Can This Monster 9% Yield in the Energy Patch Survive?

Description

Many energy stocks, after their value collapsed yet again because of sharply weaker crude, are offering monster yields of up to 14%. One upstream producer that's lost 26% since the start of the year and yielding a whopping 9% is **Surge Energy** (TSX:SGY).

That nearly double-digit yield has sparked considerable speculation that a dividend cut is looming. Let's take a closer look to see where Surge's dividend can be maintained in the current difficult operating environment.

Growing oil output — Can this monster 9% yield in the energy patch survive?

Surge has a history of steadily growing its petroleum production, which for the second quarter 2019 shot-up by an impressive 26% year over year to 21,544 barrels daily. That's important to note in the current environment because it allows the driller to make up for weaker earnings caused by the decline in crude.

Nonetheless, the North American benchmark West Texas Intermediate (WTI) has gained 13% for the year to date, which along with Surge's growing oil output indicates that the dividend can be sustained.

An important measure of whether a dividend can be maintained is the payout ratio. While Surge has reported net loss of $0.29 per share for the last trailing 12 months (TTM), indicating that the payment can't be sustained, but that doesn't give a full picture of Surge's true financial position.

You see, net income includes many non-cash items and therefore doesn't truly reflect the driller's ability to generate cash flow.

A better measure of whether the dividend is sustainable for an oil company operating in a capital-intensive industry is adjusted funds from operations (AFFO), as AFFO doesn't include non-cash items, thereby giving a more accurate reflection of the funds an oil producer can generate.

On a diluted per share trailing 12-month basis, Surge's dividend payout ratio as a function of AFFO is a very conservative 20%, indicating that it can be sustained.

This becomes more apparent when considered that over the past 12 months, Surge's average realized price per barrel sold on a quarterly basis was up to 83% lower than the $54.92 received for the second quarter 2019. That indicates that even with WTI trading at around US$50 per barrel Surge can maintain the dividend.

For the remainder of 2019 and the first half of 2020, Surge has hedged a considerable portion of its oil production at an average price floor of just under $80 per barrel, which will protect cash flows, further sustaining the dividend.

The ability to maintain the payment enhanced further by Surge's solid balance sheet, where net debt was a mere 1.9 times its annualized second quarter AFFO, finishing the period with $180 million in liquidity.

While Surge's all-in payout ratio, including dividend and capital spending, falls to 97% at US$55 WTI, the additional available liquidity and the ability to dial down capital expenditures will allow the company to sustain the payment even if WTI slides to under US$50 per barrel, for at least the immediate future.

Foolish takeaway

Despite Surge being a risky investment, which is heavily dependent on a recovery in crude, its dividend appears sustainable at this time and will likely be maintained even if WTI falls lower.

That means investors can buy a quality upstream oil explorer and producer at a deep discount, because its market value is around a fifth of its net-asset-value for its proven and probable reserves of $5.41 per diluted share and lock in a very juicy 9% yield.

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