Buy Alert: This Stock Yielding 10.1% Is Trading Well Below its Fair Value

Description

Restaurant royalty companies are some of the stocks I have mentioned before for investors to watch, as Canadian consumers shift from overconsumption to debt reduction.

Eating out at restaurants is one of the most discretionary items that people do and something that can easily be cut from budgets to prioritize more important things, such as paying down debt.

The market has generally agreed, and most of these stocks have been decimated, especially as negative same-store sales have plagued the industry, providing evidence to the theory that consumers have slowed down their consumption.

After being sold off massively earlier this year due to some of the fears that the dividends may be cut, are these restaurant stocks now a buy?

One restaurant royalty company that looks like it could be oversold and heavily undervalued at these levels is **Boston Pizza Royalties Income Fund** (TSX:BPF.UN).

In order to understand whether or not the fund is investable, we need to understand how it first makes its money.

The fund receives a royalty payment of roughly 5.5% of all qualifying sales (anything but alcohol) from the restaurants in its royalty pool.

The royalties from all the restaurants are what makes up the fund's revenue, and then after paying administrative expenses and other costs to run the fund including taxes, the company pays what's left over to shareholders in the form of a dividend.

This means as long as the fund can keep its costs flat, which it does for the most part, the main thing to watch is the level of sales in its restaurants, which is why same-store sales growth (SSSG) is such an important metric for these top-line royalty funds.

Boston Pizza has been sold off massively to end the year. Throughout 2019, it was trading mostly between $17 and $18, which is already significantly lower than its 2017 levels, and even most of 2018, when the stock was also being sold off.

You'd think the fund already cut its dividend, but it has yet to do so. That's clearly what the market is anticipating, though, with the stock down more than 40% off its 2017 highs — a huge decline for a royalty company.

It's currently paying out $1.38 a year on earnings of just $1.08, giving it a dividend yield of roughly 10.1%.

Just looking at the net earnings is not good enough analysis, however, because non-cash accounting adjustments, such as the fair-value adjustment in BP Canada LP, can drastically impact the profit the fund is actually earning.

In the fourth quarter of 2018, the fund reported distributable income of roughly $7.3 million, which is roughly in line with what it usually reports, yet its net income came in as a loss of $960,000, or $0.04 a share.

So, in actuality, over the last four quarters, the company has reported distributable cash of $1.33 per share versus the $1.38 that it's paying out in annual dividends.

From here, two things can happen to make the dividend sustainable again. Either Boston Pizza can figure out how to improve its SSSG, or the dividend will have to be cut.

If it's forced to take the latter of the two options and cut its dividend, at current sales numbers, the dividend would have to be cut by roughly $0.05, or 3.6% from its current level.

To be safe, though, and in case of continued same-store sales decreases, cutting the dividend a little further to give itself some breathing room could be prudent, such as a $0.13 decrease, or 9.4%.

This would bring the annual dividend to $1.25 and give the company a payout ratio today of 91%. The newly trimmed dividend would yield roughly 9.2% as of Boston Pizza's closing price on Tuesday of $13.61.

A 9.2% dividend that has a payout ratio below 100% seems like a pretty attractive deal to me, and shows the market may be overreacting with Boston Pizza, moving it well into oversold territory.

There are still some other risks to consider though, such as a lack of SSSG potentially causing some restaurants to close, which would impact overall sales numbers.

However, given the value that's available, and Boston Pizza's strong brand, which is considered the number one casual dining company in Canada, the rewards seem to outweigh all the potential risks, making Boston Pizza a top buy today.

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Date
2025/07/22
Date Created
2019/12/11
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