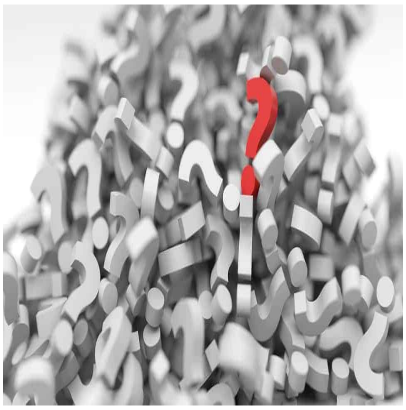

How Secure Is This +9% Yield?

Description

On the surface, **Alaris Royalty Corp.** (TSX:AD) stock's roughly 9.1% dividend yield seems to be ready to fall off a cliff, triggered by a potential dividend cut. After all, its run-rate payout ratio is about 98%.

However, it's arguable that Alaris can maintain its dividend and will try its best to do so, despite the yield having been pushed high by a declining share price from a year ago.

The business

Alaris is in the business of lending money to private businesses in the form of non-voting preferred equity. This allows the owners to remain fully in charge of and focus on the long-term goals of their businesses.

Alaris partners with these businesses and gets large monthly cash distributions from them. This ensures Alaris gets a return on its investments immediately without having to rely on an exit event.

Why is Alaris's payout ratio so high?

It's normal for Alaris's payout ratio to be high-ish, because Alaris receives cash distributions from private businesses and, in turn, distributes most of that as cash dividends to its shareholders. For example, from 2014 to 2017, Alaris's payout ratios were between 80% and 94%.

Admittedly, Alaris's run-rate payout ratio of about 98% is a little high, even for its standards. The high payout ratio is due to a number of reasons.

First, two out of the 14 businesses that contribute to Alaris's revenue stream have been problematic and have reduced their distributions to Alaris.

Second, Alaris recently exited two investments: Labstat and End of the Roll. It received gross proceeds of $69.5 million from Labstat, which delivered an annualized return of about 19% over six years.

Although End of the Roll didn't contribute materially to Alaris's revenue (Alaris invested $7.2 million in the company in May 2005), it was an exemplary investment, as over the last 13 years, it has delivered an annualized return of about 22%.

When partners exit, Alaris's revenue will decrease, and its payout ratio will be pushed higher temporarily. Alaris now has $230 million available for deployment into new or existing partners.

Is Alaris's 9.1% yield secure?

Shareholders better hope nothing more will go wrong with Alaris's partners — that is, that no more partners cut their distributions to Alaris. After all, the payout ratio can be easily pushed into an unsustainable territory of over 100%.

Thankfully, there are several events that can reduce Alaris's payout ratio.

First, its problematic partners may turn around, leading to increased distributions to Alaris.

Second, Alaris's other existing partners may be increasing their revenue. If that's the case, when it comes time to reset, which happens once a year, Alaris will be able to get higher cash flows.

Third, new deployments will help lower Alaris's payout ratio, as long as management doesn't push out more stock. I don't think it will because of the depressed share price.

Investor takeaway

I think management will try its best to maintain the dividend.

First, insiders own about 10% of the stock. Like other Alaris shareholders, they don't want the dividend to be cut.

Second, Alaris markets itself as an income investment to investors. If it cuts the dividend, it'll take a long time, if ever, for Alaris to regain trust from income investors.

Third, Alaris has funds available for deployment. So, as soon as management finds the right investments to invest in, Alaris's payout ratio will be more sustainable.

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