DSR PREMIUM NEWSLETTER

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This is your site and your exclusive newsletter. Please, feel free to share any ideas, opinions, comments, or suggestions with us via email at dividendustries@gmail.com.

AUGUST 23rd, 2024

Dear DSR member,

It is with great pleasure that we present our weekly premium newsletter which is an important component of your subscription to Dividend Stocks Rock.

You may benefit from viewing our video explaining the differences between the Buy List, our ratings, and our portfolio models. You can retrieve this information in the Videos section of the website.

Referral

Feel free to share our ideas with your friends or associates who may benefit from this information. **We would personally consider any referrals you make on our behalf to be the ultimate compliment for our efforts.**

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UNDERSTANDING THE PAYOUT RATIOS. IS THE DIVIDEND SAFE?

A few years ago, I wrote a DSR fundamental newsletter with the sole focus being dividend safety. I discussed three strategies to avoid stocks that may be subject to dividend cuts:

#1 Trust the market and beware of high dividend yield stocks.
#2 Avoid stocks with an absence of dividend growth.
#3 Avoid stocks with a weak dividend triangle.

You can find the 2024 version in the fundamental section.

Many investors like to keep things straight and to the point and use the dividend payout ratio to determine if a company can afford to share the wealth with its shareholders.

There is a lot of good information to take from dividend payout ratios, but you can't just take the number from a stock screener or financial site and draw an educated conclusion. **Context must be added**. This newsletter will help you add that context and assist you in analyzing all the various dividend payout ratios.

Let's start with the basics: how something simple could get complicated!

#1 How data is calculated and where it's coming from

The simplest way to calculate the payout ratio is to divide the dividend paid per share by the earnings per share. However, when you look at a financial site, you don't know if they use quarterly, annual, or trailing twelve months (TTM) data. Here's an example of Royal Bank (RY.TO) data during the pandemic of 2020:

October 2019:	EPS: $2.18	Dividend: $1.05	Payout ratio: 48.2%
January 2020:	EPS: $2.40	Dividend: $1.05	Payout ratio: 43.75%
April 2020:	EPS: $1.00	Dividend: $1.08	**Payout ratio: 108.00%**
July 2020:	EPS: $2.20	Dividend: $1.08	Payout ratio: 49.1%
Total:	**EPS: $7.78**	**Dividend: $4.26**	**Payout ratio: 54.76%**

If you look at the quarterly payout ratios only, you could have become alarmed back in April 2020. However, any other quarter looks normal and the last 12 months (TTM) is also showing a payout ratio under control.

When you follow Royal Banks' payout ratio from one quarter to another, you can identify April's results as an anomaly. You then need to go onto the bank's investor relations website and pull-out their quarterly reports. This is where you would have discovered that Royal Bank increased their provision for credit losses significantly, thereby bringing their earnings down. Since it's a provision for loss and not an actual loss, this doesn't affect the bank's capacity to pay its dividend. It is also important to use adjusted diluted EPS for the earnings. This will eliminate a few one-time events that should not be considered in the calculation.

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You can obtain additional perspective when you analyze the pandemic's affect on Royal Bank's payout ratios temporarily. In the following graph, you will notice how a bad quarter with weak earnings could completely change the payout ratio. Fortunately, not all economic events come with a permanent impact.

Royal Bank of Canada (RY.TO) Dividend VAL 1.35
1.35
1.20
1.08
0.96
2020 2021 2022 2023

Royal Bank of Canada (RY.TO) Normalized Diluted EPS (Quarterly) VAL 3.032
3.20
3.032
2.40
1.60
0.80
2020 2021 2022 2023

Royal Bank of Canada (RY.TO) Payout Ratio VAL 37.47%
54.00%
48.00%
42.00%
37.47%
2020 2021 2022 2023

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What I want to demonstrate with this graph is how the payout ratio can be influenced by a specific event. In this case, nobody knew how long or how bad the pandemic would be. Fast forward to four years later and we can see that the impact on the economy is getting quickly reabsorbed and that most businesses are moving back to normal. Regulators lifted the dividend growth freeze in late 2021 and everything reverted to normal.

Interestingly, the payout ratio is still under control in 2023 after the bank took the largest provisions for credit losses for the past 12 months. PCLs affect earnings negatively as they are seen as "potential losses".

In fact, if you look at the current payout ratio, you will note that Royal Bank has more room than ever to increase its dividend!

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#2 Trends are your friends

As is often the case when you look at financial metrics, a single number is not necessarily meaningful. At first glance, Royal Bank's payout ratio of 40% looks pretty good. But what if the bank used to keep a ratio historically lower? Or higher?

Let's look at the past Royal Bank payout ratio history including the financial crisis:

Royal Bank of Canada (RY.TO) Payout Ratio VAL 37.47%

75.00%
60.00%
45.00%
37.47%
30.00%
1995 2000 2005 2010 2015 2020

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Over its recent history, the bank has usually kept its payout ratio under 50%. The last time it was as "high" as 2020 was during the financial crisis of 2008-2010. For the record, RY's highest payout ratio was 81% in April 2009. For those who may have been worried that Canadian banks might suspend their dividends, adding some perspective will no doubt ease your concerns. The 10-year history graph shows us that RY's payout ratio is usually close to 45% and could increase to around 60% during a recession. As discussed on the previous page, the payout ratio is now back to ~40%. This gives the bank some buffer even if you expect a recession is coming.

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#3 What is a good payout ratio?

Many investors tend to discount companies showing a payout ratio over 100%. In some cases, the pickiest investors will aim at a 75%-80% maximum payout ratio. I will answer the question about high payout ratios in the following section, but for now let's concentrate on what makes for a good payout ratio.

In an ideal world, a payout ratio under 80% would offer enough flexibility for the company to pursue its growth objectives while continuing to increase its dividend annually. **This is assuming the company can increase its revenue and earnings consistently.** You now may better understand the reason why I focus so much on the dividend triangle.

A good payout ratio will have more to do with the company's performance versus its industry. Most Canadian banks will target a payout ratio around 45%-50%. We have observed a similar trend among utilities.

Some other companies will keep their payout ratios incredibly low as their focus is on growing their business rather than distributing the bulk of their earnings to shareholders. Companies in the tech sector are known to use their cash on hand for "opportunities" rather than being generous to their shareholders. Well-known companies like Apple with a payout ratio of 15% and a dividend yield of 0.5% or Microsoft with a payout ratio of 28% and a dividend yield of 0.8% are good examples of this trend. Some other companies will follow economic cycles while continuously increasing their dividend.

3M (MMM) has increased its dividend every year between 1959 and 2024. It was known as a dividend king until it spun off a portion of its business and jumped on the opportunity to cut its dividend at the same time in 2024. I decided to keep this example in the newsletter to show how even a company that "has been around forever" can eventually fall from grace and fail its shareholders.

Before 3M's spin off, the company saw its payout ratio moving up and down many times. During its "golden years, it hit a payout ratio in the 75-80% range when the economy slowed down. The graph on the following page clearly shows how the payout ratio can move from its ideal target of 40-60% to 75-80% when the company faces some challenges or as low as 30% when the company benefits from tailwinds.

As you can see, analyzing the trend is a lot more important than focusing on a simple number.

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3M Co Payout Ratio VAL 58.32%

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Keep in mind that the payout ratio is only one metric and there are several ways to calculate it. We will discuss other types of payout ratios at the end of this newsletter. You will see the payout ratio is a good indicator of dividend sustainability, but it's not the only one. It's always best to combine the payout ratio analysis with the dividend triangle. In 3M's case, we see that the company faced several headwinds before it finally cut its dividend in 2024.

Also, the dividend growth has been seriously slowing down for a number of years at 3M:

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3M Co VAL 105.95 CHG -0.42 % CHG -0.39%
3M Co Revenue (TTM)
3M Co Normalized Diluted EPS (TTM)
3M Co Dividend
Declining revenue
Declining EPS
Very slow dividend growth
Sep 08 2023, 9:03AM EDT. Powered by YCHARTS

What is a good payout ratio, then?

I like companies that have a payout ratio between 25% and 80%. However, I would not filter stocks by payout ratio and automatically eliminate companies outside this range. I would rather filter stocks by the dividend triangle which would find companies with 5-years of growing revenues and EPS with positive dividend growth as well. When the payout ratio goes over 80%, I'll dig a little deeper to understand what is happening.

Adding context to a ratio is crucial.

The next example will show you how the payout ratio is an "unreliable" metric when taken alone.

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#4 Is a 100%+ payout ratio sustainable?

The payout ratio is always a picture of the company's financial situation. This picture could change rapidly from one quarter to another as we saw with our example of Royal Bank. Here's another good example with Starbucks (SBUX) whose payout ratio went from under 50% to 296% "overnight".

Starbucks Corp Payout Ratio
296.0%
240.0%
160.0%
80.00%
0.00%
2018
2019
2020
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Jun 15 2022, 3:49PM EDT. Powered by YCHARTS

The company saw its payout ratio jump as it closed many of its restaurants during the pandemic economic lockdown. This was obviously a red flag and Starbucks could not sustain this level of operations for several years. However, does it mean the company's dividend is at risk? Not necessarily.

If it was the first time I had had occasion to look at Starbucks, I would no doubt be alarmed by the 296% payout ratio. However, if I added some context and looked at their latest quarterly reports, I would know that SBUX has reopened its restaurants now and its payout ratio went back to normal rapidly. In the original version of this newsletter (2020), I had mentioned that SBUX's dividend wasn't at risk while the payout ratio was way above 100%. If we look at today's payout ratio, we can see how the payout ratio has rapidly moved back towards being under control and being closer to historic norms.

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Starbucks Corp Payout Ratio VAL 62.54%
240.0%
160.0%
80.00%
62.54%
0.00%
2016 2018 2020 2022 2024
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Once again, we can clearly see how quickly a bad year can force the payout ratio above 100%. This reminds me that I read a few articles about Starbucks' high payout ratios last year and that the company could be subject to a dividend cut. Someone who looks at the payout ratio exclusively (without context), may arrive at this conclusion. But if you look at the context and you consider how the company is being managed, you would have known that a dividend reduction was possible, but unlikely, and that it would have probably been temporary.

However, it may happen that you will find companies showing a high payout ratio **all the time.** How can a company like Enbridge (ENB.TO) keep increasing its dividend annually while maintaining a payout ratio over 100%?

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In fact, the last time Enbridge's payout ratio was under 100% was in 2017! We can't talk about a single and temporary event affecting the company's financial health here. Then again, many investors might fear investing in Enbridge just because of its high payout ratio. The company is clearly not doing well, right? What if I told you that Enbridge's "real" payout ratio is around 65-70%?

Don't believe me? Let's dig further into their quarterly results presentation:

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Quarterly Financial Results

Strong financial results across every business unit

Dividend: $0.915
Adjusted EPS: $0.58
Payout ratio: 158%!!

($ Millions, except per share amounts)	Q2 2024	Q2 2023[1]	YTD 2024	YTD 2023[1]
Liquids Pipelines[1]	2,456	2,429	4,916	4,771
Gas Transmission & Midstream	1,082	1,033	2,356	2,222
Gas Distribution & Storage	567	367	1,332	1,083
Renewable Power Generation	147	132	426	271
Eliminations and Other[1]	83	47	259	129
Adjusted EBITDA[2]	**4,335**	**4,008**	**9,289**	**8,476**
Cash distributions in excess of equity earnings	142	138	238	203
Maintenance capital	(262)	(226)	(458)	(399)
Financing costs[3]	(1,176)	(1,007)	(2,283)	(2,017)
Current income tax	(158)	(84)	(421)	(264)
Distributions to Noncontrolling Interests	(88)	(103)	(166)	(195)
Other	65	57	122	159
Distributable cash flow[2]	**2,858**	**2,783**	**6,321**	**5,963**
DCF per share[2]	**1.34**	**1.37**	**2.97**	**2.94**
Adjusted earnings per share[2]	**0.58**	**0.68**	**1.50**	**1.53**
Base Business Adjusted EBITDA[2]	**4,106**	**4,008**	**8,951**	**8,476**
Base Business DCF per share[2]	**1.38**	**1.37**	**3.09**	**2.94**

DCF/share: $1.34
DCF payout ratio 68.28%

Source: ENB Q2 2024 investor presentation page 12

In their Q2 2024 earnings presentation to unit holders, Enbridge explained that it uses distributable cash flow (DCF) per share to calculate their payout ratio. As the classic ratio calculations typically use earnings per share, Enbridge is penalized as its earnings are often depressed by its capital-intensive business model which involves heavy depreciation and amortization non-cash charges against earnings.

When you use the DCF per share instead of earnings, you now get a payout ratio of 68.28% for the quarter.

Now, does that mean you should not worry about a high classic payout ratio?

You should still consider that information.

Why? Because a company like Enbridge is capital-intensive. Interest rates will continue to put pressure on their debt costs each quarter. “Homemade” calculations help understand the company’s context, but sooner or later, the company will have to pay down its debt.

Please note that several companies operate with capital-intensive business models. This is true for pipelines, but it is also true for telecoms, utilities, industrials, etc. Whenever you see a payout ratio above 100%, review the company’s business model and dig a little deeper into the quarterly earnings.

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#5 What about a negative payout ratio???

Another strange phenomenon could happen from time to time: a negative payout ratio! This could happen for both the payout ratio and the cash payout ratio. Let's use the telecom industry with Verizon (VZ) and BCE (BCE.TO) as examples as they are two large players known for their dividend growth. However, the cash payout ratios have been negative or above 100% from time to time.

	VAL
Verizon Communications Inc (VZ) Cash Dividend Payout Ratio	79.93%
BCE Inc (BCE.TO) Cash Dividend Payout Ratio	130.9%

120.0% 105.0% 90.00% 79.93% 60.00% 45.00% 30.00% 15.00% 0.00% -15.00% -30.00% -45.00% -60.00%

480.0% 440.0% 400.0% 360.0% 320.0% 280.0% 240.0% 200.0% 160.0% 130.9% 80.00% 40.00% 0.00%

2020 2021 2022 2023 2024

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To understand what happened, we must look at the payout ratio formulas (more on the explanation later in this newsletter):

Classic payout ratio: DIVIDEND PER SHARE (DPS) / EARNINGS PER SHARE (EPS)
If the company is losing money (negative EPS), the payout ratio could be negative.

Cash payout ratio: DPS / CASH FLOW FROM OPERATIONS – CAPITAL EXPENDITURE – PREFERRED DIVIDEND PAID

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If the company spends more on capital expenditures (large projects) than it generates in cash flow, the cash payout ratio will be negative.

A negative payout ratio means that the company must borrow to pay its dividend. A company could have either a payout ratio over 100% (it pays more in dividends than it earns) or a negative payout ratio (the company was losing money before rewarding its shareholders). In both cases, this means additional money will be required to finance its operations and the payment of its dividend.

For the classic payout ratio, the explanation is usually found in a one-time charge that hurts earnings. It could be a “real charge” (real money going out) or an accounting impairment (adjustment on the fair value of an asset such as a property for example). If you can explain the negative payout ratio and you can see how the situation will resolve itself in the future, you shouldn’t pay much attention to the metric.

For the cash payout ratio, we will often see a negative result for capital-intensive businesses. Companies like Verizon and BCE must invest massively in their wireless networks, especially with the development and the evolution of the 5G technology. Those projects are obviously financed by a combination of cash flow from operations, issuances of debt, or share sales. Since the calculation of the cash payout ratio includes CAPEX but disregards debt and share issuance, you have the impression the company finances its dividend with debt.

The company should be able to pay its dividend with its cash flow from operations and finance its projects with debt (also called leverage). If you borrow money today at 5% and you invest that money expecting a 10% return on your investment, you are making a smart choice, and you can still pay the dividend in the meantime!

Is BCE’s dividend safe?

That’s a pretty good question. Again, the answer will be found in adding more context to the numbers. When you look at the numbers alone, it doesn’t make any sense that a company showing a stable dividend growth policy (previously 5% per year) can show such catastrophic payout ratios:

Payout Ratio (%)	176.70
Cash Payout Ratio (%)	130.90
DGR 1-Yr	3.10
DGR 3-Yr	5.15
DGR 5-Yr	5.10

Source: Dividend Stocks Rock BCE Stock Card August 2024

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But when you dig further, you find the answer to your question:

Consolidated financial results

($M) except per share data	Q2'24	Y/Y
Revenue	**6,005**	**(1.0%)**
Service	5,308	0.1%
Product	697	(8.7%)
Adjusted EBITDA	**2,697**	**2.0%**
Margin	44.9%	1.3 pts
Net earnings	**604**	**52.1%**
Statutory EPS	**0.59**	**59.5%**
Adjusted EPS(1)	**0.78**	**(1.3%)**
Capital expenditures (capex)	**978**	**25.2%**
Capital Intensity(2)	16.3%	5.2 pts
Cash flows from operating activities	**2,137**	**(9.6%)**
Free cash flow (FCF)	**1,097**	**8.0%**

As you can see in the Q2 2024 investors' presentation, BCE shows a large amount of capital expenditure ($978M). This is the amount invested in maintaining/expanding their network to become more competitive and generate higher cash flow in the future.

The company reported a free cash flow of $1.097B for the quarter, up 8%. During that quarter, BCE paid $910M in dividends on common shares for a quarterly cash payout ratio of 83%. We could also argue that BCE must pay an additional $45M in dividends to preferred shares. Therefore, the payout ratio would be 87%.

This is definitely not a perfect situation and BCE's dividend safety should be reviewed closely each quarter.

It also explains why management reduced its dividend growth to 3% in 2024 instead of the classic 5% increase.

With such a tight cash payout ratio, several things could go wrong. Interest rates and capital expenditure may hurt future cash flow. For the first 2 quarters of 2024, BCE paid $842M in interest expenses, up from $703M in 2023. **That's $139M or 20% more than last year!**

So… Is BCE's dividend safe?

At this point in time-yes, but tomorrow is uncertain.

Before you tell me that "*BCE has been around forever*," please consider the high payout ratio, the increasing cost of interest (that will not stop in 2024), and the fact that BCE's revenue isn't growing.

I will continue to monitor BCE closely, but **don't be surprised if we downgrade BCE's dividend safety score by the end of 2024.** Management must consider the company's financial health first and increasing the dividend in 2025 doesn't seem to be in the best interest of BCE's balance sheet.

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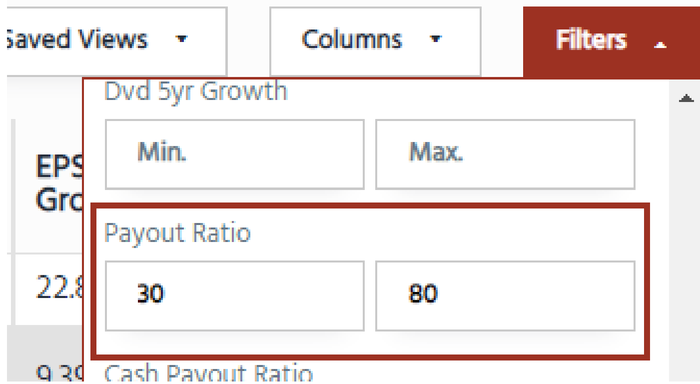
#6 Payout ratios aren't part of my first filter when I screen the market



Using the DSR stock screener, it would be tempting to use a minimum and maximum payout ratio metric. Simply by selecting stocks showing a payout ratio between 30% and 80%, you drop the stock screener list of stocks from 1,196 to 466. With a single filter, you could slash 730 companies, that's 61% of all stocks covered by DSR!

Unfortunately, you would potentially discard many amazing companies with PRO ratings of 4-5 and dividend safety scores of 4-5 by using the payout ratio as a first filter. Here are a few examples of companies you might wrongly ignore from the stock screener in August 2024:

AbbVie (ABBV): AbbVie reported major differences between their GAAP EPS and Adjusted EPS in the past 12 months. This was mostly driven by amortization and change in fair value. Both items don't have a monetary impact on cash flow.

Brookfield Infrastructure (BIPC / BIPC.TO): The company uses funds from operations as its earnings are affected by acquisitions and amortization.

Bank of Montreal (BMO / BMO.TO): The acquisition of the Bank of the West in 2023 has greatly affected its GAAP EPS. Things will get back to normal by the end of 2024 (or if you use adjusted EPS to calculate the payout ratio).

Telus (T.TO / TU): the company's CAPEX is killing its payout ratios.

Instead of using the payout ratio for my first filter, I prefer to use it as a second layer once I've built my potential list and look at each stock with a high payout ratio. If you can understand what is going on, you won't fear a dividend cut.

In conclusion, I'd say a payout ratio over 100% is not sustainable if:

- You are using the "right" payout ratio calculation
- The payout ratio remains over 100% for a long period of time
- The company doesn't show the ability to grow its revenue and earnings (or cash flow) in the coming years.

Whenever you see a payout ratio over 100%, don't discount the stock right away. Dig a little deeper, especially if the company shows consistent dividend increases. To help you understand all payout ratios, I've created a little summary on the following pages of the most common ways to calculate these ratios.

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Dividend Payout Ratio

Formula: DIVIDEND PER SHARE (DPS) / EARNINGS PER SHARE (EPS)

Utilization: Classic methodology (regular corporate entities)

It's preferable to look at a 5-to-10-year trend and look at quarterly earnings when there is an important fluctuation.

Pros: Commonly used and easy to understand.

Cons: Earnings are calculated by using generally accepted accounting principles, and it does not reflect the cash the company really has on hand to pay its dividend. It must be combined with other metrics during an analysis.

Cash Payout Ratio

Formula: DIVIDEND PAID / CASH FLOW FROM OPERATIONS – CAPITAL EXPENDITURE – PREFERRED DIVIDEND PAID

Utilization: Classic methodology (regular companies)

It's preferable to look at a 5-to-10-year trend and look at quarterly earnings when there is an important fluctuation.

Pros: It gives a clear picture of the company's ability to use its cash resources to pay their dividend. It's more precise than using only earnings.

Cons: It is also more complicated to calculate. Capital expenditures (CAPEX) are also often financed by debt and do not require cash flow from operations. Therefore, you must look at how much CAPEX the company has each quarter to determine if the cash payout ratio is high or not.

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Distributable Cash Flow Payout Ratio

Formula: DIVIDEND OR DISTRIBUTION PER SHARE (DPS) / DISTRIBUTABLE CASH FLOW (DCF) PER SHARE

Utilization: Pipelines or utilities.

This metric is often provided directly from the company itself with a detailed calculation.

Pros: Similar to the cash payout ratio where you get a clear picture of how much the company has in cash to pay dividends.

Cons: In most cases, you can't calculate the DCF payout ratio yourself or find it in a general finance website (therefore we try to mention it in our DSR Stock cards). You must rely on the company's information found in their quarterly earnings reports. It requires additional time to establish a trend over several years.

Funds from Operations Payout Ratio

Formula: DIVIDEND PER SHARE (DPS) / (ADJUSTED) FUNDS FROM OPERATIONS (FFO) PER SHARE

Utilization: Real Estate Income Trusts (REITs).

Since REITs are required to distribute at least 90% of their net earnings, the utilization of the adjusted funds from operations (AFFO or FFO) is a more precise metric. Like the payout and cash payout ratio, it's preferable to look at a long-term trend.

Pros: Similar to the cash payout ratio, you get a clear picture of how much cash the company has to pay dividends.

Cons: In most cases, you can't calculate the FFO payout ratio yourself or find it in general finance websites (therefore we try to mention it in our DSR Stock cards). You must rely on the company's information found in their quarterly earnings reports. It requires additional time to establish a trend over several years.

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FINAL THOUGHTS

As you can now more fully appreciate, a simple metric may lead to many questions and further calculations. At DSR, we first look at the company's dividend triangle. The revenue and earnings trends will tell us a lot about the company's ability to increase its dividend in the future. You will rarely find dividend growers with weak revenue growth and poor earnings increases. The dividend growth will confirm the analysis.

Then, and only then, will we look at the company's payout ratios. We will combine the dividend payout ratio with the cash payout ratio when they are available. In an ideal world, we will focus on companies with payout ratios under 80% and will investigate further when ratios are too high. By investigating, I mean looking at the company's quarterly earnings (usually press releases and investor presentations are enough) and look for plausible explanations for the high payout ratio. Most companies will issue a statement regarding their ability to continue rewarding their shareholders. You shouldn't have to search extensively to get a clear picture of a company's ability and willingness to share the wealth with their stockholders.

Cheers,

Mike.

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