Is This Monster 13% Dividend Yield in the Energy Patch Safe?

Description

North America's energy patch continues to be battered by weaker crude and the uncertain outlook for energy demand. In a recent report, **Citigroup's** global commodities research team stated that the trade war between the U.S. and China had caused oil demand growth to almost halve, weighing heavily on prices. There are fears that a full-blown trade war will have a sharp impact on the global economy, causing demand for oil to fall further.

This has sharply impacted energy stocks, causing **Vermilion Energy** (TSX:VET)(NYSE:VET) to lose 30% since the start of 2019, leaving it with a monster 13% dividend yield. The poor outlook for crude and weak prices has sparked considerable concern that Vermilion's double-digit yield is unsustainable and that the dividend will be cut.

Is the dividend sustainable?

Vermilion is a globally diversified oil and natural gas producer, generating 62% of its petroleum production in North America, 33% in Europe, and the remaining 5% in Australia. That diversified asset base gives it many advantages over its peers solely focused on operating in Canada, including the ability to access premium international Brent pricing and minimize the impact of the discounts applied to Canadian oil and gas benchmark prices. This helps to reduce the risk posed by weaker oil to Vermilion's earnings.

A primary reason for the fear that Vermilion will be forced to slash the dividend is that it has a trailing 12-month payout ratio as a proportion of net income of around 122%, indicating that the payment can't be sustained, particularly if oil falls further. While this should be of some concern, it is not as foreboding as it initially appears.

The trailing 12-month dividend-payout ratio as a function of funds from operations (FFO) is a mere 46%, and this is a better representation of Vermilion's financial position. This is because FFO provides a far better representation of the amount of cash generated by an oil company compared to net income, which is impacted by a range of non-cash items.

According to Vermilion's 2019 forecast, it will have a dividend-payout ratio as a proportion of projected FFO of 45% and a total payout ratio of around 100%, indicating that even in the current difficult operating environment, the payment is sustainable. Those projections are based on Brent averaging US$62.97 and West Texas Intermediate (WTI) US$56.50 per barrel during 2019. Both of those price assumptions are lower than the current spot prices for both crude benchmarks.

Vermilion's financial forecasts are protected by its hedging strategy, where 32% of its total 2019 oil production is hedged at an average floor price for WTI of $70.84 and for Brent of $87.38 per barrel. This further enhances the sustainability of the dividend for the remainder of 2019.

Vermilion also has a long history of growing production, with it having expanded at a compound annual growth rate (CAGR) of 8% since 2012. For 2019, it is estimated that full-year output will be 101,000 to 106,000 barrels of oil equivalent, which, at the upper end of that guidance, is 21% greater than 2018. This significant production increase will go some way to generating additional cash flow, which will offset weaker oil prices.

Foolish takeaway

The outlook for energy stocks remains extremely uncertain. Growing economic weakness and the impact of the trade war between the U.S. and China are weighing heavily on the outlook for crude. This increases the risk of Vermilion being forced to cut its dividend if oil falls sharply once again, as it moves to curtail spending to preserve cash flow and shore up its balance sheet.

Nonetheless, the dividend appears sustainable for the foreseeable future, and Vermilion was one of the very few to preserve its dividend, even when oil plummeted to under US$40 per barrel.

For these reasons, it is unlikely that the dividend will be cut any time soon, and the high yield is due to Vermilion's stock being harshly treated by the market in response to the considerable concern surrounding the outlook for crude.

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