This Dividend Was Hiked 100% and Has Plenty of Room to Grow

Description

Dividend- and income-seeking investors tend to dismiss stocks that offer low yields. That's understandable, considering the fact that investors are seeking to live off their assets and probably need a yield higher than the interest earned on a risk-free 10-year Canadian government bond to justify the investment.

One such seemingly underwhelming dividend stock is Montreal-based communications giant **Quebecor** (TSX:QBR.B). The stock currently yields 1.45%, while the 10-year government bond offers 1.69%. What's interesting is that Quebecor's dividend yield was hovering below 1% before the company decided to hike the payout this year.

After unveiling stellar first-quarter results, management announced a 100% hike to the quarterly dividend. Investors can now expect a $0.1125 payment per share every quarter on a stock that currently trades at $32. However, this hike still doesn't make Quebecor a worthy passive-income investment for most investors.

Instead, I believe the investment thesis rests on the company's intrinsic potential for growth, the stability of its industry, and its modest valuation.

Room to grow

I believe the dividend-payout ratio is just as important as the dividend yield for savvy income-seeking investors. A low payout ratio indicates that management is reinvesting in the business to drive expansion and has plenty of room to boost the dividend later.

Quebecor's managers have always targeted a payout ratio between 30% and 50% of free cash flow. This means less than half of what the company generates in cash ends up in investors' pockets, while the rest is deployed in acquisitions and infrastructure expansion. Eventually, as the company's earnings power rises, the dividend will most likely keep up.

In fact, at the moment Quebecor's payout ratio is a mere 12.4%.

Telecoms are cash cows

There's reason to be optimistic about the company's future prospects for better cash flow, considering that Canada's telecommunications sector is a hotbed for high-yield dividend stocks. Quebecor's three largest rivals offer dividend yields between 2.9% and 5.3%.

Deploying cash to create network infrastructure helps telecom companies dominate a region and extract value over the long term. While the largest telecom companies dominate Canada's most populated states, Quebecor is the undisputed champion in Quebec. This near-monopoly in the Francophone region makes it a steady and underappreciated growth opportunity.

Valuation

Being underappreciated means being undervalued. Quebecor trades at a price-to-earnings ratio of just 14.2, while its larger rivals trade at ratios between 17 and 19.

Considering the fact that the company operates on a 24% operating margin and generates a 44% return on equity, the valuation may seem too pessimistic. However, Quebecor's enormous pile of debt could be the reason behind the investment community's anxiety.

At the moment, the company's debt is nine times greater than its equity. That's far higher than any other rival in the telecom business and leaves the company more exposed to the next market downturn in the debt and interest rate cycle.

Bottom line

Quebecor has a lot going for it. It dominates a critical region with competitive services and generates a high return on equity. The dividend yield is low only because of the tight payout ratio, which means investors can expect better capital appreciation over time.

However, debt is a concern and could chew into the company's prospects if not managed well. At the moment, I think Quebecor could fit into an aggressive growth portfolio but should be avoided by risk-averse, income-oriented investors seeking stability.

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