How To Avoid Dividend Time Bombs

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How To Avoid Dividend Time Bombs

By Jim Fink (bio at end)
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What do General Electric, Teva Pharmaceuticals, Mattel, NuStar Energy and Mosaic Company all have in common? They have all cut their dividends at least once over the past year.

It is every dividend investor's nightmare, especially for those who rely on dividends to meet their living expenses. The key to avoiding dividend cuts is to invest only in companies with strong fundamentals and cash-generating businesses that can support their dividend payouts over the long term.

Dividend Cut Warning Signs

Before buying a dividend-paying stock, I try to weed out companies that show any of the following warning signs:

1. Heavy Debt Load

Cash flow is uncertain but the interest due on debt is a mandatory certainty. If a company does not have enough cash flow to pay both a dividend and make interest payments, the dividend gets chopped first. A good example was SuperMedia, which changed its name from Idearc after filing for bankruptcy in 2009. The company was the yellow pages business of Verizon before Verizon spun it off in 2006 along with a huge chunk of debt.

At the time, many analysts recommended the stock based on its high dividend, dismissing the high debt load as easily covered by current cash flow. When cash flow declined more than expected as advertisers switched to Internet platforms, the $9.1 billion in debt overwhelmed the company, the dividend was eliminated, and bankruptcy followed.

2. Change in Business Conditions

In 2008, Fairpoint Communications, a North Carolina-based telephone company, agreed to buy Verizon's telephone businesses in northern New England (Maine, New Hampshire, and Vermont) for $2.8 billion. Fairpoint incurred a lot of high-cost debt to pay for the deal and agreed to pay for expensive capital improvements in order to get regulatory approval.

Many analysts recommended the stock, arguing that the increased cash flow from the Verizon businesses was more than enough to cover the increased debt expense. When more-than-expected telephone customers canceled their landline telephone service and switched to wireless and cable alternatives, cash flow disappeared and Fairpoint could not service its debt load. Bankruptcy followed in 2009.

Other historical examples of dividend cut disasters include General Motors in 2006, Eastman Kodak in 2009, American International Group in 2008, J.C. Penney in 2012, and RadioShack in 2012. All except J.C. Penney subsequently went bankrupt after the dividend cuts started.

3. Verizon Involvement

Based on the SuperMedia and Fairpoint examples, be wary of any dividend-paying stock that is the result of a transaction involving Verizon. It almost makes me want to buy Verizon stock, given how the company has an uncanny ability to unload its garbage onto other parties. Did I mention the bankruptcy of Hawaiian Telcom in 2008 after Verizon sold it to the Carlyle Group for $1.6 billion in 2005?

How about the slow-motion and relentless stock-price collapse of Frontier Communications after it cut its dividend several times to pay for various disastrous telephone-line acquisitions, including the 2010 acquisition of Verizon telephone lines in 14 states, the 2014 acquisition of AT&T telephone lines in Connecticut, and the 2016 acquisition of Verizon telephone lines in California, Texas, and Florida?

4. Not Enough Cash and Declining Return on Equity (ROE)

Bottom line, a company can only pay its dividend if it generates enough cash to do so. Return on equity (ROE) is considered a key profitability metric when comparing companies against their peers and is used by many of the world's top investors, including Warren Buffett. Any company with a declining ROE and that pays more out in dividends than it generates in normalized cash flow is high-risk and I would run - not walk - away.

5. Recent Dividend Cut

Just as you almost never find only one cockroach, companies in trouble rarely stop at only one dividend cut. Just look at Capstead Mortgage, which has cut its dividend six times since 2014. At the time of its first cut, it was trading at $12 and now it is trading for about $9.20. Investors who sold after the first dividend cut did better than those who held on.

Other examples of serial dividend cutters include CYS Investments and AGNC Investment Corp.

Some Dividend Cuts are OK

Of course, not all dividend cuts are warning signs. Some cuts are due to one-time events that do not signify deterioration of the business. For example, Royal Caribbean Cruises suspended its dividend in November 2008 in order to fund the delivery of new ships and pay for product improvements, and the stock has increased more than ten-fold since then.

Similarly, ConocoPhillips cut its dividend in February 2016 to conserve cash during a period of low oil prices and the stock price subsequently more than doubled.

As I have just explained, trying to find stable, reliable income is getting harder in these volatile times.

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See About the Analyst below

About the Analyst

Jim Fink is chief investment strategist for *Jim Fink's Options for Income* and *Velocity Trader*. He has traded options for more than 20 years and generated personal profits of more than $5 million. Jim also serves as an investment analyst at Investing Daily's flagship investing publication, *Personal Finance*.

Hopelessly overeducated, Jim holds a bachelor's degree from Yale University, a master's degree from Harvard's Kennedy School of Government, a law degree from Columbia University, and an MBA from the University of Virginia's Darden School of Business. For good measure, he has been a member of the Illinois and D.C. bars and is a CFA charterholder.

Prior to joining Investing Daily, and when not incurring student loans hiding out in academe, Jim practiced telecommunications regulatory law for nine years until he realized that he made more money trading stock options than writing briefs. After attending business school, Jim switched gears to the investment realm full-time, working for a university endowment, a private wealth management firm, an insurance and financial planning company, and as a Senior Analyst for an online investment newsletter service that encourages the wearing of funny hats.

A possible but unlikely descendant of legendary brawler and boatman Mike Fink, Jim defies his heritage, believing that investing success requires patience and analysis, not swashbuckling bravado. Besides his passion for analyzing and writing about stocks, Jim likes to hike in the desert Southwest, vacation in Las Vegas, play tennis, and feed his toddler son Cheerios.