Dividend Stocks: Will Debt Load Put a Damper on This Top Stock in 2023?

Description

The last year has been pretty brutal for many dividend stocks. After being taken to new heights during the pandemic, many dividend-payers fell flat on their faces when inflation and interest rates started climbing. **MTY Food Group Inc.** (TSX:MTY), on the other hand, has been on a clear and unwavering ascent higher. Can this continue despite the company's rising debt load and rising interest rates? Should shareholders sell in the face of this potential trouble?

Let's explore.

Dividend growth at MTY has been strong

MTY Foods is one of the largest franchisors in Canada's restaurant industry. Years of introducing new quick-service restaurants, as well as acquiring successful brands, have resulted in good things. In fact, MTY is currently a $1.7 billion company with record of strong cash flow generation and strong returns – a business that lends itself well to dividend growth and stability. For example, in 2021, MTY generated $132 million in free cash flow. This represented 24% of revenue and demonstrates the cash flow power of this company. Also, cash flows have grown steadily and consistently for MTY, as its business is pretty predictable and consistently growing.

All of this has resulted in top stock price performance for MTY stock. In fact, it was one of the best dividend stocks in Canada in the last year. Strong cash flows drove strong dividend increases and shareholder returns. MTY upped its dividend by 19% last month, in what was the latest of a long string of dividend increases. MTY's growth strategy has literally "paid dividends". In fact, in the last 10 years, MTY stock's annual dividend has grown at a compound annual growth rate (CAGR) of 14%, to the current $1.00 per share.

MTY's growth strategy has been successful but can it last?

It's no secret that acquisitions have fueled much of MTY's growth. These acquisitions have been pivotal in helping MTY become the large player that it is today. In the last five years alone, MTY's revenue doubled as the company continued to acquire new restaurant brands across North America. Furthermore, margins have been strong and returns healthy. MTY's growth strategy was simply carried out impeccably well, with strong operational practices driving strong synergies and returns.

As a point of proof, we can take a look at MTY's profit margin of 15% and return on equity of 14%. The restaurant business is not one with the greatest margins, but MTY has been able to carve out nice returns for itself.

Growth by acquisition comes with risks

While MTY's business is a resilient one that should perform relatively well in this economically sensitive environment, there are some risks worth monitoring. These risks place MTY's financial health, and ultimately, its dividend, into question. Firstly, inflation is rearing its ugly head and everything, including food, is going up in price. Also, labour shortages have been an issue and rising wages may become an increasingly bigger issue. This has the potential to eat away at MTY's profits quite quickly.

The second thing to monitor closely is MTY's debt load, which currently stands at 51% of total market capitalization. Aggressively growing by acquisition is always a tricky balance to strike, especially if a large portion of the acquisitions are financed with debt. In a normal environment, companies can get into trouble with this after a while. In today's rising interest rate environment, buying sprees become even more perilous.

If food and labour costs rise, rising costs will hit MTY's earnings power at the same time as interest costs are rising as well. In turn, interest coverage ratios would deteriorate. This double whammy is certainly something that concerns me. Clearly, it has the potential to place this dividend stock at risk. Thus, I don't believe that MTY stock will remain one of the best dividend stocks in Canada.

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