Avoiding the Dreaded Dividend Cut

Most investors fear the prospect of a company's dividend being cut. As commonly known, some companies pay a portion of their profits to shareholders as dividends. These dividend payments tend to be completely discretionary, meaning that a company's board of directors may, at any time, decide that it is not in best interests of the company to continue paying the dividend. Any corporate decision to reduce or eliminate a dividend has consequences. If the decision is unexpected, some existing shareholders will probably react negatively and sell their shares, driving down the share price. The shareholders who stick around may be forced to re-evaluate their reasons for investing in the company.

These consequences are not particularly palatable, which raises the question - what can be done to avoid investing in companies that are about to cut their dividends? We have some basic suggestions. First, pay attention to the payout ratio. The payout ratio is simply the percentage of a company's earnings that are paid out as dividends to shareholders. A lower payout ratio means that the company has more flexibility to continue to pay dividends at a time when its earnings are temporarily depressed. On the other hand, a high payout ratio may mean that there is little margin for error.

Second, do not expect all companies in cyclical or volatile industries to pay uninterrupted steady dividends. An oil pipeline company with steady cash flows is far different from an oil tanker company with exposure to volatile tanker rates. A regulated utility is far different from a homebuilder. Sustainable dividends go hand in hand with sustainable underlying businesses. Cyclical companies have to be closely monitored. When a cyclical company's results are weakening along with its industry, a dividend cut can come at any time.

Third, view an extremely high dividend yield as a possible red flag. The market may be anticipating a dividend cut in advance of an announcement. When we run a simple screen for companies with the highest dividend yields, we often see a dog's breakfast of companies with high payout ratios, companies in declining industries, like fixed-line telecom, natural resource companies with depleting assets, companies with lots of debt, and even foreign-based companies where shareholders face currency exchange risk. We are not saying all high-yield companies are bad; rather, we are simply suggesting that investors be skeptical.

Let's look at a concrete example. In July, American coal producer Walter Energy Inc. (NYSE:WLT) cut its dividend by over 90 per cent – from 12.5 cents to 1 cent per quarter. The company had little choice in the matter, as prices for the commodity it produces, metallurgical coal, had dropped sharply, and its lenders demanded the change. The company's shares declined by more than 15 percent in one day in response to this news. Evaluating this situation, we reiterate that cyclical companies like Walter cannot all be expected to pay uninterrupted steady dividends. Our point about payout ratios also applies, but since this company has been losing money recently, it seems pretty obvious.

We have mentioned some risks and situations to avoid, but inverting our message, when we find companies with substantial (but not extremely high) dividend yields, moderate payout ratios and sustainable business models, it is usually worth doing further research. The upside of a great dividend stock is a profitable multi-year hold period that includes a healthy, or even rising, dividend payout to the shareholder. We want to be involved in those situations.

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