Goodreid
INVESTMENT COUNSEL

87 Front Street East
2nd Floor
Toronto, ON M5E 1B8

T. 416 364 0890
TF. 1 888 466 3734
goodreid.com

How Safe Is That Dividend?

Goodreid eArticle, Summer 2019

Goodreid
INVESTMENT COUNSEL

87 Front Street East
2nd Floor
Toronto, ON M5E 1B8

T. 416 364 0890
TF. 1 888 466 3734
goodreid.com

How Safe Is That Dividend?

Goodreid eArticle, Summer 2019

One of the realities of living in what seems to many like a perpetually low interest rate environment is that investors find themselves chronically starved for income, whether they are retirees needing regular cash flow, or simply investors who like the stability of a regular income stream. At Goodreid, we address investors' need for income and cash flow in a variety of ways, ranging from investments in highly rated corporate bonds, which offer a modest yield premium over the paltry yield on government bonds in exchange for moderate credit risk, to preferred shares which offer high and tax advantaged dividend yields in exchange for some interest rate, credit, complexity and illiquidity risk, to high yielding common stocks which offer the prospect of tax advantaged dividend income as well as some scope for capital appreciation over the long term.

One of the most common and crucial questions investors in high yielding common stocks face is: "Will the dividend be safe?"

Dividend yield is simply the annual dividend divided by the current share price. The dividend is fixed, but the share price fluctuates continuously. The challenge is in deciding whether a dividend yield is high because the shares are attractively priced, or if the yield is high but unsustainable due to business weakness and is signalling an imminent dividend cut. Few things are more detrimental to the portfolio of a yield seeking investor than the dreaded unexpected dividend cut by one or more companies in the portfolio. Context is important, so we measure dividend yield relative to the company's long-term average dividend yield and also compare it to similar companies in the same industry. An unusually high yield versus either peers or versus the company's own history heightens the importance of doing very extensive and thoughtful research on the company because the market is telling us either that this is a very good investment, or it is a "too good to be true" investment…which almost always then turns out to be a very bad investment.

Accordingly, our approach in managing income seeking portfolios is to cast a wary eye towards the siren song of an alluringly high dividend yield until we have thoroughly satisfied ourselves that the company can at least sustain, if not actually grow the dividend over time. We use a ten point checklist encompassing areas like leverage and financial risk, capital allocation policy, long term business fundamentals and behavioural factors to help us gauge the probability and severity of a dividend cut in each company we invest in. Armed with this checklist, we are then prepared to answer the question: "Is the yield offered by this company worth the risk of a possible dividend cut?", which would likely be hurtful to the share price and is really just a narrower re-framing of the fundamental risk vs. return trade off implicit in every investment decision investors in every asset class must make.

Leverage/Financial Risk

1. ***Financial leverage***: in the same way a homeowner must qualify for a mortgage, by demonstrating sufficient income to service the mortgage, and sufficient equity in the home or a down payment to be a committed stakeholder, companies need also to demonstrate sufficient financial capacity to service their debt. We measure this capacity to service debt in a variety of ways, depending on the industry in question, but a common one is the debt to EBITDA ratio, which measures the number of years of earnings before interest, taxes, depreciation and amortization that would be required to retire the company's debt. Stable industries like real estate and utilities carry limited operating risk, and thus can bear higher financial leverage, whereas deeply cyclical industries like mining, energy or

semiconductors as a matter of prudence should carry less debt. Our practice is to assess the current leverage of the company against its long-term average leverage and also to compare it to similar companies in the same industry. High leverage relative to either a company's own history or relative to its peer group are cause for concern.

2. *Credit covenants*: when banks or bond investors loan money, often they will do so under a set of prescribed conditions that limit their risk of loss. These conditions are called covenants, and often they prescribe maximum leverage ratios, sometimes expressed as the ratio of debt to total capital. Other times covenants will take the form of a minimum interest coverage ratio, which is ratio of earnings before interest and taxes to annual interest expense. Regardless of the form of the covenant, we measure how much slack the company has in its covenants by comparing the current value of the ratio against the relevant minimum or maximum. A company that is very close to their covenant thresholds is flying too close to the sun and may be at heightened risk of a dividend cut to avoid breaching the covenant and triggering a possible legal remedy by the lender.

3. *Credit watch/credit downgrade risk*: credit rating agencies like Standard & Poors, Moodys, Fitch and DBRS publish ratings on most companies' bonds. Chief financial officers typically have a target credit rating in mind that they view as optimal (i.e. BBB- or A-, etc.), and most have a good understanding of the financial metrics they need to maintain to avoid their credit rating being downgraded. We watch these same metrics and are wary of companies that are skating on thin ice for their desired credit rating, or those companies that the rating agencies have formally put on "negative credit watch", which is often a precursor to an actual credit rating downgrade. Observing how the company's bonds are trading is another good clue that a credit downgrade may be in the cards, as the bond market usually sniffs out an imminent credit downgrade before the credit rating agencies formally announce one. The importance of avoiding issuers with credit downgrades is that downgrades make debt issuance more costly, and so to conserve scarce capital and avoid having to tap the now more expensive bond market, companies will sometimes grudgingly sacrifice their dividend.

4. *Pending maturities*: banks and other lenders rarely actually want their money back, but nevertheless, most bank loans and all bonds have a specific maturity date, at which point, the borrower either repays the principal or refinances (i.e. renegotiates) the bond or the loan. We scan companies pending loan and bond maturities, looking for unusually large pending maturities. While many creditworthy companies have huge debt balances and routinely refinance these bonds and loans with ease (i.e. Canadian banks), less creditworthy issuers may be much more at the mercy of their lenders when large dollar figure bonds or bank loans come due. This is particularly true if their creditworthiness has deteriorated since the last refinancing; the parallel scenario for a personal borrower would be one where a mortgagee has been divorced, lost their job, and seen their property value decline 30% since their last mortgage renewal. The company may then face very difficult decisions about their capital priorities, including their commitment to the current dividend policy.

Capital Allocation Policy

5. Payout ratios: a dividend payout ratio measures the proportion of earnings (or sometimes we measure dividend payouts relative to cash flow) that the annual dividend represents. Logic dictates that a company cannot pay out more than all of its earnings in perpetuity, and certainly cannot pay out more than all of its cash flow sustainably either, so a useful bright line test here is 100%. This would be a hard upper limit though on the sustainable payout ratio, as most companies need to retain some earnings to replace worn out assets and to fund growth initiatives lest they lose their competitive edge in their industry. As such, we evaluate a company's payout ratio relative to our understanding of its capital spending and reinvestment needs. As a shorthand measure, we will often benchmark its current payout ratio against its long term average payout ratio and against the payout ratios of its peers within the same industry. Values above 100% are a red flag, and values significantly above peers and above historic averages are yellow flags on this measure.

6. *Other capital allocation concerns*: by far, the dividend payout ratio is the most important consideration here, but sometimes other considerations like a pivot away from dividend increases and towards share buybacks via normal course issuer bid need to be considered. This can be important in light of executive compensation practices; if executives are compensated heavily via stock options, their preference will typically be to hoard cash within the company for reinvestment either organically or via acquisitions, whereas paying out dividends to shareholders can actually reduce the value of their stock options. Other practices to be mindful of are dividend reinvestment plans. Ostensibly, these afford investors the opportunity to take quarterly dividend payments and immediately reinvest them commission free in additional shares of the company as opposed to receiving them in cash, oftentimes at a slight (1-3%) discount to the prevailing market price. On the surface this would appear an attractive opportunity, but it can be a clue that the company is hard up for cash…hence the discount incentive for investors to reinvest dividends in shares, rather than take them in cash.

Long Term Business Fundamentals

7. ***Structurally declining profitability:*** The importance of this issue cannot be overstated. No dividend is safe if the underlying business is a melting ice cube, in permanent secular decline (i.e. buggy whips, newspaper businesses, photocopiers, analog cameras, etc.). We try to understand strengths, weakness, opportunities and threats for every company we own, whether a dividend payer or not, and we try to understand the attractiveness of their industry on a long term basis, as well as their competitive position within that industry. Companies that are in irreversible structural decline will usually exhibit declining profit margins, and declining returns on shareholders equity and returns on invested capital. It is important to isolate companies that are structurally in decline from those that may merely be experiencing a cyclical downturn as occurs in a recession, for instance. One will recover from the downturn and will likely continue paying dividends, whereas the other will not.

8. ***Commodity exposure:*** Companies with unhedged exposure to one or more commodities, either as a producer of that commodity (i.e. oil & gas producer), or as a buyer of it (i.e. airline) are not in full control of their own financial fate…the highly volatile commodity markets will deal them many ups and downs over a full economic cycle, some of which, in conjunction with other risk factors on this checklist may imperil the ongoing payment of their dividend.

Behavioural Factors

9. ***Repeat offender:*** "fool me once, shame on you, fool me twice, shame on me" …companies that have cut their dividends before are more likely to cut them again. The reason for this is twofold: first, a dividend cut in the past is indication that several, if not many of the risk factors identified here are pertinent to the company. Secondly, the fact that the dividend has been cut in the past indicates that in the eyes of management, the dividend is not sacrosanct, as it undoubtedly is for of managers of so-called "dividend aristocrats", who have multi-decade track records of paying and often regularly increasing their dividends. Further to this, we hold the view that the best defense is a good offense, so companies with a long, unbroken record of clockwork regular dividend increases are far less apt to cut their dividend than those that simply maintain a static dividend year in and year out.

10. ***New management:*** this is the "fresh start" (or less charitably, the "blame your predecessor") concept…a company that has a clearly unsustainable dividend is a company that has gotten itself into trouble…sometimes big trouble. The dividend decisions, the financial leverage, the various mergers and acquisitions and all manner of strategic decisions that got them to this point occurred on the watch on the executives and the board, who will often be extremely loath to admit and own accountability for their errors by cutting the dividend. But the moment a new CEO, CFO and/or board of directors come onto the scene (sometimes with the backing of an activist investor), they can erase the mistakes of the prior management team with the stroke of pen by cutting the dividend, and can pin the blame on the outgoing executive team.

Investing for income has rarely been more difficult than it is today, courtesy of a decade of sluggish economic growth and extraordinarily accommodative interest rate policy by the world's central banks. Some investors have taken to calling the current market environment a T.I.N.A. ("There is No Alternative") market which forces ordinarily risk averse savings account, guaranteed investment certificate (GIC) and government bond investors further out onto the risk spectrum into the stock market to meet their income and cash flow needs. We recognize that market reality and stand ready, as detailed here, to prudently meet the income needs of an aging investor base weary of lower for longer interest rates, all while avoiding the traps, pitfalls and minefields that can derail a naïve approach to income investing.