Is Inter Pipeline Ltd.'s 7% Dividend Safe?

Description

Locking in a good dividend can be a great way to secure some recurring income for your portfolio. However, if you simply look at which stock is offering the best yield, then you will be neglecting other factors that are important when choosing a dividend stock. A dividend yield that is high may not be sustainable and could result in the payout being cut or stopped entirely. In addition to the dividend yield, you should consider the payout ratio as well as the future prospects for the company. If you select a stock that is on the decline, you may just find yourself using that dividend to offset your losses.

Inter Pipeline Ltd. (TSX:IPL) currently offers a very attractive yield of over 7% annually, which is paid on a monthly basis. This would be a great way to collect monthly income, but, normally, dividend yields of 5% are hard to come by, making 7% seem a little too good to be true.

Let's have a closer look at the stock to see whether or not you can expect this dividend to continue and if it makes for a good investment today.

Payout ratio

When investors look to determine if a dividend is sustainable, that usually means looking at the company's payout ratio.

The simplest way to calculate payout ratio is by dividing the dividends per share by the earnings per share to see how much of net income is being paid out as dividends. In the trailing 12 months, Inter Pipeline's earnings per share has been $1.34. The monthly dividend of $0.135 the company currently pays would total $1.62 per share per year, or 121% of the company's earnings. This may be a little concerning at first glance, but also consider that earnings per share is based on net income, which includes non-cash items, so it will not necessarily suggest that the company can't afford the dividend.

Another way to calculate the payout ratio is to look at the statement of cash flow and how much of the company's free cash is being paid out as dividends. In the last fiscal year, Inter Pipeline had free cash flow of $620 million compared to cash dividend payments of $470 million for a payout ratio of about 76%. Under this approach, it certainly looks as though the company is managing a sustainable payout ratio, although, in the previous year, the dividends were 96% of free cash.

Payment history

Another item to consider when evaluating a dividend is how long the company has been paying dividends. In the case of Inter Pipeline, the company only started paying dividends in 2013. A company with a long history of paying dividends would certainly find it more difficult to cut or stop its dividend than a company that only recently started paying out its shareholders.

Bottom line

I wouldn't invest in Inter Pipeline solely for the dividend because the company's stock has plummeted 20% in the past 12 months, and the dividend may end up just offsetting the loss in the share price. However, should the price of oil increase, then Inter Pipeline could make for an attractive investment.

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