



Is This 8% Dividend Yield Sustainable?

Description

An abnormally high dividend yield is often a warning sign that a company is about to cut the dividend — which in turn may point to other bad news such as a deteriorating profit base, cash flow and balance sheet. It is therefore usually better to avoid the high yield temptations.

Sometimes, however, opportunities may be found among the high-yield pretenders — companies that have been through a difficult time but that have improving prospects and a balance sheet and cash flow strong enough to maintain and eventually grow the profits dividend again. The opportunities obviously do not come without risk and even the most careful analysis may turn out to be wrong.

AGF Management ([TSX: AGF.B](#)) is one of the largest independent investment management firms in Canada with assets under management (AUM) of \$36 billion at the end of February 2014. The problem for the company is the declining trend in AUM, which peaked at \$54 billion in 2007 – this is the lifeblood of any asset management business. The main independent competitors, **IGM Financial** ([TSX: IGM](#)) and **CI Financial** ([TSX: CIX](#)) have also been struggling with related problems over the past few years.

The wider AGF group manages a broad range of investment strategies and products for retail, institutional and high net worth clients. These products are distributed through banks, life insurance companies, financial adviser and brokers.

The path back to enhanced success for AGF is through an improved investment performance. This key metric drives AUM and profitability and supports the ability of the company to pay dividends. The funds have not been performing well, with the performance of the retail-focused mutual funds mostly lagging the peer group, holding positions in the third quartile over 1-10 year measurement periods. AGF is searching for a replacement for its Chief Investment Officer, whose departure was announced in December 2013.

On the more positive side, the AUM of the group has increased by 5% from \$34 billion in November 2013 to the current \$36 billion and the earnings per share in the most recent quarter was much better than the market expectation. The AUM increase was mainly driven by an improvement in the

investment markets but also new inflows. Investment performance has also improved over the past few months with 30% of the AGF mutual funds ranked above median in the last quarter of 2013 compared to 20% in the previous quarter.

The balance sheet of AGF is solid with a cash balance of \$286 billion by the end of February 2014. Free cash flow has been adequate to cover the quarterly dividend payments but was lower in the first quarter of 2014 as result of a large tax payment related to a historical transfer pricing audit, resulting in a dividend payment not fully covered by the free cash flow.

Barring a sharp drop in AUM and further tax penalties, it seems unlikely that the dividend will be cut in the near future. AGF has also been buying back shares over the past few years, reducing the outstanding shares by almost 10% over the past 24 months. This will work wonders for profitability and dividends per share when profits start to recover.

However, dividend investors also would like to see growth in the dividend to support some capital gain over time. This is where the challenge lies for AGF and only time will tell whether it can be successful in growing the AUM base and business profitability.

The business is not expensively valued. The conventional measure for asset management companies is the enterprise value/AUM ratio; for AGF this is 2.4% as compared to the 5.9% for the Canadian independent managers group.

Foolish bottom line

AGF is cheaply valued and is offering a very attractive dividend yield of over 8% at the current price. Barring a further ongoing deterioration in the AUM, the company should be able to sustain the dividend for the foreseeable future with upside potential should the investment performance and AUM start to improve.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:AGF.B (AGF Management Limited)
2. TSX:CIX (CI Financial)
3. TSX:IGM (IGM Financial Inc.)

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