Danger: These 3 Monster Yields Are on Thin Ice

Description

Many investors are attracted to high yields, eager to convert their savings into a huge, sustainable income stream.

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Unfortunately, there's no free lunch in the world of finance. The reason why that dividend is so attractive is because there's a major risk to the payout. The market is discounting that risk by increasing the yield.

I think it's possible for investors to analyze a company's forward prospects and make an educated guess about the future of the payout. Nothing is guaranteed, of course, but an investor willing to look at the long term can often make a decision that someone who is worried about short-term risks overlooks.

Let's take a closer look at three of Canada's top dividend stocks, companies that pay dividends in excess of 14% in one case. Are these payouts doomed to be cut? I certainly think so.

Vermilion Energy

I like much of what **Vermilion Energy** (TSX:VET)(NYSE:VET) is doing. The company has production around the world, including places like France, Germany, and Australia. Oil prices are higher in these regions, which leads to better profits. And the international diversification is an easy way for Vermilion to differentiate itself from the competition.

On the surface, the company's succulent dividend of $0.23 per share each month – which works out to a jaw-dropping 14% yield – looks to be sustainable.

The company should earn approximately $850 million in funds from operations in 2020. Subtract some $450 million in planned capital expenditures and we're left with $400 million in free cash flow. Dividends work out to approximately $400 million each year. The payout is sustainable, albeit only barely.

The problem is we have no idea where crude oil prices will head over the next year. If crude slides again, it'll impact Vermilion's free cash flow in a big way. It doesn't take a genius to see such a move wouldn't be positive for the dividend.

Whitecap Resources

There are a lot of similarities between Vermilion and **Whitecap Resources** (TSX:WCP). At least Whitecap's dividend is a mere 8.3%, which looks to be at least a little safer on the surface.

Whitecap is focused on producing low-cost energy primarily in Alberta and Saskatchewan. It uses an active hedging program to help minimize its exposure to volatile energy prices, and management was aggressive in acquiring assets during the 2016–17 period. Now the company must spend money to maximize production from these areas.

Assuming a $57 per barrel price for oil in 2020, Whitecap has a payout ratio in the 75% range. But like Vermilion, that projection is only as safe as the crude market, which isn't exactly known for its stability.

Besides, I'm not sure it makes much sense for Whitecap to continue paying such a big dividend. If I was in charge I'd cut the payout substantially and put the proceeds toward more growth.

Rocky Mountain Dealerships

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Rocky Mountain Dealerships (TSX:RME) consists of 37 farm machinery dealerships in Alberta, Saskatchewan, and Manitoba, making the company Case IH's largest independent group of farm machinery dealers in North America.

Unfortunately, the last couple of years haven't been great ones for the industry. China's ban on Canadian canola has made many farmers skittish, and poor crop conditions made 2019 a lacklustre year for many producers in the prairies.

The company's recently released third-quarter results saw sales decline by more than 21% and the bottom line swing from a healthy profit to a slight loss, putting the company on pace to lose money for the entire year.

The company's balance sheet is still pretty healthy, but it would appear its 7.6% yield is a luxury it can no longer afford. Although results could bounce back quickly, farmers are known for being a conservative lot. Even if the macro picture starts to improve, these folks will likely be cautious.

It looks like the company needs to prepare for a lean few years, which could very well mean the dividend will be cut, if not eliminated completely.

The bottom line

If you're looking for sustainable yield, stay away from Vermilion Energy, Whitecap Resources, and Rocky Mountain Dealerships. While it's certainly possible for these companies to maintain their payouts, the future doesn't look particularly good. Risk-adverse investors should look for yield somewhere else.

CATEGORY

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