Warning: 3 Signs Your Dividend Is About to Get Cut

Description

A few weeks ago, I heard from a relative who had bought shares of **Penn West Petroleum Ltd** (TSX:PWT)(NYSE:PWE).

He had backed up the truck and bought the stock in November "for the big yield", which at the time was about 15%. He figured the company – which is one of the largest oil producers in the country – was a no-lose proposition.

He wasn't fazed by the giant payout, but he should've been. What happened next highlights the most important lesson of income investing: stocks with huge yields often come with huge risk.

On December 17, Penn West cut its dividend. Citing the impact of falling crude prices, management slashed the quarterly payout 79% to 3¢ per share. That sent shareholders fleeing.

And Penn West isn't the only stock to disappoint investors. **Baytex Energy Corp** and **Trilogy Energy Corp** both once sported hefty payouts. However, last month, Baytex slashed its dividend by 58%. Trilogy was forced to eliminate its distribution entirely.

All of this highlights an unfortunate point about investing in stocks. Unlike bank deposits or government bonds, dividends are not guaranteed. If you're not paying attention, you can watch your income stream dry up.

Thankfully, dividend cuts are far from random. If you know what to look for, you can usually spot problems long before they arise. Here are three signs your dividend is at risk.

1. Business problems

Dividends don't fall out of the sky. They come from earnings. But if a company can't make a steady profit, management will not be able to reward shareholders.

Take investment giant **AGF Management Limited** (TSX:AGF.B). The company had been struggling for years. Thanks to the advent of new low-cost exchange traded funds, profits at AGF's once lucrative mutual fund business have been in decline.

That’s why investors had been anticipating a dividend cut. Finally, last month, management caved in. In December, AGF slashed its quarterly payout to 8¢ per share from 27¢ per share.

2. High payout ratio

The best indicator of a dividend’s safety is the payout ratio. This is a measure as to how much of a company’s earnings or cash flows are paid to shareholders. If the payout ratio is above 90%, it leaves the business with little wiggle room.

For example, consider **Canadian Oil Sands Ltd** (TSX:COS). Assuming oil prices at around US$75 per barrel, the company is expected to generate 0.35¢ per share in free cash flow this year. Management, however, had pledged to pay $1.40 per share in annual dividends.

Clearly, that’s not sustainable. If you run the numbers, Canadian Oil Sands was paying out more than four times its expected free cash flow. To no one’s surprise, last month the company announced a 42% distribution cut.

3. Big yield

The final sign of a looming dividend cut is the stock’s yield itself. When analyzing a distribution, look at how the company’s payout compares to others in the industry. If the firm sports a double-digit yield, a dividend cut is likely looming.

Take **Just Energy Group Inc** (TSX: JE), for example. This summer shares of the natural gas and electricity retailer yielded more than 13%. The market was clearly saying that it didn’t think this dividend was sustainable.

Think about it. If Just Energy’s yield was really a sure thing, other income investors would bid up the shares to take advantage of such a great deal. That’s why it was no surprise to see management slashed the dividend 33% last June.

You must stay vigilant. If you’re not careful, your dividend income could dry up faster than puddle in July. But by keeping these three points in mind, you should be able to spot a dividend cut long before the announcement.

CATEGORY

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TICKERS GLOBAL

1. TSX:AGF.B (AGF Management Limited)
2. TSX:BTE (Baytex Energy Corp.)

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