Is Potash Corp./Saskatchewan Suitable for Income Investors?

Description

Potash Corp./Saskatchewan Inc. (TSX: POT)(NYSE: POT) yesterday kept its dividend unchanged at U.S. $0.35 per share for the third quarter of 2014. For sure, its 4.1% dividend yield makes it an interesting income-producing investment when compared to fixed-income yields, but is it sustainable?

Despite the company's strong track record of consistent and growing dividends — with payments increasing without fail by almost 10% per year over the past 10 years — this was the fifth quarterly dividend without growth. And given that profits are under pressure, the question is whether this dividend can be maintained and if investors could expect dividend growth again at some point in the future.

Free cash flow is key

An important factor to consider when determining dividend payments is the amount of free cash available to the company. Free cash flow is net income adjusted for non-cash items, such as depreciation or deferred tax, minus capital expenditures. It's the amount that is potentially available for distribution as a dividend or repurchase of shares from the market. Other factors such as the strength of the balance sheet, expectations of future profitability, company liquidity, or capital commitments may also play a role, but free cash flow is normally a good indicator of the sustainability of dividend payments over time.

For the first two quarters of the current financial year, Potash Corp. had free cash flow of $904 million available to support dividend payments. The total dividend payment during the first two quarters amounted to $576 million, which implies that the dividend was comfortably covered. However, the company also has a considerable share purchase program ongoing, which accounted for another $1.07 billion during the first two quarters, indicating that Potash Corp. had to dip into its cash balance to finance both the dividend payment and share repurchases.

Given the sensitivity of investors to dividend reductions, one would assume that most boards would rather cut back on the share repurchase program than dividend payments to provide some level of comfort as to the sustainability of that dividend.

Not a sure thing

Potash Corp.'s total dividend bill has increased sharply over the past few years, providing a considerable cash outflow estimated at more than $1.0 billion per year at the current rate of dividend payments. This is much higher than in previous years. 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.

Investors have to realise that Potash Corp. faces fairly volatile and rather unpredictable input and output prices for its products. Over the past 15 years, it experienced losses for two of them and reached peak profitability of $3.5 billion in 2008 compared to a 2014 expected profit of around $1.5 billion — less than half its peak profit. Since profitability has been unpredictable, there is a risk to the ability of the company to deliver consistent and growing dividends.

The bottom line

Despite its subpar financial performance so far this year, Potash Corp.'s management recently raised its profit estimate for the full year and increased its forecast of global potash demand for 2014. Given the more positive outlook, it's unlikely that the company will not maintain the current dividend level for the foreseeable future.

However, a sustained improvement in fertiliser prices and volumes will be required to improve the level of profitability and free cash flow in order to support current dividend payments and dividend growth over the medium term.

The volatility of Potash Corp.'s profitability and cash flow at the moment doesn't give income investors who seek consistent and growing dividends much confidence.

CATEGORY

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