Is it Time to Buy This Juicy 8% Yield in the Energy Patch?

Description

Canadian energy stocks remain under considerable pressure and unpopular with investors, despite crude soaring higher in recent days to see the North American benchmark West Texas Intermediate (WTI) break through the psychologically important US$60-a-barrel mark. While WTI has gained around 24% since the start of 2019, **Surge Energy** (TSX:SGY) has lost a whopping 17%; its dividend now yields a very tasty 8%.

It isn't the only Canadian upstream oil producer to possess a monster yield. **Whitecap Resources's** dividend also yields 8%, and **Vermilion Energy's** has hit double figures at 10%. This has triggered considerable conjecture among market pundits that those payouts are unsustainable and another round of dividend cuts is on the way. That is despite the CEOs of Whitecap and Vermilion attempting to allay market fears by publicly announcing that the payments are safe.

Let's take a closer look at Surge's dividend to determine whether it is under threat.

Dividend appears sustainable

In mid-2018, Surge hiked its monthly dividend by 5% to $0.008333 per share, or $0.10 annually, giving it a very juicy 8% yield. Upon initial observations, it is easy to understand the concern surrounding that payment. The most widely accepted means of testing whether a dividend can be maintained is to calculate its payout ratio as a proportion of net income. For the trailing 12 months ending March 30, 2019, Surge reported a net loss of 0.27 per diluted share, indicating that the payment is unsustainable.

Nonetheless, this is not best measure of dividend sustainability for an upstream oil producer because of the industry's capital-intensive nature. Furthermore, using net income is unreliable because it is calculated using deductions for a range of non-cash expenses, distorting the amount of cash or funds flowing through a company.

A superior measure is to determine the dividend-payout ratio as a proportion of adjusted funds from operations. This is essentially funds from operations after deducting the capital required to sustain production and provides a more accurate reflection of the funds flowing through an upstream oil company from its operations. When using this measure, Surge's dividend-payout ratio falls to a very and manageable conservative 20%, indicating that it is sustainable.

Surge's ability to maintain the dividend in the current operating environment becomes clearer when it is considered that if WTI averages US$55 per barrel, it anticipates a 2019 all-in payout ratio of 97% and excess cash flow of $5 million after allowing for capital spending and the dividend. If WTI averages US$65 per barrel during 2019, then the all-in payout ratio falls to 70% and excess cash flow rises to $70 million.

Aside from that juicy yield, Surge is an attractive stock to buy because it is trading at a deep discount to the value of its oil reserves. Industry consultancy Sproule calculated that Surge's proven and probable oil reserves at the end of 2018 had a net asset value of $5.58 per share, which is around 4.5 times greater than the company's price. That highlights the considerable potential upside available should oil rally for a sustained period and confidence returns to global energy markets.

Foolish takeaway

Investors should note that Surge does not possess the financial or operational strength of either Whitecap or Vermilion, which means that it may not be able to sustain the dividend if oil collapses once again. It has, however, established oil hedges to mitigate the impact of weaker oil on its finances, and that will help to preserve the dividend over the short term if Surge does encounter financial difficulty.

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