Income Investors: Avoid This Yield Trap

Description

Many investors are aware of the term *value trap*. This relates to the idea that some stocks look too cheap to ignore. However, their value continues falling. Additional problems snowball in a downward spiral that can leave investors both dumbfounded and poor.

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For dividend-seeking investors, finding companies with mouth-watering, double-digit dividend yields can seem very attractive on the surface. But, these often turn out very poorly over time. Here is a great example of dividend “yield traps” I’d suggest investors avoid.

Vermilion Energy

Perhaps the poster child for Canada’s hurting energy sector, **Vermilion Energy** (TSX:VET)(NYSE:VET) has seen its share price plummet of late. Many investors are fleeing the oil and gas sector for a multitude of reasons.

Vermilion is a standard Canadian energy company with poor balance sheet fundamentals and relatively high costs of production. This makes the company a highly levered bet on the price of oil for risk-taking investors. As we all know, the price of oil continues to hover around one-year lows, making levered plays like Vermilion look toxic to many investors with low risk tolerances.

A double-digit dividend

At the time of writing, Vermilion’s dividend yield hovers around 18% due mainly to the drop in commodity prices through the end of February. Any company with a dividend yield of 18% is expected to cut its dividend (the market is pricing a cut in).

However, some investors continue to believe Vermilion’s management team will not cut its dividend, because “the company has never cut its dividend in the past,” but Vermilion cut its dividend by 50% as of March 6.

The market simply seems to be ignoring the company's management team, which has indicated it can be profitable at $40 oil. Instead, the market is focusing on the fact that Vermilion currently pays out more in dividends than the cash flow that comes in. This action is obviously unsustainable.

Bottom line

Investors need to keep something in mind: it is not uncommon for management teams to loudly proclaim that they will never cut their dividends. But, in most cases, the financial markets will simply force such a company into a position whereby not cutting their dividends will be more detrimental. This results in an inevitable dividend cut — a sort of self-fulfilling prophecy.

If Vermilion continues to stand pat and pay out its existing dividend with cash flow streams that continue to decline, at some point, the company will need to either raise debt or equity to pay the dividend. This is something that is unlikely to be greeted warmly by shareholders.

This is a textbook example of a dividend yield trap, which should be avoided. That is, until the company does the right thing and shifts its focus from paying out a dividend to repaying debt and investing in improvements. Such improvements could include improving operational efficiency and margins. These are key drivers that will support dividend growth in the future.

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Stay Foolish, my friends.

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Date
2025/08/23
Date Created
2020/03/19
Author
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