
Should You Be Worried About Dividend Cuts?

### Description

Dividend yields add to total returns. However, when yields get up to 7% or higher, the market is second-guessing their sustainability.

**TORC Oil and Gas** (TSX:TOG) currently offers a yield of 7.5%. Can you trust the oil and gas producer to maintain its dividend? Perhaps dividend safety isn't what you should be aiming for.



## Business overview

TORC estimates average production of 28,300 barrels of oil equivalent per day for this year. Its production mix is about 88% light oil and liquids and 12% natural gas.

The Canada Pension Plan Investment Board (CPPIB) has a big stake of about 28% in the company.

## Is TORC's +7% yield sustainable?

The company prioritizes its cash flow as follows. First, it maintains a strong balance sheet by keeping its debt levels in check. Second, it ensures it sustains its asset base in an efficient manner. Third, it grows its production. Its dividend is at the bottom of its priority list.

In the past, TORC cut its dividend when the operating environment got too tough. However, notably, when that happens, price appreciation usually followed.

There's no doubt that lower oil prices will increase the risk of a dividend cut. Currently, the WTI oil price sits at US$52 and change per barrel, while TORC estimates that with a WTI price of US$50, it'll come out with a payout ratio of 97% (after accounting for maintenance capital expenditure and net dividends).

I'll explain a bit more about the net dividend. Investors are free to reinvest the monthly dividend for more shares. The recent participation rate of that program is 30%, thanks largely to CPPIB's 100% participation in the program. Since CPPIB is a long-term investor and has been reinvesting the dividends for a long time, it's unlikely to turn it off since TOG stock is trading at such cheap levels. The net dividend is the actual cash dividend that the company pays out after subtracting the amounts that are reinvested.



Depending on how severe the commodity price drops will be and how long they stay down for, TORC's dividend may or may not be sustainable.

If the WTI price drops below US$50 per barrel for an extended period of time, TOG will have trouble maintaining its dividend.

## Foolish takeaway

Investors' hopes are that WTI won't fall below US$50 per barrel for an extended period of time. If it does, TORC will probably have to cut its dividend because of its priority ladder.

That said, a dividend cut is not necessarily the end of the world. After all, investment returns come from dividends and price appreciation. The occurrence of a dividend cut would likely mean the cash flow was saved to grow the business, which may in turn lead to strong price appreciation, like it has in the past.

TOG stock is trading at multi-year lows and is very attractive from a price-to-cash flow perspective, as it trades at a multiple of about 2.7, while its long-term multiple is about six. The **Thomson Reuters's** mean 12-month target is $7.69 per share, which represents 93% near-term upside. And at a multiple of six, TOG is actually worth $8.81 per share, which implies 121% upside potential.

So, the high yield is not the only consideration. Outsized price appreciation is also in the cards, but investors need to have an above-average appetite for risk and be very patient.

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