



## How Safe Is This Juicy 10% Yield?

### Description

Oil is [rallying](#) once again because of a range of bullish factors, including further supply constraints and more positive global economic outlook now that a trade war between the U.S. and China appears to have been averted. The North American benchmark West Texas Intermediate (WTI) has gained around 30% since the start of 2019 to be trading at just over US\$60 per barrel.

Despite the improving outlook for crude, Canadian oil stocks remain out of favour with investors, and quality names like **Vermilion Energy** ([TSX:VET](#))([NYSE:VET](#)) have failed to perform. Vermilion has lost just over 1% for the year to date, and the ongoing weakness of its stock sees it sporting a monster 10% yield, sparking considerable speculation that the dividend is not sustainable.

### Is the dividend safe?

These fears are founded on the fact that the dividend, on a trailing 12-month (TTM) basis, represents 153% of Vermilion's net income per diluted share over that period, illustrating that it is clearly unsustainable.

Nonetheless, in a capital-intensive industry such as oil exploration and production, where several non-cash items that don't have a direct bearing on cash flow are recorded on the profit and loss statement, this may not be the best measure of sustainability.

A superior means of testing the sustainability of an upstream oil producer's dividend is to determine its payout ratio as a function of funds from operations (FFO). FFO measures the cash generated by an oil company and is a better measure of their performance because it compensates for cost-accounting methods that may inaccurately represent a driller's net income. When using FFO per diluted share, the dividend has a trailing 12-month payout ratio of 46%, highlighting that it can be easily maintained.

If we turn to Vermilion's 2019 guidance, where it is predicting full-year FFO of around \$970 million, the dividend is certainly sustainable when it is considered that on a fully diluted basis, it has a payout ratio of 45%. Vermilion is also projecting a total annual FFO payout ratio of 98%, including the dividend as well as capital spending on exploration and development activities.

The sustainability of the dividend becomes even clearer when it is considered that Vermilion's 2019 guidance is based on an average annual price for WTI of US\$58 per barrel, which is around US\$2 per barrel lower than the current market price. Based on that guidance, which appears achievable in the current environment, the driller expects free cash flow of between \$2.50 to \$3 per share, further underscoring that it can comfortably cover the payment.

While it is understandable that a high double-digit dividend yield like Vermilion's can spook investors because it is typically a sign of something wrong, in this case the dividend is fully covered. In fact, the low payout ratio as a function of FFO coupled with significant free cash flow and a solid balance sheet with considerable liquidity, including \$600 million of unutilized credit capacity, indicates that the dividend can be covered even if oil falls lower.

Vermilion's CEO recently stated in an interview that a dividend cut is "not something we're even entertaining."

That — along with Vermilion being one of the very few upstream oil producers not to cut or even eliminate its dividend when the price of crude collapsed in late 2014 — further indicates that the payment is safe.

## Foolish takeaway

Vermilion is a "best-in-class" upstream oil explorer and producer that provides investors with international exposure across North America, Europe, and Australia. When that is considered along with its high-quality assets, copious long-life reserves, and solid balance sheet, it remains a [top stock](#) to buy to gain exposure to higher oil. While investors wait for the stock to appreciate, they will be rewarded by its sustainable monthly dividend and that monster 10% yield.

### CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing

### TICKERS GLOBAL

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

### PARTNER-FEEDS

1. Msn
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