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Energy Dividend Trend Is Catching On. Not Everyone's on Board.

By Avi Salzman Follow Nov. 3, 2021 12:19 pm ET

An oil pumpjack
Frederic J. Brown/AFP via Getty Images

Oil companies are pumping out more cash than they have in years, and the question now is what to do with it.

Most have been paying down debt, some of it amassed during the depths of the pandemic when oil prices dropped below the cost of production. But with oil prices now over $80 a barrel, there is enough cash to pay off debt and return some to shareholders. Increasingly, oil companies are choosing a unique way of doing that: paying variable dividends based on the amount of cash flow they are producing. In good times, the strategy can lead to dividend yields nearing 10%.

Variable dividends are one way to solve a thorny problem for oil companies. Before variable dividends, oil companies were left with a dilemma. When oil prices were high, it made sense to send more money back to shareholders in a dividend. But once a company raises its dividend, it feels pressure to maintain the payout at the same level through good times and bad.

When oil prices turn south, the dividend can become an albatross. That's what happened to Exxon Mobil (ticker: XOM) last year — the company's quarterly dividend payment was so large that many analysts argued it was better for the company's long-term future to cut it. After taking on debt, and preserving cash through extraordinary measures like suspending some employee benefits, Exxon was able to preserve the dividend and recently increased it. But other companies like BP (BP) chose to cut their dividends, sending their stock prices down sharply.

Variable dividends allow companies to pay out large dividends to shareholders when times are good. When oil prices go down, they can reduce the size of the variable dividend while still paying a modest core dividend.

The two companies that were early proponents of variable dividends are shale producers Devon Energy (DVN) and Pioneer Natural Resources (PXD). Devon reported earnings late on Tuesday, and announced its fixed-plus-variable dividend is 71% higher than a quarter ago, at 84 cents per share. At the current stock price, that would give the company a 7.9% dividend yield on an annualized basis. The best may still be yet to come: Devon says that its 2022 dividend could be more than 90% higher than its 2021 payout. CEO Richard Muncrief said on the company's earnings call that "our dividend policy provides us the flexibility to return even more cash to shareholders than any company in the entire S&P 500 Index."

Devon is finding other uses for excess cash too, announcing a $1 billion share repurchase program. Pioneer reports earnings after the market closes on Wednesday.

Muncrief argues that variable dividend policies will make the whole industry more attractive to investors. He says he's encouraged by "a growing number of other peers who have elected to prioritize higher dividend payouts. These disciplined actions will further enhance the investment thesis for our industry, paving the way for higher fund flows as investors rediscover the attractive value proposition of the E&P space."

Among the other companies discussing or announcing variable dividends are Diamondback Energy (FANG) and Comstock Resources (CRK). Diamondback plans to "use repurchases and variable dividends interchangeably depending on which presents the best return to our stockholders at that time." Comstock CEO Miles Allison talked about the possibility of adding a variable dividend sometime in the future too.

But not everyone is on board with the strategy. Big diversified oil companies like Exxon and Chevron (CVX) already have large core dividends. They'd presumably have to cut those dividends to change their policy to pay out a fixed-plus-variable dividend. Any cut would likely be considered a sign of weakness and is unlikely to happen in the near term. "We'll keep an open mind, but we don't see the value in it," said Chevron CFO Pierre Breber on an earnings call in April.

Some other companies simply don't like the concept of a variable dividend.

Magnolia Oil & Gas (MGY) CEO Stephen Chazen brushed the concept aside in the company's earnings call on Tuesday, saying that he believes investors like fixed, predictable dividends that are based on the company's earnings and not their cash flow. If the company has excess cash, he would rather pay out a one-time special dividend.

On an earlier call, he said that the variable dividend doesn't fulfill a core purpose of dividends: "We're trying to convey information about how strong the business is at fairly low oil prices that we can afford to do this, that's the point of the dividend."

Truist analyst Neal Dingmann wrote in an email that the industry appears to be split on the concept, with about one-third of CEOs supporting Chazen's position.

Dingmann wrote that he recently talked to an executive who argued that a variable dividend has "the same perceived problems of a buyback. When oil goes down, the variable is going to go down and that company will have less cash at the bottom of the cycle."

Despite those arguments, more companies may follow Devon's lead for one simple reason: its stock is up 165% this year, about twice as much as the broader group of energy producers. Investors so far are voting with their dollars.

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