Income Investors Beware: This Royalty Company Could Be a Major Dividend Trap

Description

Back in March I wrote about the benefits of royalty companies for income investors. The main reasons being they are usually simple to understand businesses and cash flows are mostly stable.

With most companies the royalty is based on top line numbers, which makes it relatively easy to estimate future cash flows, especially when those companies have many locations that are spread throughout the country.

The larger the number of locations, the more diversified the revenue, which is why most royalty companies can target close to 100% payout ratio.

One Income fund that may look attractive with its high yield dividend is **Boston Pizza Royalties Income Fund** (TSX:BPF.UN). Although the 7.9% dividend is attractive, Boston Pizza has had its fair share of problems recently and is in a tough position going forward. Investors should be mindful that this could be a textbook dividend trap.

Boston Pizza is one of the biggest and most well-known casual dining restaurants in Canada. It operates in 10 provinces and two territories. The fund has 391 licensed franchise locations in its royalty pool, as well as owning and operating five corporate restaurants.

The main problem Boston Pizza is facing and the main reason why the stock has pulled back since 2017 is the slowing of same store sales growth (SSSG). SSSG both annually and quarterly has been virtually nonexistent since the beginning of 2016.

The growth is now trending downward, the last two quarters have been negative with the most recent, Q1 coming in down 1.3%.

The problems Boston Pizza face with slowing SSSG is not an easy fix, however. Boston Pizza has done numerous things the last few years to try to improve traffic and sales numbers. It has been constructing mandatory renovations on all restaurants to revitalize the inside and outside.

There have been many different marketing campaigns, and it has even tried menu changes to add new and trendy food, as well as increase prices.

The slowdown in SSSG is reflected in the lack of dividend increases the past few years. Boston Pizza had raised its dividend each year since 2011 as the number of stores grew along with SSSG.

However, since 2016, the dividend has stayed flat. Additionally, the payout ratio has been continuing to rise with the trailing 12-month payout ratio now at 103%.

Surplus cash has also been falling since 2016. Now sitting at a surplus of $2 million, its looking more likely that a dividend cut will be unavoidable.

Going forward, Boston Pizza faces the additional risk that consumers may slowdown their discretionary spending. The casual dining segment of the food market is very discretionary and will be impacted greatly should consumers slow their consumption.

Although investors are not directly exposed to profitability of the franchises, prolonged periods of profitability issues will result in the closure of restaurants, bringing the number of locations in the royalty pool down, which is less income.

Therefore, the ability for individual franchises to turn a profit should not be dismissed.

Although the problems are not catastrophic yet and the company could still turn it around, the future does not look great. The dividend is not worth the risks investors are taking on. Investors are therefore advised to take wait and see approach until Boston Pizza can figure out its strategy moving forward.

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Date
2025/09/01
Date Created
2019/05/20
Author
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