Cenovus Energy (TSX:CVE) Turns Into a Dividend-Growth Stock: Time to Buy?

Description

Integrated oil giant **Cenovus Energy's** (TSX:CVE)(NYSE:CVE) management gave out a significantly bullish signal on the stock on Wednesday, and contrarian investors long on the ticker could be smiling all the way to the bank very soon, as the company returns to dividend growth.

Here's why.

There's a strong message in the dividend

The argument for the relative better quality of dividend-paying stocks versus non-dividend-paying ones can't be stretched any further, and this argument can actually be stronger when a once-battered company suddenly hikes its quarterly dividend and management loudly promises further annual increases over a period of five years.

Cenovus announced a 25% increase to its quarterly dividend on October 2, and this was the first dividend increase in several long years after the company battled with a sickening debt level accumulated because of an ambitious acquisition of **ConocoPhillips** assets.

Company efforts have been largely on debt repayment over the past few years, but the company's impressive results during the first half of this year has made management more optimistic about future cash flow generation capacity for the business.

I would therefore take the latest dividend increase as management's strong message to the market that Cenovus Energy has finally turned an important corner financially.

Actually, given that this announcement was made soon after third-quarter close, I would expect the company to release a pleasing set of financial results in the next quarterly earnings release.

This won't be surprising though. The company's operations are designed to generate positive returns for investors at US$45 per barrel Western Texas Intermediate (WTI), and oil prices have averaged better than that so far this year and could even soar if Saudi Arabia's recent warnings concerning potential conflict with Iran are to be taken seriously.

Further, Cenovus expects to generate about $11 billion in free cash flow in its five-year budget, and the company expects to reach its $5 billion net debt target within the next 12 to 18 months if oil price hold within “mid-cycle” ranges, and could use a potential excess $9 billion of remaining cash flow for opportunistic share repurchases, dividend growth, additional debt reduction, and investments.

That’s an encouraging outlook for a turnaround play, and suddenly it’s not that surprising to see a strong wave of new bullish buy orders on the ticker lifting the valuation significantly, as the company repairs its balance sheet and grows cash flow over the next five years.

Should income investors buy the stock today?

The just announced dividend raise increases the current annualized yield to just 2.15%, and that’s not much to quickly turn income investors’ heads, considering the risk profile on the investment today.

A given guidance for a 5-10% annual dividend growth is very encouraging though, as the yield on cost could be as high as 3.15% exiting 2024. That’s not so bad.

But the stock didn’t respond much to the news of a dividend increase on Wednesday. This probably has to do with the subliminal message from a reduced 2019 expenditure budget, which falls by about $150 million back to the $1.1-$1.2 billion range.

Reducing capital investments while increasing dividend payouts could imply that management has determined that the company’s internal projects can’t offer much investment returns to match the cost of capital employed.

Under such scenarios, paying out cash flows in the form of dividends and share buybacks and debt reduction is more desirable than reinvesting them back into the business. This ultimately describes a poor growth potential for the business, and management has described the outlook for the next five years to 2024 just as such … the expected production growth rate is a modest 2-3% per annum.

If growth will be this slow, then capital gains could mainly come from de-risking the firm by paying down debt and from share buybacks but so little from growing the business, which is heavily affected by exogenous factors.

Such an outlook dampens enthusiasm, but this turnaround story still deserves a closer look.

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Author
brianparadza