Income Lovers: Is it Time to Load Up on This 12.8% Yielder?

Description

We've all heard the term value trap before, which refers to a stock that is hiding some serious issues, despite looking cheap on the surface. These securities aren't necessarily ready to plunge, but, at best, they're usually dead money.

I think Canadian investors are in more danger from a group of stocks I like to call dividend traps. These are stocks that offer compelling yields, but the succulent payout inevitably is at risk of being cut. Shares might chug along for a year or two, staying about the same until the inevitable happens. The dividend is then slashed, and the stock craters 30% on the news.

One of the things that is interesting about high-dividend stocks is, some of them end up being compelling investment opportunities. Not only do they continue paying generous dividends, but the underlying share price does well, too. If you pick the right stock, it can easily post a 20-30% annual return for a few years.

This is why investors are so conflicted. There are some interesting opportunities for investors who choose the right high-yield securities.

Let's take a closer look at one of Canada's top dividend payers — a company that offers a 12.8% yield today. Is it a dividend trap, or can it recover and be an excellent investment?

An opportunity?

Chemtrade Logistics Income Fund (TSX:CHE.UN) is a manufacturer of specialty chemicals. Its business is divided into three separate divisions. The first makes chemicals for the petroleum industry, including refiners and fracking companies. The second makes water treatment chemicals used by municipalities to keep our drinking water safe. And the third supplies bleaching products to the pulp and paper industry.

In terms of quality of the business, it's a mixed bag. On the one hand, these are steady businesses that supply mature industries with predictable demand. Long-term contracts are used because they're beneficial to both suppliers and customers. On the other hand, investors must remember Chemtrade sells commodity products. There's really no way it can differentiate itself to its customers. That means profit margins are razor thin, and the company must constantly be controlling its costs.

Unfortunately, the firm has been having difficulties lately, which have hit its bottom line. It has had supply chain issues. Cash has been put aside to deal with a lawsuit against one of its subsidiaries. And it was forced to deal with unplanned outages at one of its plants.

After last quarter's results were solid, investors might have assumed the company's issues were behind it. Unfortunately, they assumed wrong. Shares tumbled last week, falling close to 15% on weak 2020 guidance. The company projected it would post adjusted EBITDA of between $300 and $350 million, thanks to maintenance on a key plant and a planned outage from one of its main oil refinery customers. That came in a little below investor expectations.

Is the dividend safe?

Chemtrade Logistics has quietly paid a very generous dividend for years now. In fact, the company has paid its current $0.10 per month distribution since 2007. This is an obligation management takes seriously, and a dividend cut would be one of the organization's last resorts.

Besides, even at the reduced EBITDA levels, the distribution should be fine. Through the first three quarters of 2019, the company posted $225 million in adjusted EBITDA, which puts it on pace to deliver total EBITDA of around $300 million for the year when it reports full-year results. And yet, the dividend-payout ratio based on distributable cash flow was in the 70% range for 2019.

This means that even with somewhat disappointing results in 2020, the dividend looks to be safe.

The bottom line

Chemtrade's dividend — which is the main reason many investors hold the stock — looks to be safe, at least over the short term. That's good news.

However, I'm not sure this is a stock I'd want to own over the next decade or two. It's a competitive business with low margins, sensitive to both key customer risk and competition. If it does have an economic moat, it's a weak one.

Over the long term, stocks with weak moats don't tend to post good returns. I believe Chemtrade will ultimately suffer the same fate.

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