Is This 8% Yield in the Energy Patch Safe?

Description

Oil weakened yet again after Trump announced an additional 10% tariff on US$3 billion of imports from China, and the East Asian nation retaliated by devaluing the yuan. The North American benchmark West Texas Intermediate (WTI) dipped to US$54 per barrel, and much of the optimism surrounding crude at the start of 2019 has disappeared. This has hit energy stocks hard, and upstream oil producer **Whitecap Resources** (TSX:WCP) has lost 9% since the start of 2019.

Is the dividend sustainable?

Whitecap has a monster 8% dividend yield, which, combined with the weaker outlook for crude, has sparked considerable speculation as to whether it is sustainable, particularly with softer WTI and declining oil production. For the second quarter 2019, Whitecap's oil output fell by 7% year over year to 70,611 barrels daily, because the driller reduced capital spending as it seeks to shore up its balance sheet in a difficult operating environment. That has certainly spooked investors, because lower oil output coupled with softer prices means that there will be a sharp decline in earnings.

Second-quarter funds flow fell by 10% year over year to just under $176 million, yet diluted net income per share was $0.14 compared to a $0.05 loss a year earlier. Whitecap also reported that free funds flow had risen by 18% to $114 million, despite weaker oil and lower production. That can be primarily attributed to the driller slashing capital expenditures, which, for the quarter, were less than half of what they had been a year earlier. Whitecap's hedging strategy also helped to boost earnings and therefore reduce the impact of weaker crude during the quarter, seeing it report a net gain of almost $18 million on its risk-management contracts.

Importantly, the driller reported a total funds flow payout ratio of 35%, which increased to 65% for the first half of 2019, indicating that even in the difficult operating environment that exists, Whitecap's dividend payment is sustainable.

That becomes even more apparent when considering the company's 2019 guidance, where it expects to generate funds flow of $753 million if WTI averages US$55 per barrel during the year. After deducting maintenance capital, there is a $353 million surplus, which equates to $0.85 per share, giving the annualized dividend of $0.34 a payout ratio of 40%. Even if WTI falls sharply and only averages US$45 per barrel during 2019, the surplus falls to $162 million after deducting sustaining capital, giving the dividend a payout ratio of 87%.

In both cases the payout ratio is sustainable. Whitecap can also dial down capital spending, which would free up additional capital to support the dividend, plus it finished the second quarter with almost $151 million of accounts receivable, providing it with short-term funding to sustain the payment if required.

Foolish takeaway

It does appear that Whitecap's decision to increase its dividend payment in May 2019 because of firmer crude was premature, but the payment and juicy 8% yield is safe for at least the time being. When this is coupled with Whitecap's copious oil reserves, high netback, and ongoing focus on driving efficiencies from its operations, it is an attractive stock to play higher crude.

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mattdsmith