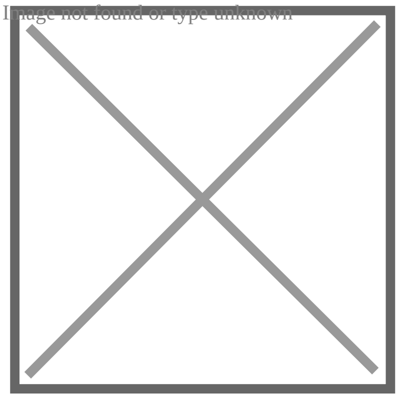

Profit From Higher Oil in 2020 With This 9% Yield From the Energy Patch

Description

Despite the price of crude rallying substantially toward the end of 2019 to see the North American benchmark West Texas Intermediate (WTI) up by 37%, many Canadian energy stocks have failed to perform. One that has been roughly handled is **Surge Energy** (TSX:SGY), which is down by 23% since the start of 2019 to see it now yield a very juicy 9%.

Despite firmer crude, there is considerable speculation that the driller will cut its dividend because typically such high yields are unsustainable, particularly when volatile oil prices are considered. There are, however, a range of indicators that, after failing to follow crude higher, Surge is very attractively valued making now the time to buy.

Is the dividend sustainable?

Key to Surge's appeal as an investment is whether the dividend and that juicy 9% yield is sustainable. Aside from the company reporting a net loss for the last four consecutive quarters there are signs that the payment can be maintained. For the trailing 12 months to the end of the third quarter of 2019, Surge's dividend has a payout ratio of adjusted funds from operations of 22% per share on a diluted basis.

The driller anticipates that ratio will fall to 19% of 2020 AFFO and is forecasting an all-in payout ratio of 86% for the year if WTI averages US$56.50 per barrel over the year. That appears likely in the current operating environment where crude has rallied significantly to see WTI trading at around US$62 per barrel and averaged US$57 per barrel for 2019.

In fact, after OPEC and Russia announced that they would shave 500,000 barrels daily off their collective oil output**,** considerable optimism returned to global energy markets. If the trade war between the U.S. and China is successfully resolved**,** this will buoy oil further. Fears that the conflict would spark a global recession in 2019 weighed heavily on prices.

Aside from higher oil lifting earnings and funds flow, thereby making the dividend more sustainable, Surge is actively strengthening its balance sheet with a focus on reducing debt. By the end of the third quarter 2019, Surge had reduced its long-term debt by 24% to $308 million and total long-term liabilities including debt, leases, and convertible notes by 8% to $417 million. The driller anticipates reducing debt by another $20 million during 2020 if WTI averages US$56.50 per barrel.

This has enhanced Surge's financial flexibility, which along with firmer oil and growing funds flow, will bolster the dividends sustainability.

Trading at a deep discount

What makes Surge a very attractive play on higher crude is that it is trading at a deep discount to the net asset value of its proven and probable oil reserves, which totalled 123 million barrels at the end of 2018. Those reserves were determined to have a net present value of $1.7 billion after applying a 10% discount rate and deducting taxes. After deducting long-term debt, convertible notes, and leases, the reserves are worth $3.25 per share after tax.

That is almost three times greater than Surge's current share price, highlighting the considerable potential capital gains available should oil continue to rally. The value of Surge's oil reserves will expand as oil moves higher and their volume grows because of its exploration and development drilling, further increasing the upside available to investors.

Foolish takeaway

Surge is a very attractively valued play on higher oil because it is trading to a significant discount to the value of its proven and probable oil reserves, meaning there is considerable potential upside available.

The growing optimism surrounding the outlook for oil, coupled with a sustainable dividend yielding a very juicy 9%, enhances that appeal making now the time to buy.

CATEGORY

1. Energy Stocks
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