Is Inter Pipeline’s 7.6% Dividend Too Good to Be True?

Description

Inter Pipeline Ltd (TSX:IPL) is one of the top-yielding dividend stocks on the **TSX**. The company has posted a profit in each of the past four quarters and it has strong financials despite operating in a risky oil and gas industry.

Paying shareholders a dividend yield of 7.6%, Inter Pipeline offers a mammoth payout, and to make matters even better, payments are made every month. It’s a high rate of pay and a consistent one.

Nonetheless, when the yield is as high as it is, questions are going to surface as to whether investors should trust these dividend payments or if the company is likely to cut them.

Is Inter Pipeline producing enough profit?

Over the trailing 12 months, Inter Pipeline has earned $582.8 million in net income, which equates to an earnings per share (EPS) of about $1.40. Meanwhile, its monthly dividend payments of $0.1425 total an annual payout of $1.71 per share.

That means that Inter Pipeline is paying over 122% of its profits out as dividends. The company’s EPS has been below $1.60 in each of the past three years and it’s not an anomaly that they’re below the annual dividend rate.

However, it’s important to remember that net income may not be an accurate representation of a company’s ability to pay dividends. It includes amortization and other non-cash items that will weigh down the company’s earnings. When evaluating a dividend, it’s also important to look at the strength of its cash flows as well.

Can free cash flow cover dividend payments?

In 12 months, Inter Pipeline has generated negative free cash flow of $609.8 million. Not only is that not positive, it’s nowhere near sufficient to cover and maintain the $341.3 million that the company paid out in dividends during that time.

It does, however, have operating cash flow of $884.6 million, which would be more than enough to cover its dividends. But that shouldn't leave investors at ease, as a company isn't going to forgo capital expenditures in order to pay a dividend, it's just not a prudent use of money.

From both a cash flow and income perspective, Inter Pipeline's dividend may be on shaky ground. Its free cash flow has also worsened over the years.

In 2017, it reported free cash flow of $649.6 million for the year and that proceeded to drop to $133.7 million in 2018. That could fall even further in 2019 as the company's free cash flow has been negative in each of the past four quarters.

What does this mean for investors?

Investors should be careful not to rely on Inter Pipeline's dividend. While it's a good bonus if you like the stock, it shouldn't be the primary reason you invest in the company.

With things not getting any easier in the oil and gas industry, a dividend cut is a possible option for the company if conditions get worse and Inter Pipeline needs more access to cash.

As tempting as a 7.6% dividend yield is, investors need to be cognizant of the risks and not be quick to assume that the dividend payments will continue as the company is under no obligation to keep them going.

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