This 3.6% Dividend Yield Is Riskier Than it Looks

Description

Pason Systems (TSX:PSI) is one of the most fascinating stocks listed on Canada's stock exchange. It's a technology company focused on a particular niche: oil rigs.

The company's software solutions help energy companies across the world manage all their oil rigs, collect data from operations, and analyze the data for critical business decisions. Over the past 40 years, the company has consolidated its position as a market leader.

Pason's software now has 61% penetration in the United States, its most important market. It also has majority market share in Canada, Latin America, Australia, and a 10% market share in the Middle East.

By all accounts, Pason is an asset-light, high-margin software-as-a-service provider in an industry with high barriers to entry. The business model is so lucrative that Pason's stock yields 3.6% in annual dividends at the current market price.

However, a closer look at the underlying fundamentals and the medium-term outlook for the global oil market should have some investors concerned.

Bottom-up risks

Pason's attractive dividend is fueled by a nearly 96% payout ratio. In other words, the company has decided to pay nearly every cent it earns back to investors. This means a sudden drop in revenue or a sudden spike in costs could have a direct and quickly noticed impact on the dividend.

It's worth noting that the company has $204 million in cash and cash equivalents on the book, enough to pay the dividend for the next three years. However, Pason's core market is no stranger to volatility and dramatic shifts within a few years.

Top-down outlook

Taking a look back at Pason's bottom line over the past five years, it's clear that the company's fortune is tied to the global price of oil. As the price of a single barrel of Brent crude plunged from $105 to $35 between 2014 and 2016, Pason's total revenue dropped from $499 million to $160 million — a difference of 68% — over the same period.

Operators are quick to suspend rigs when the price of oil is below their marginal costs of production. This hasn't happened since oil bottomed in 2016, but recently the price has been trending downward again.

According to data published by **Baker Hughes**, the total number of operational rigs is down across North America. At the end of 2018, active oils rigs across Canada were down 50% year on year.

Energy analyst Richard Masson told *CBC News* he was deeply concerned that a decline in oil rigs could have ripple effects on the economy.

In other words, a lower price of oil means less rigs to manage. Pason could be facing a decline in revenue, which could have knock-on effects on the dividends.

Bottom line

There's no certainty in the oil market. Prices could go anywhere over the next few years. However, management at Pason has left little room for maneuvering should the market collapse.

Its cash hoard may be enough to sustain dividends, fuel research, or be deployed in acquisitions. But the company has already saturated its target markets, which means prospects for expansion are limited and Pason's stock is a proxy for the price of oil.

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