Is it Time to Buy This Monster 13.7% Oil Yield?

Description

All things being equal, big yields are riskier than smaller ones. After all, there's no free lunch in finance.

But one of the best things about the stock market is, every situation is unique. Some monster dividends are doomed; it's only a matter of time until they're slashed or eliminated completely. But many others are based on sustainable cash flow and solid business plans that are just temporarily out of favour.

Those kinds of stocks offer two sources of upside potential, which makes them particularly enticing. The succulent dividend is only the beginning. Investors are also drawn to the healthy upside potential. Add them both together, and it's possible a beaten-up high dividend stock could be one of the better investments you'll end up making.

It's easy to see why so many investors are attracted to these opportunities. But remember, you must be extremely careful. These stocks are known to crater if the dividend gets slashed. Nobody wants a 25-50% loss in their portfolio.

Let's take a closer look at one such opportunity today in the energy sector, **Vermilion Energy** (TSX:VET)(NYSE:VET) and its gigantic 13.7% yield. Is the payout sustainable?

Why Vermilion?

You have to hand it to Vermilion's management team. These folks have done a lot right.

Production is spread around the world, including assets in Canada, the United States, across Europe, and even in Australia. Although a little more than two-thirds of total company production comes from North America, more than half of its free cash flow comes from Europe and Australia. This is because oil prices are higher in those two regions.

It's never a bad idea to focus on low-cost production, and Vermilion is reaping the benefits of this today. The company is able to generate enough cash flow to be able to reinvest in capital expenditures, which should ensure consistently growing production. After getting close to 100,000 barrels per day in output in 2019, Vermilion should finally pass that important symbolic level in 2020.

Even with oil prices staying stubbornly low, Vermilion should be able to afford to spend $450 million in capital expenditures in 2020, with $250 million invested in Canada, $59 million in the U.S., and the rest spread across Europe and Australia.

Unfortunately for Vermilion's management, the company is being impacted by the one thing it can't control — the price of crude. And if the price remains low, it puts the payout on thin ice.

The dividend

Thanks to its low-cost business model and the emphasis on European production, Vermilion generates gobs of cash flow. Funds from operations should be approximately $900 million in 2020. Free cash flow, which accounts for capital expenditures, should be in the neighborhood of $450 million.

Vermilion pays a dividend of $2.76 per share, and it has 155.5 million shares outstanding as of September 30. That works out to a total dividend expenditure of $429 million. This gives the stock a 95% payout ratio, which many would classify as acceptable. In fact, many REITs and other high-yield securities offer payout ratios of +90%, and investors don't really stress about them.

But there's one major difference. Vermilion is in the energy space, and the price of crude oil is volatile. Real estate is much more boring. It's hard to predict what Vermilion will generate in cash flow next year without knowing the future of crude.

The bottom line

If crude oil shoots higher, Vermilion's dividend will become much safer, and shares will rally. It'll be a home-run investment. Inversely, a small decline in oil would put Vermilion's dividend in serious jeopardy.

Ultimately, a bet on Vermilion is a bet on crude. If you're a believer, then this 13.7% yield is a fantastic deal today.

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Date
2025/06/30
Date Created
2019/11/07
Author
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