3 Reasons to Fear High-Yield Stocks

### Description

High dividend yields can be very appealing to income investors. Once dividends push above the 7% level, investors really need to do their research to determine whether the stocks are irrationally low or if there are dividend cuts most likely coming in the future. The fate of **AltaGas's** (TSX:ALA) dividend is a clear reminder that high yields can mean a cut is imminent. Investors should be prepared for the possibility when a yield pushes north of 7%.



## For many companies, high debt is dividend death

If used effectively, debt can be used to leverage returns in a tax-favourable manner. Debt used for investment can be extremely useful for companies to gain quick, easy capital for which the costs are known and income is steady, even regulated, to meet debt obligations. If rates have been locked in long term at ultra-low rates, companies can benefit from predictable payments to secure cheap funding.

Problems arise when companies take on too much debt, have unpredictable cash flows, or have dividends that pay out too much of their earnings to shareholders. Debt is one of the main indicators that indicate a lack of confidence in the long-term viability of a company's dividend.

AltaGas is one of the recent examples of a stock whose generous dividend seemed to signal a cut was imminent. The company has midstream pipelines, a utility business, and power-generation assets. The company put itself into a fair amount of debt last year when it completed its approximately $9 billion acquisition of WGL. Located in the United States, WGL was expected to significantly contribute to the company's clean energy ambitions.

With the acquired company in its fold, the company expects 80% of its EBITDA to come from its regulated gas utilities. While this does make its income more predictable, AltaGas felt pressure from the debt it had to take on to close the deal. It made the decisions to cut the dividend by more than 50% to put more of that cash flow towards paying down debt. While this was probably a good long-term decision to protect the balance sheet, it speaks to the danger of excessive debt.

## Collapsing free cash flow

Growing earnings and increasing free cash flow is the bedrock that indicates whether a company can continue to pay its dividend or not. Of the two, free cash flow is often seen as the more important indicator of long term, sustainable dividends and dividend growth. The giant WGL acquisition burned a lot of AltaGas's free cash, since it must now be applied to the outstanding debt obligations instead of towards dividends.

## Management's commitment to the dividend

Many companies target a certain level of dividend growth, which they commit to for a certain amount of time. Even though it has a large amount of debt, **Enbridge** (TSX:ENB)(NYSE:ENB) for example, has forecasted that it will raise its dividend by about 10% a year until at least 2020. This clarity, along with the company's long history of dividend raises, provided investors with more comfort in the dividend's security than was the case for AltaGas.

AltaGas was unable to commit to its dividend. In the face of its debt issues, the company made the choice to strengthen its balance sheet at the expense of its huge payout. AltaGas bit off a little more than it could chew, making its dividend vulnerable to a cut.



## High dividends are always high risk

It is rarely obvious whether a company will cut its dividend or not. Until the cut actually occurs, investors are left guessing. All you really know for certain is the fact that if a company has a high yield, the market has judged the dividend to be riskier. Both AltaGas and Enbridge's share prices at one point indicated a dividend cut could come. In the case of AltaGas, the heavy debt load and management's decision to focus cash flow on that leverage made the cut a reality.

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