FINDING SAFE HIGH-YIELDING SHARES

Phil Oakley helps investors understand the tools they can use to identify which high-yielding shares are most likely to maintain or grow their dividends

Dividend income has always been a major consideration for investors. It has become even more of one during the past decade of very low interest rates on savings accounts and government bonds. High-yield shares have increasingly become a go-to investment for those looking for income.

Yet, blindly buying shares with high dividend yields is often a minefield for the unwary. The stock market rarely gives away free lunches – except perhaps when markets in general are depressed – and in many cases high yields on shares are a sign of danger which is telling you to mind your eye.

However, as with many things in life there can be some notable exceptions to general rules. This article will focus on some of the questions you as an investor can ask as well as some tools you can use to identify high-yielding shares that can maintain or grow their dividends.

Why shares have high dividend yields in the first place

Generally speaking, shares have high dividend yields for the following reasons:

- Investors are worried that the dividend may be cut or scrapped. This often causes the share price to fall and the yield to rise.
- Slowing rates of dividend growth. This also tends to lead to a fall in share price and a rise in yield so that the shares offer more of a return through their current dividend income than expected dividend growth.
- A company is deliberately paying out most of its profits in dividends. This happens when a company does not need to hang on to its cash to fund new growth projects.
- The shares have been harshly treated or overlooked by the market and are undervalued.

Your job as an investor is to try and work out which of these four situations is the cause of the high yield share you are looking at.

Next you need to assess how safe the company's dividend is. Here's what to do.

Understand the business behind the shares

Remember, a high yield is often a sign that investors may have serious concerns about the company's future prospects. You need to try and find out why.

The best way to do this is read as much you can about the company and its history. Visit the company's website to see what products and services it sells. Read its annual report, check out its investor presentations and find out how it has been getting on.

Then ask yourself some very simple but revealing questions:

- Do you understand how the company makes money? If you don't then don't waste any more time looking at this company. You will never be comfortable owning its shares if you don't understand it.

- Is this a steady business or a cyclical one where profits move up and down with the economy? Cyclical businesses such as housebuilding or engineering can often cut their dividends in harsh recessions.
- Does this business have lots of competition? Rising competitive threats can cause profits to fall. You need to pay particular attention to any comments a company makes about its competitive environment.
- What is its strategy? How is it going to make more money in the future? Be wary of companies that grow by buying other companies. This can give a misleading picture of how good a company really is.
- How good is the management? How long have they been there? Do they have good track records? Do they own lots of shares in the company?

Some quick number checks

Looking at a company's financial performance is a great way of enhancing your understanding of it and ultimately helping you to work out if its dividend is safe.

Here are some quick checks on financial performance:

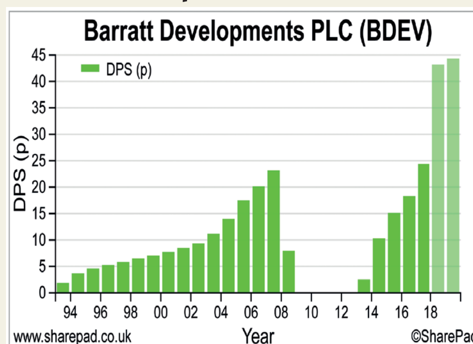
- Are profits rising or falling? You want to see stable or rising profits.
- What is happening to profit margins? Falling margins can be a sign of trouble. Be wary of businesses with very low profit margins – less than 5 per cent – as profits can turn to losses if trading conditions deteriorate.
- Is operating (trading) cash flow rising or falling? You can't pay a dividend without cash. Falling cash flow makes this harder.
- Are debts rising or falling? Rising debts mean higher interest bills which can mean less money left over for dividends.
- Are there big pension fund deficits or long-term rent agreements? These are significant liabilities which need cash to pay them off. If they are big then it can eat into the amount of cash for dividends in the same way that debts can.

Dividend history

A company with a long track record of paying and growing its dividends is often a good sign – but not a guarantee – of a robust business that can deliver for shareholders through thick and thin. A company which has had to cut its dividend in the past may do so again if times get tough.

Halma (HLMA) has one of the best dividend growth records on the London market and is expected to keep on increasing dividends to its shareholders (lighter bars show forecast dividends).

Barratt Developments DPS



Housebuilding has tended to follow a boom and bust cycle in the UK which has caused big swings in profits and dividends for building companies. **Barratt Developments (BDEV)** cut its dividend in 2008 and then did not start paying one again until 2013. It is currently increasing dividends at a very healthy rate but investors would do well to consider its dividend history.

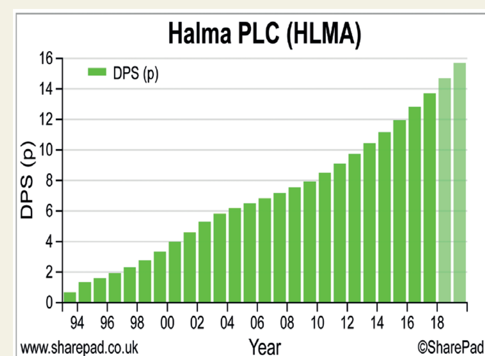
Dividend cover

This measures how many times a company's earnings per share (EPS) covers the dividend per share (DPS). The old rule of thumb was that dividend cover of at least two times was a sign of a safe dividend but this is not necessarily the case.

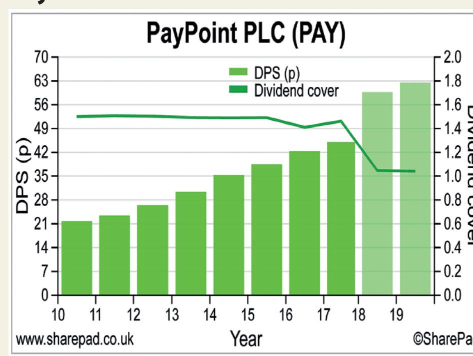
Companies may have deliberately low dividend cover ratios because they are paying out most of their profits as dividends. Certainly, a higher level of dividend cover makes for a safer dividend but if profits are still growing or are stable then the dividends can be perfectly safe with lower cover – at least for a while.

Take **PayPoint (PAY)** as an example of this. Its

Halma DPS



PayPoint DPS and dividend cover



Phil Oakley is a stock analyst for Ionic Information, makers of SharePad and ShareScope investment software. Read more from Phil, including his excellent Step-by-Step Guide to Investment Analysis at www.sharepad.co.uk/philoakley.

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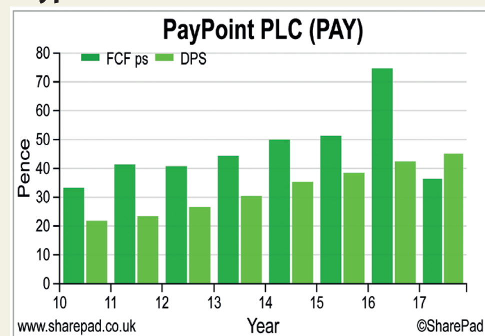
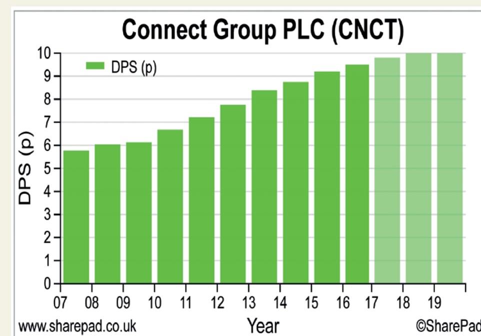
Paypoint FCF and DPS



Connect DPS



dividend has been increasing in recent years whilst dividend cover has been coming down. City analysts still expect dividends to keep increasing but dividend cover will fall to just over one as the company is expected to pay out virtually all its profits as dividends by adding special, one-off dividends on top of its annual dividend.

An even better test of dividend safety is whether the company has had enough spare – or free – cash flow to pay them. Free cash flow is the cash flow that is left over from trading cash flow after interest on borrowings, pension fund top ups, tax, and spending on new assets has been paid for.

Companies which produce lots of free cash flow are usually in a good position to pay and grow their dividend payouts. However, as we shall see shortly, companies that look as if they have very poor levels of free cash dividend cover can have better dividend prospects than you might initially think.

PayPoint has fared well on this test up until recently as its free cash flow per share (FCF ps) has generally been greater than its dividend per share. Investors need to satisfy themselves that this will be the case in the future.

Some potentially safe high-yielding shares to consider

Here is a selection of high-yielding shares which may be able to keep investors happy by maintaining or increasing their dividends. This is despite them apparently falling short on some key tests of dividend safety.

The table shows details of forecast dividend yield, dividend cover, profit margins, fixed charge cover (how many times trading profits cover interest and rents) as well as how many consecutive years a dividend has been paid.

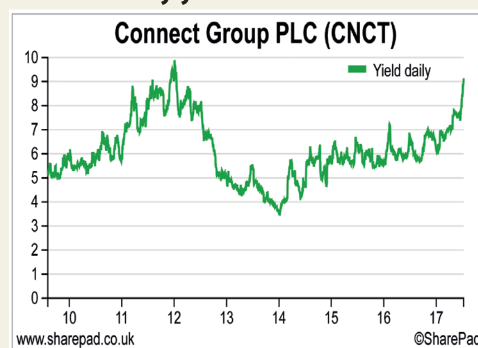
Let's take a look at them in turn.

CONNECT

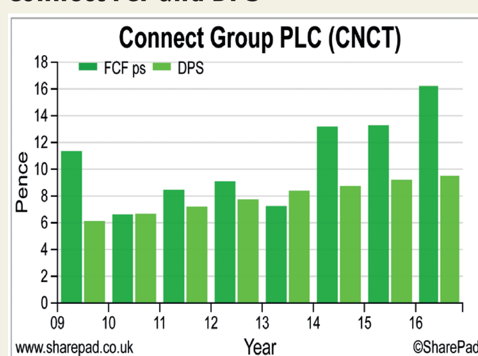
Since it demerged from WH Smith back in 2006, **Connect (CNCT)** has proven to be a very reliable dividend payer.

This is despite the fact that its core business of

Connect daily yield



Connect FCF and DPS



Some potentially safe high-yielding shares to consider

Name	Close	fc Yield	fc Dividend cover	FCF div cover	EBIT margin	Fxd charge cover	Years div paid
Connect	100p	9.8	1.7	1.71	3.1	2.4	24
Greene King	534p	6.2	2	0.94	17.6	2.3	25
Marston's	106.7p	7.1	1.8	-0.72	17.6	1.9	14
Trinity Mirror	83.25p	6.8	6	3.76	20.2	10.2	3

Source: SharePad

distributing newspapers and magazines has been shrinking for years. The company has expanded into book distribution and specialist parcels but operates in a very competitive and low-profit margin industry.

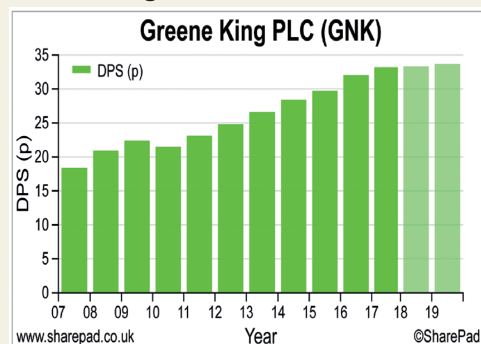
At a share price of 100p, the shares have a forecast dividend yield of nearly 10 per cent. This kind of yield is literally screaming "dividend cut on the way" at you.

Yet Connect has traded at yields as high as this before and defied the doomsayers. It may well do so again as it has proven to be very adept at taking costs out of its business and still has plenty of scope to keep on doing so.

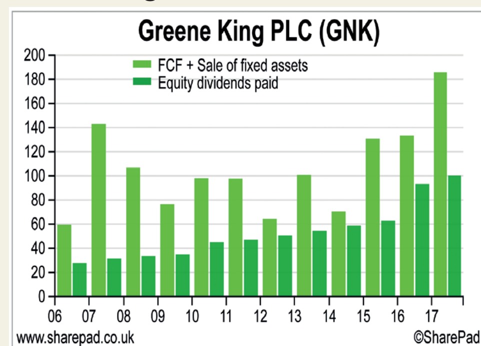
The company's great strength is its prodigious free cash flow. It may have low profit margins but it doesn't have huge amounts of cash sunk into trucks and sheds – it rents them instead. So as long as the business remains reasonably profitable the cash flow tends to follow on. Historically this has meant that it has produced more than enough cash to keep on growing its dividend.

There are plenty of reasons not to like Connect but its dividend should not be one of them at the moment.

Greene King DPS



Greene King FCF and dividends



GREENE KING

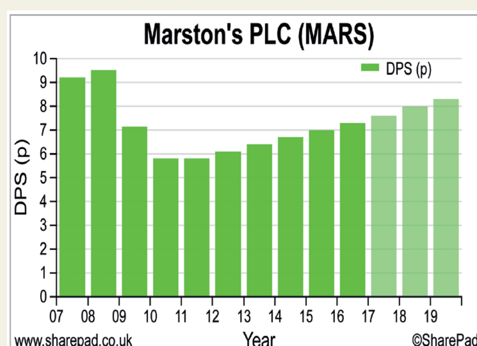
Brewer and pub operator **Greene King (GNK)** has a very decent dividend track record. It has paid a dividend every year through good times and bad with its only blemish on continuous growth being a very small cut in 2010.

The company is going through a rough patch at the moment with difficult trading conditions and cost pressures in its pubs division. This has seen its share price fall and dividend yield increase. However, this yield looks safe for two good reasons.

Firstly, management has committed to maintaining dividends.

Second, the company's very good cash generation. Whilst the dividend is not covered by free cash flow, this ignores the regular disposals of pubs every year as the company gets rid of underperforming locations. This raises significant amounts of cash flow to pay dividends. When this is taken into account, Greene King has had plenty of spare cash to pay its dividend.

Marston's DPS

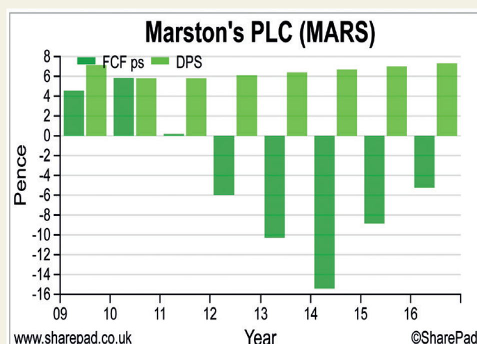


MARSTON'S

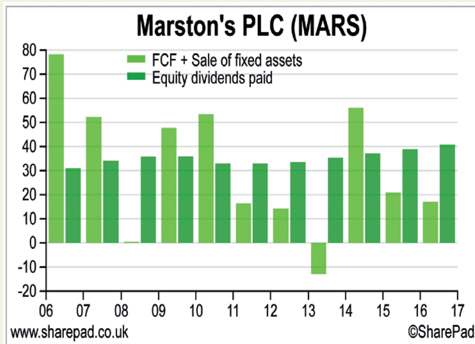
Like Greene King, **Marston's (MARS)** is having a tough time at the moment. However, it exhibits a number of red flags which might make you think that its dividend is very much under threat. Given this backdrop, it is right to question the sustainability of the current dividend payout.

The dividend looks well covered on the basis of profits with dividend cover of 1.8 times, but the cash flow is telling a different story. Sure, there is cash being spent on new pubs and extensions and there

Marston's FCF and DPS



Marston's FCF and dividends



is also the fact that Marston's – like Greene King and other pub owners – can raise significant amounts of cash by selling a number of its pubs each year. So what's really going on here?

The company is loaded up with debt as evidenced by a very high net debt to ebitda ratio – a common measure of company indebtedness – of over six times.

Its free cash generation looks awful as it has ploughed lots of cash into new pubs and lodges.

Even when the cash from selling pubs is taken into account, Marston's appears not to have had enough cash to pay its dividends for the last couple of years. So are Marston's shareholders going to see their dividend payout slashed?

Probably not yet. Marston's very helpfully tells investors how much money it is spending to keep its pubs in good condition. This allows you to get a clearer picture of the company's cash flow and the sustainability of its dividend.

Taking 2016's results as an example, there is nothing to worry about here.

If we adjust free cash flow to just include maintenance capex then it would have been an inflow of around £68m compared with an actual outflow of £30m in 2016. This would have been enough to pay the dividend comfortably. With disposals of £47.6m it is in a more comfortable position still. The company then borrows to fund some of its extra investment as shown in the table below.

With profits expected to keep on nudging up in 2017, Marston's underlying cash flow should remain decent enough and its dividend is not expected to be cut.

3.75
TRINITY MIRROR'S FREE CASH FLOW DIVIDEND COVER IN 2016

TRINITY MIRROR

If you think Connect is an ugly business then **Trinity Mirror (TNI)** is arguably even uglier.

It operates in a rapidly declining print newspaper industry with declining advertising revenues. This cannot be offset by growth of digital media revenues. It has a massive pension fund deficit which is currently running at more than twice the company's market capitalisation. There are also the ongoing liabilities relating to phone hacking by its journalists in years gone by.

To build a strong case for selling the shares is not very difficult. You could even put together a case for saying that it is a future bankruptcy candidate. The market currently takes a very dim view of Trinity Mirror's shares which have fallen by 20 per cent so far this year.

Despite all this, the company is putting up a fight. Like Connect, the company has bought businesses which have given it lots of scope to cut costs and become more efficient. Its business retains very high profit margins and has also proven to be very good at generating lots of free cash flow.

After returning to paying a dividend in 2014, Trinity Mirror has been growing its dividend and increased it by 7.1 per cent at its half-year results in July. Free cash flow dividend cover was 3.75 times in 2016 and should be a very comfortable number this year as well.

Further support for the dividend comes from an increase in its annual cost-saving target for 2017 from £15m to £20m and an ongoing share buyback program. The company has repurchased over 6m shares so far this year which will be supportive to its free cash flow per share figure. The high yield on the shares therefore looks to be safe for a while yet.

Marston's borrows to fund investment

Metric	2016 (£m)
Operating cash flow	192.8
Tax paid	-9.8
Net cash flow from operating activities	183.0
Net interest paid	-70.2
Maintenance capex	-45.0
Cash available for dividends	67.8
Dividends paid	-40.8
Cash available for investment	27.0
Disposal proceeds	47.6
Growth capex	-98.7
Extra borrowing needed	-24.1

Source: SharePad

Trinity Mirror FCF and DPS