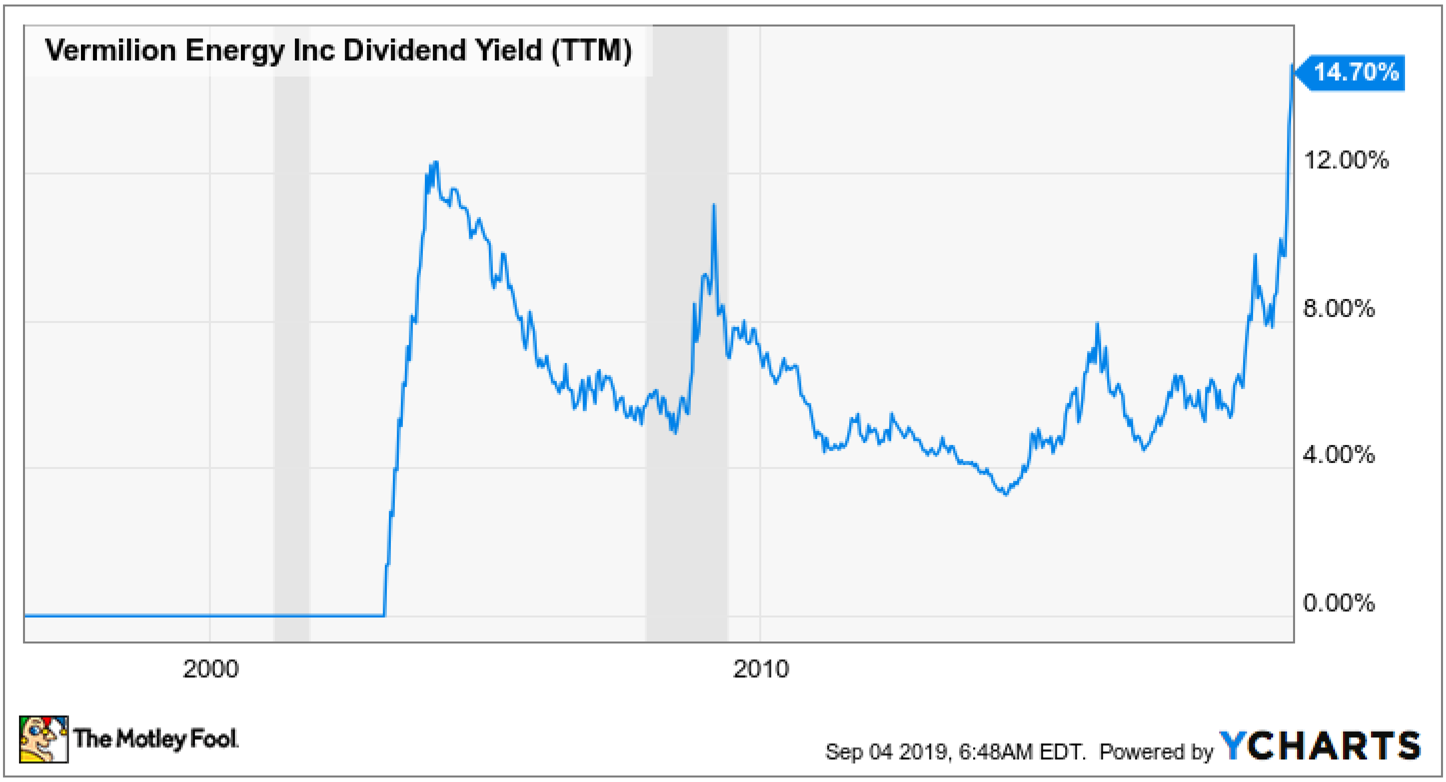
Is Vermilion Energy's (TSX:VET) 15% Dividend Safe?

Description

The allure of high yields can sometimes be too good to pass up. Unfortunately for investors, this leads to poor decision making. A high yield is not good business practice and, in most cases, is not sustainable over the long term. This is especially true of companies that are looking to grow the business. Why? It is very difficult to grow when you are paying out a high dividend.

Even if the dividend was well covered, it just isn't good business practice. This is why investors and analysts are justified in questioning abnormally high yields. Case in point, **Vermilion Energy** (TSX:VET)(NYSE:VET) and its 15% yield. Take a quick peak at the chart below.



Vermilion's yield has ballooned to all-time highs, more than double its historical average. The dividend hasn't been this high since the financial crisis. Why has it ballooned to current levels? The answer is quite simple: industry weakness.

Canada's oil and gas industry has been mired in a year-long downtrend. It all started last summer when Canadian crude hit a record-high price differential from benchmark North American crude. In the past year, Vermilion's stock price has been almost halved (-44%). This has caused its yield to spike.

As you can see in the chart above, Vermilion has been here before. Between 2003 and 2009, Vermilion operated as a trust and benefited from favourable tax laws. Once the government made changes to the taxation of income trusts, it converted into a corporation.

Why is this important? The company maintained its dividend following the transition. However, it is not directly comparable because of the difference in taxation. When analyzing the company's dividend on a historical basis, it is best to look at 2010 and beyond.

Dividend history

Throughout its history, the company has never cut its dividend. In fact, it raised dividends between 2011 and 2014 before keeping its dividend steady for a number of years. The price of oil fell off a cliff in 2015, which led to a multi-year bear market. It was thus prudent that the company kept its dividend steady as it waited for the price of oil to stabilize.

Vermilion Energy returned to growth last year as it raised dividends by 7% in February. Since then, its dividend has remained steady for 17 consecutive months. Based on its history, the company remains steadfast in its commitment to maintaining a sustainable dividend. In fact, it is listed as a key strategic priority for the company.

Payout ratio

There are countless examples of management declaring their commitment to the dividend, only to cut it a few months later. As such, investors are right to be skeptical. The company's current payout ratio of 123% immediately raises red flags. On a forward basis, it looks even worse. The company currently pays out $2.76 in dividends, and it is only expected to earn $0.61 per share in 2020.

Does this mean the dividend will be cut? Not necessarily. Earnings contain many one-time and non-cash expenses that have no direct impact on a company's ability to pay a dividend. For this reason, it is always best to also look at the dividend in relation to cash flows, as dividends are a cash outlay. Vermilion has two cash flow metrics it monitors: funds from operations (FFO) and free cash flow (FCF).

In 2019, Vermilion is targeting $6.00 and $2.60 per share in FFO and FCF. Although it is generating plenty of cash from operations, it isn't generating sufficient FCF to cover dividends. This means that it will need to borrow to fund capital expenditures and the dividend. Otherwise, something has to give.

Does this mean a dividend cut is inevitable? Once again, not necessarily. The company was in a similar FCF position from 2010 through 2015, and it managed to maintain its dividend. That doesn't mean the dividend is safe, it simply means it has navigated a similar cash crunch before.

Vermilion’s dividend prospects are neutral, and it will most likely maintain it over the short term. Don’t, however, expect any raises, and don’t be surprised if the company cuts its dividend. This would be good business practice, as a 15% yield is not a sustainable long-term strategy.

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. Business Insider
2. Msn
3. Newscred
4. Sharewise
5. Yahoo CA

Category

1. Dividend Stocks
2. Energy Stocks
3. Investing

Tags

1. Editor's Choice

Date
2025/07/19
Date Created
2019/09/05
Author
mlitalien