year.

Also noteworthy is that in the energy space, safer dividends with over 5% yields are offered by energy infrastructure stocks like **Keyera** and **Enbridge**, which generate stable cash flows irrespective of the prices of the underlying commodities.

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