



Can Potash Corporation Sustain its Dividend?

Description

Potash Corporation (TSX: POT)(NYSE: POT) has a strong track record of consistent and growing dividend payments. Over the past 10 years, the quarterly paid dividend has increased by almost 10% per year without any omissions or dividend declines.

However, it is really over the past five years that the company pushed ahead with a more liberal dividend policy improving the annual dividend from \$0.133 in 2009 to the current \$1.40 per share. The 2014 yield on the current share price is about 3.5%, which could make it an interesting income-producing investment when compared to fixed income yields.

Is Potash a true dividend champion?

The characteristics of a true dividend champion, a company that can deliver consistent and growing dividends over time, have been described in my earlier article on ["How to Spot a Dividend Champion"](#). The purpose of this article is to consider how Potash stacks up against these criteria.

Characteristic #1: A track record of consistent and growing dividend payments: Potash certainly scores well over the past 10 years given the track record as described above. However, the company and its peers including **Agrium** (TSX: AGU)(NYSE: AGU) are faced with highly volatile product and input prices, which can result in considerable swings in profitability. A brief study of the financial history of Potash over the past 15 years indicate losses in two financial years and a peak profitability of \$3.5 billion reached in 2008 when nutrient prices reached record levels.

The latest quarterly results again highlighted the inherent business volatility when net income declined by 39% from a year earlier. The unpredictability of the company profitability does raise an orange flag for the ability of the company to deliver consistently growing dividends.

Characteristic #2: A rock-solid balance sheet: Potash has a moderate level of debt and the debt to equity; assets to equity and interest cover ratios are within reasonable limits, which provide some degree of comfort. Nevertheless, with a volatile profit profile and substantial capital expenditures on the horizon, these ratios need to be monitored carefully as they can move very quickly in the wrong direction.

Characteristic #3: A pay-out ratio that leaves room for unforeseen events: The cyclical nature of the company's profits and especially the free cash flow (that is operating cash flow minus capital expenditure) are important factors to consider. For a company with the Potash profile, I would like to see a payout ratio (dividend payments as a proportion of free cash flow) of less than 50% which would provide some wiggle room should the company face an extended period of low product prices.

This unfortunately is where investors seeking regular and consistent dividend payments from Potash face the biggest risk. For the last quarter the payout ratio was 93% and one does not need to go back far (2009) to observe a period of negative free cash flow.

The ability of Potash to continue paying the current level of dividend is constrained by the sharply higher dividend payment costs (estimated at more than \$1.0 billion in 2014) compared to the past. The company also has a considerable ongoing capital expenditure program (estimated at \$1.1 billion for 2014), although this is expected to decline in 2015 and 2016 as the potash expansion program completes. The company also regularly buys back shares but this can readily be curtailed should cash resources be required for other purposes.

Will Potash be able to sustain and grow the dividend payments?

It is unlikely that Potash will not be able to maintain the current dividend level for the current year. However, a sustained improvement in nutrient prices will be required to improve the level of company profitability and free cash flow in order to support current dividend payments and dividend growth over the medium term.

The unpredictability of the Potash profitability and cash flow combined with the current low levels of dividend cover provide a low confidence level for income investors seeking consistent and growing dividends. Potash cannot be classified as a true dividend champion.

CATEGORY

1. Investing

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Date

2025/07/02

Date Created

2014/05/16

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