Alaris Royalty Corp.: Is the 7.1% Dividend in Danger?

Description

There are a lot of things I like about **Alaris Royalty Corp.** (TSX:AD).

The biggest is the scalability of its business model. Alaris gives capital to a company looking to expand, usually in the form of a special kind of preferred share. These preferred shares pay Alaris an attractive royalty in the neighborhood of 12-15% per year, and they also come with built-in inflation clauses.

And that's it. That's the whole business. The only limitations are the availability of deals and access to capital.

Because the business is so simple, Alaris runs a pretty lean operation. It only has 14 full-time employees — a tiny amount for a company with an enterprise value close to $1 billion.

Low expenses mean plenty of cash flow that gets passed on to shareholders. Alaris has hiked its dividend 10 times since 2010 — an increase of 93%. The current dividend is 7.1%.

There's just one problem. What happens when the underlying royalty investments start to turn sour? That is the situation Alaris is in today, and it's causing some investors to get concerned the dividend is in danger of being cut.

The bad news

Let's start with KMH, which provides Nuclear Cariology imaging services to some 10,000 physicians in Canada and the U.S. The company has run into some financial difficulties and hasn't been able to pay a nickel in royalties back to Alaris since 2014.

Additionally, three other partners — Group SM, Kimco, and SCR — all elected to defer their 2016 royalty payments. That's $18.8 million of revenue that Alaris didn't collect in 2016. These decrease the company's annual revenue from over $100 million to just $82 million.

But it's not all bad. Alaris does expect to receive $28 million from a sale of KMH units — a deal which should close sometime soon. Regular distributions from Group SM, Kimco, and SCR are expected to kick in again in 2017. Additionally, the company expects revenue to go up $2 million in 2017 from distribution raises from its other royalty partners.

How secure is the dividend?

If we look at 2016's numbers, the dividend looks to be in hot water.

On November 8, Alaris posted what it expected full-year 2016 results to look like. Revenue was projected to be just under $83 million with net cash from operations coming in at $57 million, or $1.57 per share. Dividends are $1.62 per share, giving the company a payout ratio of 103%.

No company can afford to pay out more than 100% of earnings for a long period of time, but over a short period of time, it's not a big deal. Can Alaris increase earnings enough to cover the shortfall?

If the three partners that deferred their distributions start to pay again, it won't be an issue. Remember, these three companies represent about 18% of revenue. That solves the problem right there.

Alaris also announced a partial reduction in royalties from Sequel, its largest partner. It will receive US$30 million as a one-time payment and retain US$62.2 million worth of units in exchange for an annual US$6.2 million royalty.

Last year's royalty from the same company was $16.3 million when converted to Canadian dollars.

After it's all said and done, Alaris will see a slight reduction in 2017's royalties versus 2016's, assuming everything else stays the same.

The bottom line

Alaris has a lot of moving parts, so allow me to summarize. If the company can get the three deferred distributions back, I estimate it'll post approximately $90 million in revenue in 2017. If that happens, it'll easily be enough to maintain the dividend.

If the three deferred distributions continue to defer in 2017, revenue will drop to $72 million, which is less than 2016. If that were to happen, I would become very concerned about Alaris's dividend.

Thus, I would recommend dividend investors wait until there is more certainty surrounding the deferred distributions. Those are the key to Alaris's overall dividend health.

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