Attention Retirees and Income Investors: Avoid This 16%-Yielding Stock at All Costs

Description

Back in July, I wrote that **Medical Facilities's** (TSX:DR) dividend was in serious jeopardy, given the shocking underperformance of its key assets and business strategy. Now, almost two months later, despite management (inexplicably) not cutting the dividend, the stock is trading at half of where it was thanks to a second quarter that was even worse than the prior one.

More pain ahead for Medical Facilities

There's no other way to put it: Q2 was a disaster. System-wide revenues fell year over year to $200 million down from $204 million, led by large drops in key surgical centres like UMASH and SFSH, which saw top-line declines of 31% and 7%, respectively, once again thanks to unfavourable case mix and payor mix. To recap: case mix refers to more expensive procedures versus less expensive ones, and payor mix is the difference in payouts received from governmental payors such as Medicare, Medicaid, and commercial insurance, with the former entities paying out less than the latter.

But more than decreases in revenue, Q2 also saw margins continue to erode sequentially from Q1. For example, operating expenses to run UMASH were 121% of revenues, OSH, 95% of revenues, and BHSH, 78% of revenues. Overall, Q2's operating expenses were a whopping 119% of total revenues, up from 83.2% in the year prior. These margin pressures and underperformance of key assets led to a goodwill impairment charge of $29.5 million at UMASH and an adjusted EBITDA (which can be used as a proxy for cash flow) of $19 million, down 20% from $24 million in the prior year. All these critical misses flowed to the payout ratio, which is now an incredible 179%, giving this battered stock a mind-boggling yield of 16.5% — well above the company's own target payout ratio of 70%.

Naturally, such a dividend implies an untenable burden in light of other pressures facing the company. For example, several of DR's key surgical sites like Black Hills are facing mounting competitive pressures and lack of skilled physician availability, leading to lower case volumes. The lack of qualified doctors on staff mean DR will have to start paying a premium to attract or retain its current surgeons,as more and more surgical centres spring up in the area.

Furthermore, DR's acquisition pipeline looks bleak. By management's own admission, the ambulatory surgical centre space is seeing mass consolidation, leading to an increase in multiples being paid across the sector. However, with such a large dividend hanging over its head, I fail to see how DR can shell out the cash to acquire new assets without over-leveraging themselves.

In summation, Q2 was even worse than Q1. And while management seemed upbeat on the conference call, I sense there is a bit of wishful thinking on the part of the C-suite and the board to keep this unsustainable payout. In this regard, I did not recommend DR in Q1, and I certainly cannot recommend it now — even if the yield is over 16%.

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