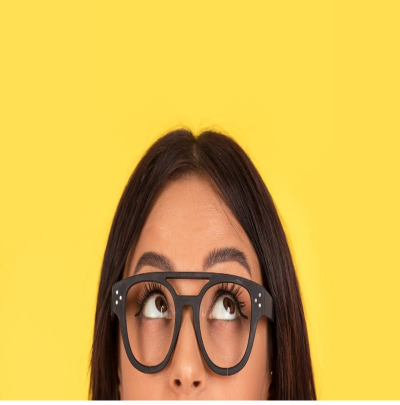

Safe Payout or a Dividend Trap? 1 Royalty Stock With a 10.72% Yield

Description

The **TMX Group's** website lists **Labrador Iron Ore Royalty** (TSX:LIF) as one of the stocks that pays the highest dividends. As of this writing, the royalty stock trades at $43.21 per share and yields an ultra-high 10.72%. The payout is very attractive, especially to yield-thirsty investors.

Investors, however, need to be extra careful and look beyond the juicy dividend. While the payout is fantastic, it might not be safe or sustainable. Double-digit yields are rare, and for all you know, Labrador could be a dividend trap.

Investment thesis

Labrador Iron Ore provides exposure to the iron ore market. Its subsidiary, Hollinger-Hanna Limited, has a 15.10% equity interest in Iron Ore Company of Canada (IOC). IOC is North America's leading producer and exporter of premium iron ore pellets and high-grade concentrate.

IOC owns the infrastructure or assets that mine and produce iron ore pellets and high-grade concentrate. It transports finished products by rail to its destinations, specifically ship-loading facilities and marine terminals. Labrador derives its revenues (royalties and commissions) from IOC.

Labrador has yet to present its Q4 and full-year 2021 results, but it should be impressive due to higher ore prices and pellet premiums. In the nine months ended September 30, 2021, revenue and net income grew 48.5% and 96.9%, respectively, versus the same period in 2020. Cash from operations increased 398.1% year over year to $295.9 million.

Market outlook

Commodity producers like Labrador benefits from inflation and attendant commodity super cycle. According to Fitch Solutions, iron ore price will remain high (over US$100 per tonne) until 2023. The credit ratings agency added that supply will remain stable while demand will increase.

However, Fitch predicted that after 2023, iron ore prices will decline below US$100 per tonne from 2025 before it falls to US$50 per tonne by 2031.

Factors to consider

Hollinger-Hanna collects a 7% gross overriding royalty from all iron ore products IOC produces, sells, delivers, and ships on top of the US$0.10-per-tonne commission interest on iron ore sales. Other interests, including leases, are economically dependent on IOC.

Seasonality is another factor to consider when investing in Labrador Iron Ore. The operations of this $2.76 billion royalty corporation depend on royalty and commission revenues from IOC. Since production and revenues from the source isn't constant throughout the year, operations and operating cash flows vary from quarter to quarter. According to management, the winter months produce the lowest results.

Crazy dividends

The royalties Labrador gets from IOC are before expenses are deducted. While the royalty company has zero exposure to operating costs, cash flows are entirely dependent on the price of iron ore and IOC sales. Because of this structure or business model, expect dividend payouts to be irregular if not fluctuating constantly.

Since the basis for its dividends is exclusively off the royalties from IOC, the drawback is the unstable payouts. The return to shareholders is higher when cash flows are significant due to higher iron ore prices. Inversely, the yield is lower if iron ore prices fall and cash flow dips. Labrador isn't exactly a dividend trap. However, investors must understand the nature of the business and then anticipate the dividend yield to move around.

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