HOW TO STEER CLEAR OF **DIVIDEND** TRAPS

How can you avoid the shares that let you down? **Phil Oakley** finds out

If you are investing in shares for their dividend income then the last thing you need is for a dividend to be cut or scrapped entirely. If this happens, not only do you see a sharp reduction in your income from the share, but the value of your shareholding tends to take a battering as well.

But how can you avoid shares that might let you down? In last week's article on finding safe high-yielding shares I went through a checklist of dividend safety and highlighted some of the warning signs to look out for. In this article, I will develop these further with a specific emphasis on how to spot a company that might be about to cut its dividend.

SIGNS OF TROUBLE AHEAD

It is possible for a company to have signs of dividend risk for some time before a dividend is actually cut. A company with a vulnerable dividend may have many of the following red flags.

A high dividend yield

This is the simplest and most straightforward sign that investors are questioning the sustainability of a company's dividend. The stock market doesn't tend to give away many free lunches, which means that a high dividend yield tends to be a sign of high dividend risk.

As I mentioned in last week's article, there can be acceptable reasons for high dividend yields – such as a company paying out most of its profits as dividends or a share that is genuinely undervalued – but generally speaking, a dividend yield of over 6 per cent in the current stock market is telling you to tread carefully before buying it.

Deteriorating business performance

While a lot of dividend safety checks come in the form of crunching numbers and calculating certain financial ratios it is important to stress that those numbers come from a real business. Good investing – not just dividend investing – is all about understanding the business behind the share as much as you can.

Dividends will come under threat if the company has suffered deteriorating business performance, which puts downward pressure on sales and profits. This can come about for a number of reasons, including:

- Rising levels of competition.
- The loss of a major customer, patent or contract.
- A failed business strategy such as entering a new market or country.
- Paying too much for a large acquisition with borrowed money where the anticipated profits fail to materialise but the debts still have to be paid.
- Actions by competition authorities or industry regulators which cut the prices of a company's goods or services. This is a big risk with regulated utilities such as water and electricity network companies.

These kinds of problems start to show up in a company's financial performance and there are some tell-tale warning signs that investors would be well advised not to ignore:

- **A falling return on capital employed (ROCE) or return on investment**. ROCE is arguably the best measure of company profitability. It measures a company's trading profit as a percentage of the money it has invested in its business – like an interest rate on a savings account. Many analysts and investors focus on measures of profits like earnings per share (EPS) which take little account of the money spent to produce them. Just as putting more money into a savings account can give you more interest income, spending more money on new assets can grow a company's profits. But if the rate of interest or return on the money spent is going down this can often be a sign of trouble ahead.
- **Falling or negative free cash flow**. A company cannot pay a dividend without cash flow. Spending money on new assets causes cash to flow out of a company. Companies regularly have to replace worn out assets in order to maintain their levels of sales and profits as well as investing in additional assets in order to try and grow future profits. This is not a problem if the returns on the money spent will lead to higher levels of cash in the future but this does not happen with poor investments. Instead they eat up a company's cash flow meaning there is less free cash flow – or none – to pay dividends to shareholders.
- **Slowing or stalling rates of dividend growth**. A struggling business eventually has to slow down its rate of dividend growth or stop growing it completely. A maintained dividend can be the first step to an eventual dividend cut and is often a signal of a dividend that will be harder to afford.

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Rising debt levels and pension fund deficits

It's often forgotten but one of the most important things to realise as a shareholder in a business is that you are the last to get paid. The more costs and liabilities that rank ahead of you the greater the chance that your dividend payment will fall or disappear if a company's trading profits or cash flows fall.

Two of the biggest threats to a dividend come from rising levels of debt and pension fund deficits. These are claims on a company's cash flow that can leave nothing left over for dividends if they get too big.

Final-salary pension fund deficits can be big problems for many old companies that have employed a lot of workers. Any shortfall in the pension fund – where the liabilities to pay pensions is bigger than the assets of the fund – has to be put right. This is usually done over a period of 10 years with annual top-up contributions into the pension fund. As a rough rule of thumb, divide a pension fund deficit by 10 and this is the extra cash flow that will be needed to plug the hole. It might mean that the dividend has to be cut.

Investors should see pension fund deficits as debt and add them to a company's existing borrowings to get a true picture of indebtedness. You should then compare the levels of debt with the company's market capitalisation or enterprise value (the market capitalisation plus debt) or EV for short. A debt to EV of 50 per cent or more might be considered too high and a sign of increased dividend risk.

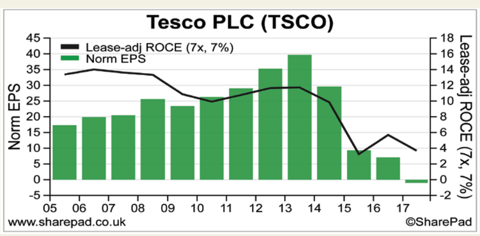
Tesco's road to a dividend cut

For many years **Tesco (TSCO)** was a popular share with investors. All seemed well as profits kept on growing as the company dominated the UK grocery market and expanded overseas. There were many signs that all was not well for many years before the dividend was eventually cut. A few analysts at the time pointed things out, but many were overwhelmingly bullish on the company.

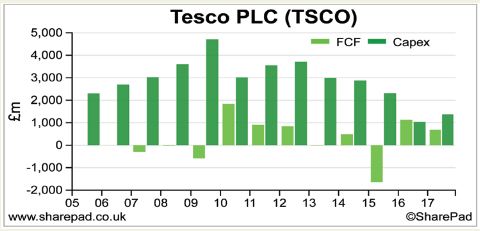
Tesco had many of the characteristics described above. In the mid 2000s it was a pretty decent business with a mid-teens ROCE. EPS kept on generally rising until 2013 but ROCE was on a general downwards trend before both fell off a cliff in 2014 and 2015.

One of Tesco's many problems was that its growth was coming from spending on new supermarkets, which were earning lower returns. This ate into the company's free cash flow. At the same time borrowings remained very high – despite the company selling supermarkets to property companies and renting them back – and the pension fund deficit started to grow.

ROCE's downward trend

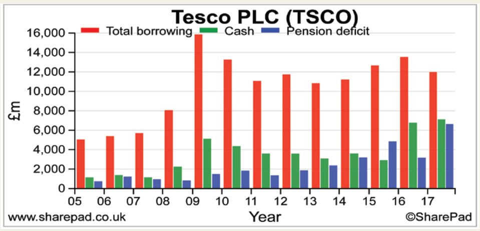


Weak free cash flow



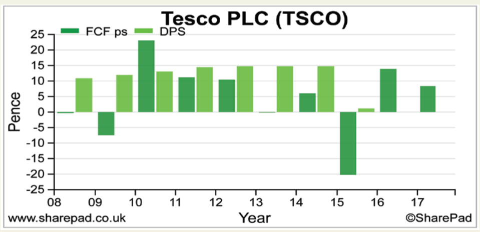
This meant that free cash flow performance was weak and that there wasn't enough free cash flow to pay dividends. Tesco only produced enough free cash flow per share to cover its dividend per share in one year during the decade between 2004 and 2014.

Debt hurdles



Dividend growth eventually came to a halt and dividends were maintained between 2012 and 2014 before being scrapped during the second half of 2015.

Scrapped dividend



> 'Final-salary pension fund deficits can be big problems for many old companies'

SOME COMPANIES WITH DOUBTFUL DIVIDENDS

Some companies will tough things out and improve profitability and cash flows to maintain payouts, but often the market's pessimism is well founded. The table below lists some shares where investors might want to question the sustainability of dividend payouts. This does not mean the dividend will be cut, but the high yields are combined with additional signs of increased risk. The biggest risk for all these companies comes from weak or weakening free cash flows and difficult business conditions.

Is the dividend sustainable?

TIDM	Name	Close	fc Yield	fc Dividend cover	FCF div cover	Lease-adj ROCE (7x, 7%)	Debt to EV (inc. pen.def)
SGC	Stagecoach Group PLC	163.7p	7.3	1.7	0.4	9.9	60.5
SSE	SSE PLC	£13.79	6.8	1.2	0.3	11.9	39.0
BT.A	BT Group PLC	262.1p	6.0	1.8	1.6	10.8	46.1
VOD	Vodafone Group PLC	216.15p	6.0	0.6	-0.2	3.5	43.1
PDG	Pendragon PLC	25.25p	5.5	2.2	-4.1	11.5	50.2

ROCE (7x, 7%) This means that ROCE has been adjusted for leased or rented assets. Capital employed has been increased by 7x the annual rent expense with trading profits increased by 7% interest on those rented assets.

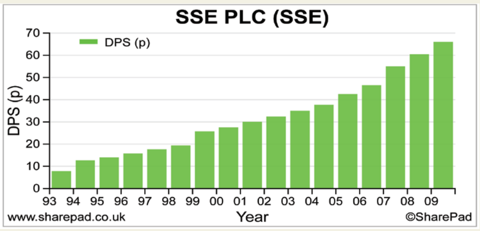
SSE

SSE (SSE) has been a very reliable dividend payer with annual increases for the past 25 years. Dividend growth in recent years has slowed dramatically and dividend cover is now very thin at 1.2 times profits. Dividends are not covered by free cash flow as the company has been investing heavily in its electricity grids and networks and ploughing lots of money into wind farms.

SSE's problem is that pre-tax profits have gone essentially nowhere for the past few years while borrowings have increased.

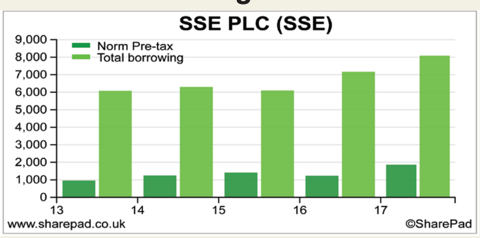
The hope is that the investment in wind farms will produce a growing stream of extra profits, which will keep the dividend safe. However, there is a chance that profits at the regulated electricity networks business will be cut when new price controls come into effect in 2021.

Dividend growth slowdown



Political pressure on the regulator to cut prices will be high. If this happens then SSE's dividend may have to be cut. While the company has promised to increase dividends by the rate of retail prices index (RPI) inflation until 2021, the threat of a dividend cut looks set to continue to be a cloud over the company's share price.

Increased borrowings



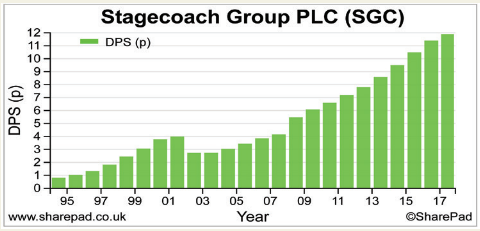
STAGECOACH

Since recovering from its disastrous acquisition of Coach USA in 2000, bus and rail company **Stagecoach (SGC)** has proved to be a very reliable dividend payer.

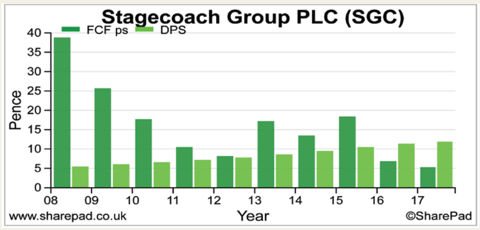
The company now finds itself in a bit of a sticky patch again. It has taken on the poisoned chalice of the East Coast rail franchise between London and Edinburgh. This is the same franchise that ended the rail business of Sea Containers in the early 2000s and blasted a gigantic hole in National Express's finances in 2009.

In order to win the franchise, Stagecoach promised to pay the government a lot of money until 2023. It now finds that its assumptions on passenger volumes and revenues have been too optimistic and is trying to renegotiate the contract. There is no guarantee it will do so on satisfactory terms, which could see it incurring big losses or paying a large sum of money to exit.

Solid dividend record



Uncovered dividends



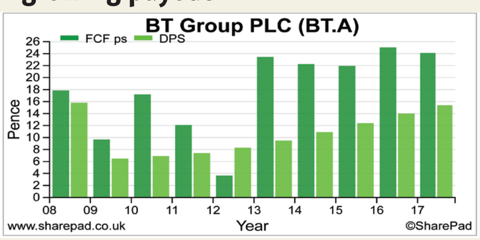
Its bus businesses, which had been growing nicely, are also finding it difficult to keep on doing so. Free cash flow has not covered the dividend for the past couple of years. If the East Coast franchise problem is not settled then a dividend cut cannot be ruled out.

BT

A quick glance at **BT (BT.A)** would suggest that its dividend looks pretty safe. For the past few years there has been more than enough free cash flow to keep on growing its dividend payout. However, several dark clouds are hovering over the company, threatening to blow a big hole in its cash flows and potentially threaten its dividend payment:

- **Rising investment costs at Openreach in order to improve the broadband network and keep the regulator off its back.** Openreach has been a cash cow for BT in recent years, but rising capital expenditure could see vastly reduced free cash flow from this business.
- **The increased cost of sporting rights.** BT has become a major player in televised sport in order to protect and grow its share of the UK broadband market. This strategy is getting very expensive and could get even more so.
- **A ballooning pension fund deficit.** This is the

A growing payout



£2bn
BT'S ACTUARIAL DEFICIT WILL REQUIRE £2BN OF CASH OVER THE NEXT TWO YEARS

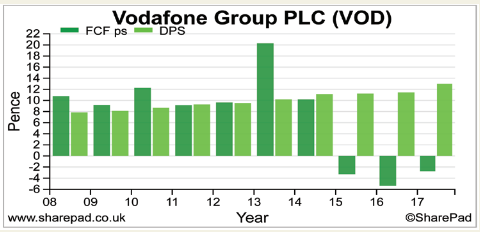
elephant in the room. Credit rating agency Moody's reckons that BT's actuarial deficit will have increased substantially and will require £2bn of cash over the next two years to help plug it – an increase of £600m compared with what was agreed three years ago.

VODAFONE

Vodafone (VOD) used to be a prodigious generator of free cash flow, thanks mainly to the huge dividends it used to get from its shareholding in Verizon Wireless. Since it sold its stake, generating enough cash to cover the dividend has been difficult as the company's revenues have come under pressure while it has been spending large amounts of cash investing in its mobile and fixed-line telecoms networks.

Vodafone's free cash flow has been negative for the past three years. The company has tried to calm investors by pledging to improve free cash flow, but it still faces lots of challenges. City analysts seem to believe the company and are forecasting significant improvements in free cash flow despite capital expenditure only coming down slightly. Vodafone needs to generate more trading cash flow or its dividend will continue to look questionable.

Negative free cash flow



PENDRAGON

Last week's profit warning from **Pendragon (PDG)** saw weakness across all of its three businesses. Third-quarter profits have fallen in new cars, used cars and aftersales.

A softness in the UK car market is not totally surprising given the rapid growth in credit-driven personal contract plan (PCP) sales in recent years. The fear now is that a glut of used cars hitting the second-hand market will trash residual values factored into new PCP contracts and make buying new cars more expensive for customers going forward.

The company is now making a concerted push on growing its used-car business where profit margins are usually much better than on new-car sales.

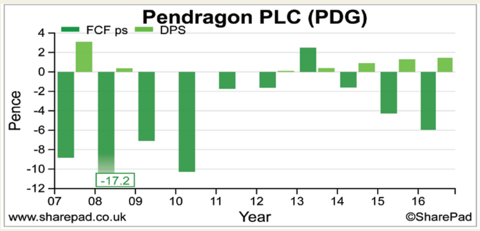
Despite a challenging outlook, analysts are not yet predicting a dividend cut. However, consensus estimates are currently for no dividend growth after 2018.

Pendragon's dividend is covered more than twice by expected EPS going forward, but its free cash flow performance has been terrible due to heavy capital expenditure in recent years.

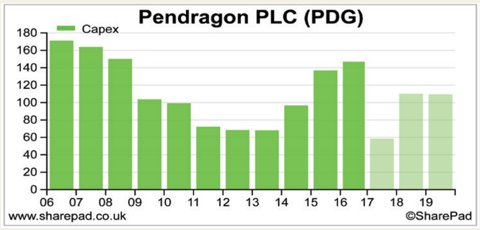
Analysts expect a sharp drop-off in capital expenditure in 2017 with an increase in 2018.

The current cash cost of the dividend is just over £20m. Interest and tax costs of around £40m are estimated for the next few years. This means that pre-tax, pre-interest free cash flow needs to be around £60m to generate enough cash to cover the cash cost of the dividend.

The cost of high capex

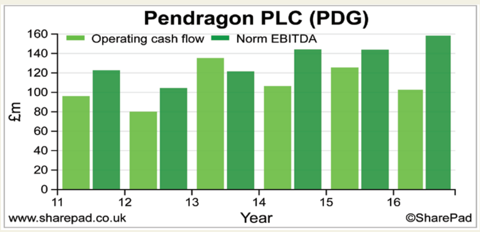


Expected expenditure



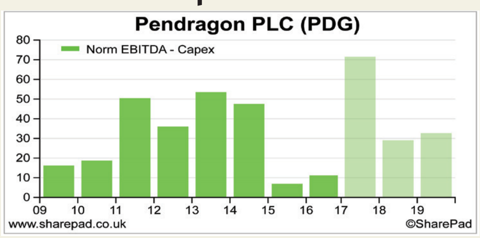
An estimate of this cash flow number can be derived by taking estimated earnings before interest, tax, depreciation and amortisation (Ebitda) and subtracting estimated capital expenditure from consensus analyst estimates. Ebitda has generally been greater than operating cash flow, so we can argue that we are being generous to Pendragon here.

Ebitda versus operating cash flow



This looks sufficient in 2017 – more than £60m – but not in 2018 and 2019 and certainly not if trading conditions deteriorate.

Ebitda minus capex



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