Can Vermilion Energy's (TSX:VET) Monster 10% Yield Survive Weaker Oil?

Description

An ongoing global supply glut, despite sanctions on Iran and Venezuela, continues to weigh on oil prices, sparking disquiet that upstream oil explorer and producer **Vermilion Energy's** (TSX:VET)(NYSE:VET) 10% dividend yield is unsustainable. The North American benchmark West Texas Intermediate (WTI) has lost 17% over the last year to trade at around US$54 a barrel. There are well-founded fears that oil could fall even further, seeing WTI slide under US$50 per barrel. If that were to occur, it would certainly create a situation where Vermilion may be forced to slash its dividend.

How sustainable is the dividend?

According to the driller's 2019 guidance, it will be free cash flow positive, generating around $3 per share if WTI averages US$58.60 per barrel and if Brent averages US$66.73. With the annual dividend totalling $2.76 per share, it appears sustainable if oil averages those benchmark prices over the course of 2019.

The key concern is that oil will remain weak and fall further, despite a range of supply constraints, and this will cause the payout ratio to rise to levels where the dividend payment can't be maintained. According to Vermilion's guidance and sensitivity analysis, if WTI falls sharply and only averages US$50 a barrel for 2019, then annual funds from operations (FFO) will decline by around $162 million to roughly $838 million.

When allowing for a 2019 exploration and development budget of $530 million, the total payout ratio as a function of FFO rises to around 114% on a diluted basis, indicating that the dividend isn't sustainable over the long term.

Over the short term, however, Vermilion could fund the payment because of its solid balance sheet; even at the lower FFO caused by a lower average WTI price, long-term debt is still a manageable 2.2 times FFO. This means that unless there is a sustained downturn for a lengthy period, it is unlikely that Vermilion will cut its dividend. Even during the darkest moments of the current oil slump, when WTI fell to under US$30 a barrel, the driller maintained its dividend. Vermilion hiked the dividend in mid-2018 when the outlook for crude started to improve.

The company also has a range of tools at its disposal to reduce the total payout ratio**,** including being able to trim exploration and development spending or utilize the $600 million of unutilized credit facility.

While a dividend cut would appear to make sense given the considerable uncertainty surrounding energy markets, it is highly unlikely given management's conviction for maintaining the payment. There also appears to be little sense in cutting the dividend unless there are signs of another catastrophic collapse in oil or Vermilion encounters significant prolonged operational issues that impact production and cause costs to balloon.

Foolish takeaway

Vermilion remains a "best-of-class" oil stock that will perform strongly once oil rebounds as supply constraints eventually kick in and demand growth rises because of a firmer global economy. While weaker oil could put its dividend at risk, that monster 10% yield appears sustainable for now.

CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NYSE:VET (Vermilion Energy)
2. TSX:VET (Vermilion Energy Inc.)

PARTNER-FEEDS

1. Msn
2. Newscred
3. Sharewise
4. Yahoo CA

Category

1. Dividend Stocks
2. Energy Stocks

3. Investing

Tags

1. Editor's Choice

Date
2025/08/16
Date Created
2019/06/20
Author
mattdsmith