Is it Time to Buy This Monster 10% Dividend Yield in the Energy Patch?

Description

Despite whipsawing wildly in recent months because of a mix of good and bad news, crude has firmed since the start of 2019 to see the North American benchmark West Texas Intermediate (WTI) up by 25% to be trading at US$56 per barrel. While that has been good news for Canada's energy patch, many oil stocks have failed to rally, instead moving significantly lower because of the downbeat outlook for crude.

One oil stock that has been roughly handled by the market is **Surge Energy** (TSX:SGY), which has plunged by a whopping 31% over that period, leaving it with a monster 10% dividend yield. Such a large double-digit yield has triggered considerable speculation that Surge will slash the dividend to maintain its balance sheet and cash flow in an operating environment weighed down by the poor outlook for crude.

Dividend is sustainable

Normally in such circumstances, particularly with Surge reporting a net loss of $0.29 per diluted share for the last trailing 12 months (TTM), a dividend cut would make sense, but there are signs that the driller can sustain such a monster yield. The capital-intensive nature of the oil industry means that the traditional way of measuring whether a dividend is sustainable by determining whether it is less than 100% of a company's net income is not an appropriate approach. This is because when calculating net income, many non-cash items are included, making it a less-reliable means of concluding whether a dividend is sustainable.

A superior method is to find the dividend-payout ratio as a proportion of adjusted funds flow. Over the last 12 months, Surge generated adjusted funds flow of $0.49 per diluted share, giving it a dividend-payout ratio of a mere 20%. That ratio does increase to over 100% once capital expenditures are accounted for, but they can be dialed down by Surge as required and/or dictated by the operating environment.

An even better indication that Surge can maintain the dividend is based on its 2019 guidance where it is forecasting an all-in payout ratio, which is dividend plus capital expenditures, of 97% if WTI averages

US$55 per barrel over the year. That ratio falls to 70% if WTI averages US$65 a barrel, which appears unlikely, but the North American benchmark has averaged around US$57 per barrel since the start of 2019 and that may increase now that crude has rallied once again.

Surge's ability to grow oil production at a steady clip also bodes well for dividend sustainability. For the second quarter 2019, its production rose by 26% year over year to an average of 21,544 barrels daily.

More importantly for the dividend, Surge's netback, which is a key measure of operational profitability, is one of the best among its peers and continues to grow despite weaker oil. The driller's second-quarter operating netback was $31.24 per barrel, which was 4% greater than a year earlier, despite Surge's average basket price falling 2%. The primary drivers of that impressive result were Surge's focus on reducing costs, which saw operating and transportation expenses fall 7% and a healthy 33%, respectively.

Foolish takeaway

Surge's dividend certainly appears sustainable in the current difficult operating environment, especially with WTI already having averaged more than US$55 per barrel since the start of 2019. Growing production and a stronger netback, despite weaker crude, also point to the dividend being sustainable, at least for the foreseeable future.

Nonetheless, management couldn't be blamed if it took the opportunity to cut the dividend by up to half to boost cash flow and preserve the driller's balance sheet, because it would still leave Surge with a juicy yield of around 5%. That additional cash flow could be used to complete a share buyback, with now an opportune time to do so, because Surge is trading at a fifth of the net value of its proven and probable oil reserves.

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mattdsmith