HD Is That It For Woodside's Dividends?

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Oil & gas companies, like miners, are not typically "yield" stocks. Wells and mines only offer finite resources, thus resources companies must continually invest earnings into future growth opportunities, which usually means only a minimal payout of cash flows to shareholders. But as the China-driven resources boom of the twenty-first century has shifted from the growth stage to the production stage, and commodity prices have fallen back towards longer term averages, Australia's resources companies have decided to back off on their ongoing growth spending and increase their dividend payouts to shareholders.

In the mining space, the two big diversified miners have done it, or at least are in the process of doing it. Australia's oil & gas companies with LNG interests in PNG and/or Queensland are still spending on development, but are about to lift their dividend payouts once revenues flow. Woodside Petroleum ((WPL)) in the meantime had already lifted its dividend payouts, substantially, given a lack of viable growth opportunities to invest in.

While Woodside's Pluto LNG facility began producing in 2012 and providing solid cash flows, the hope had always been to build a second and maybe third train, but the gas just wasn't there. The company's Sunrise asset in East Timor waters has pretty much gone into the too hard basket and its attempts to invest in the Leviathan project in Israel were abandoned after frustrating indecision from the Israeli government. That left the Browse project as about Woodside's only option, but an onshore LNG facility would have attracted all sorts of problems and costs.

Woodside stuck with Browse, but pushed out its timeframe on the intention to build a floating LNG facility. Management then began a worldwide search for suitable projects in which the company could invest for future growth purposes, but nothing was ever going to jump out immediately, and all the good ones were gone. In the meantime, cash was rolling in by the barrow-load from both Pluto and Woodside's stake in the legacy North West Shelf operation. There was little choice but to pass that cash onto shareholders ? a popular move in an investment environment dominated by the search for yield.

So Woodside became a "yield" stock, rivalling Australia's banks. The problem was, this could only prove relatively temporary given either the company would find an acquisition to spend its money on or earnings, and thus dividends, would slowly reduce as production from existing projects wound down. Woodside does not pay a quantum of dividend, a la Telstra, but a payout ratio of earnings, a la the banks. Thus were earnings to fall, dividend amounts would fall, and if earnings were diverted towards acquisitions, the payout would fall.

In the former case Woodside's yield would still look good, but its share price would fall. In the latter case, the yield would fall. But none of this takes into consideration what happens if the oil price falls.

And the oil price has fallen a long way. Woodside's share price has also fallen a long way, which means the apparent yield has held up, and indeed risen, but only until the company resets LNG contract pricing at lower oil-indexed pricing. To put this into perspective, the FNArena database currently suggests a consensus yield expectation for Woodside of 8.7% in 2014, dropping to 6.1% in 2015. UBS points out that were it to apply current oil spot pricing to its forecasts, that 2015 yield would be 2.9% and 2016 would be 2.2%.

Did the falling oil price hasten Woodside into action?

Woodside has announced the acquisition of various stakes in oil & gas projects from US energy company Apache. These include 13% of the Wheatstone LNG project and 65% of the Balnaves oil project in offshore Western Australia, and 50% of the Kitimat LNG project in Canada which includes 320,000 acres of the Horn River and Laird unconventional gas acreage. Wheatstone is around 50% complete, is expected to deliver first gas in 2016, and is operated by Chevron. Balnaves is already producing oil. Kitimat is a long term prospect and the unconventional acreage, even longer still.

The way Goldman Sachs sees it, Woodside has acquired a producing asset in Balnaves, near term growth in Wheatstone and long term optionality in Kitimat.

The assets did not just suddenly come onto the market, they've been on offer since mid-year. Apache's Exmouth oil production and WA domestic gas assets were not put up for sale, so Apache is not simply exiting Australia. Woodside did not suddenly start looking for assets, management has been scouring the globe for some time. As Macquarie notes, the deal comes despite Woodside apparently looking to diversify away from Australian LNG via greater international exposure.

So it would seem there was a level of "hurry up" in Woodside's decision. But was it a good decision?

At an ultimate US$3.75bn price tag, the deal looks reasonable from a value perspective, brokers agree, and immediately earnings accretive given Balnaves is already producing. But is it sufficiently opportunistic? Woodside is a Big Oil company on the global scale, sitting on truck-loads of cash and little debt from its current operations, meaning it should be in the perfect position to swoop on M&A opportunities as weaker operators falter under a collapsing oil price. But the deal appears to be net asset value neutral under a long-term oil price of US$90/bbl, and oil spot prices are currently below US$60/bbl.

JP Morgan sees the deal as value accretive on its own long term price assumption of US$90. But Deutsche Bank suggests that at US$90, Woodside has not made the most of its financial strength to take advantage of current industry conditions. Macquarie calculates an oil price of US$83 is required to deliver a 10% return, "suggesting the deal comes too soon to reflect recent oil price weakness". In other words, negotiations have taken time and Woodside had locked itself in before the oil price really collapsed this month.

Woodside management has described the deal as a "natural fit" and aims to capture synergies and "value enhancing" opportunities. JP Morgan likes the fact the WA assets are "only a stone's throw" from Woodside's Pluto and North West Shelf heartland. But Balnaves is already up and running and the Wheatstone resource is already discovered/appraised, offtake deals are already largely marketed and the project is already sanctioned. "It is difficult to see," says Macquarie, "what value WPL brings to the project other than its cash pile".

UBS agrees that with Wheatstone development locked in and most of the LNG sold, it's a struggle to see areas where Woodside can add value". It doesn't seem to fit with the company's "value-accretive growth" mantra. "Is it just a play on oil prices?" UBS asks. Credit Suisse, similarly, suggests "it's not clear how this acquisition fits into Woodside's mantra of being able to add value".

What the deal does do, as all brokers agree, is help to fill the big hole in Woodside's growth profile. Macquarie estimates it adds around three years to the company's proven and probable (2P) reserve life and stems annual production decline to 2% from 5% out to 2020. It basically buys management time. Then there's the Canadian assets, but these are very long-dated propositions. Deutsche Bank sees Kitimat as a high-cost source for LNG, and notes no Canadian LNG projects have been sanctioned to date. Macquarie suspects Woodside was unable to buy the Wheatstone stake if it didn't take Kitimat as well.

As for the included unconventional (tight/shale) acreage also thrown in, JP Morgan notes this is a left of field move for Woodside, but suggests that the difficulty in buying large-scale, quality conventional resources at the right price means Woodside would have been forced to move down this path eventually.

But now to the important question: what about those dividends?

The good news is Woodside has so much cash and so little debt that it can draw on existing facilities and fund the acquisition while still remaining at the bottom end of its preferred 20-30% gearing range. As the deal is relatively value neutral, Woodside can continue to pursue other M&A possibilities, and do all of this while still maintaining an 80% dividend payout ratio.

So that payout, which has become so popular with yield seekers, remains intact. But once again it must be pointed out that 80% of earnings depends on earnings, with regard the actual size of the dividend. Woodside earnings will fall from here on lower oil prices, given LNG prices are indexed to oil prices.

Woodside's foray into being one of the most attractive yield stocks on the Australian market was never intended to be a long one. Woodside will continue to offer a sizeable payout, at least until another M&A prospect comes along, but is still a play on capital appreciation.

That play depends on where the price of oil is going to be in the future.

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