investors CHRONICLE

Private Investor Seminar

Income strategies for a low rate world

Sponsored by Property Partner Standard Life Investments

Lessons from recent dividend disasters

Algy Hall

Investors Chronicle Tips Editor and Stock Screen Columnist

- 19-years experience in financial journalism
- 10 years at Investors Chronicle
- Tips Editor since April 2013

@AlgyHall

Dividend Disasters

What's a dividend disaster?

• A large dividend-paying companies that has made a significant (25%+) cut to its dividend during one of its last two financial years (see appendix for full definition)

+ Out of 312 stocks looked at, 7 per cent (21 shares) qualified as dividend disasters.
+ An above average yield of 3.4% or more was boasted by 57% of these shares at the start of the period looked at.
+ Data on 14 fundamental factors relating to dividend quality over 3 years prior to cuts analysed for signs of impending dividend disaster

Dividend Disaster Clues

The results were broadly inconclusive (it can be very hard to spot potential disappointments early), although, many of the stocks showed:

• a decline in dividend growth or rate of zero growth rate in the 3yrs prior to the cut (90%);

• a bottom quartile dividend growth rate in year prior to cut (81%);

• an Altman Z-score* that was distressed (1.8 or below) or that had deteriorated in the 3yrs prior to the cut (78%).

*see appendix for definitions

Case Studies

Trading difficulties have been a key trigger for the dividend-disaster stories of the last two years (especially in the highly operationally-geared resources sector). But it's difficult to find convincing common themes in fundamental data. Nevertheless, some of the most headline grabbing dividend-disaster stories of recent years provide lessons in how to spot growing vulnerability.

ROLLS-ROYCE

Source of sales and long-term P&L estimates:

Rolls-Royce's P&L provides an explanation of the commercial logic of the company's strategy while its cash flow statement shows the commercial reality - the stories being told by the two statements before the dividend was pulled were very different.

ROLLS-ROYCE

Year to end Dec	2011	2012	2013	2014	2015
Underlying pre-tax profit	£1,157m	£1,429m	£1,759m	£1,620m	£1,432m
Capex*	£412m	£435m	£669m	£648m	£479m
Increase in receivables	£62m	£284m	£533m	£878m	£836m
Free Cash Flow	£424m	£651m	£781m	£447m	£179m
Dividends paid**	£315m	£318m	£357m	£406m	£421m
Net cash / -debt	£223m	£1,317m	£1,939m	£666m	-£111m

source: Company
* Purchase of property plant and equipment
** Based on C Share redemptions, excludes £500m buyback following sale of Energy business

Rolls has been selling engines at a loss in the expectation it will profit from long-term service agreements (Total Care). Constant margin is assumed from the combination of the asset sale and service contract over the course of the engine’s life, but cash collection is “back-end loaded”. Major assumptions have to be made to estimate profit.

ROLLS-ROYCE

Accounting policies from 2015 results:

KEY SOURCES OF ESTIMATION UNCERTAINTY

In applying the accounting policies, estimates are made in many areas; the actual outcome may differ from that calculated...

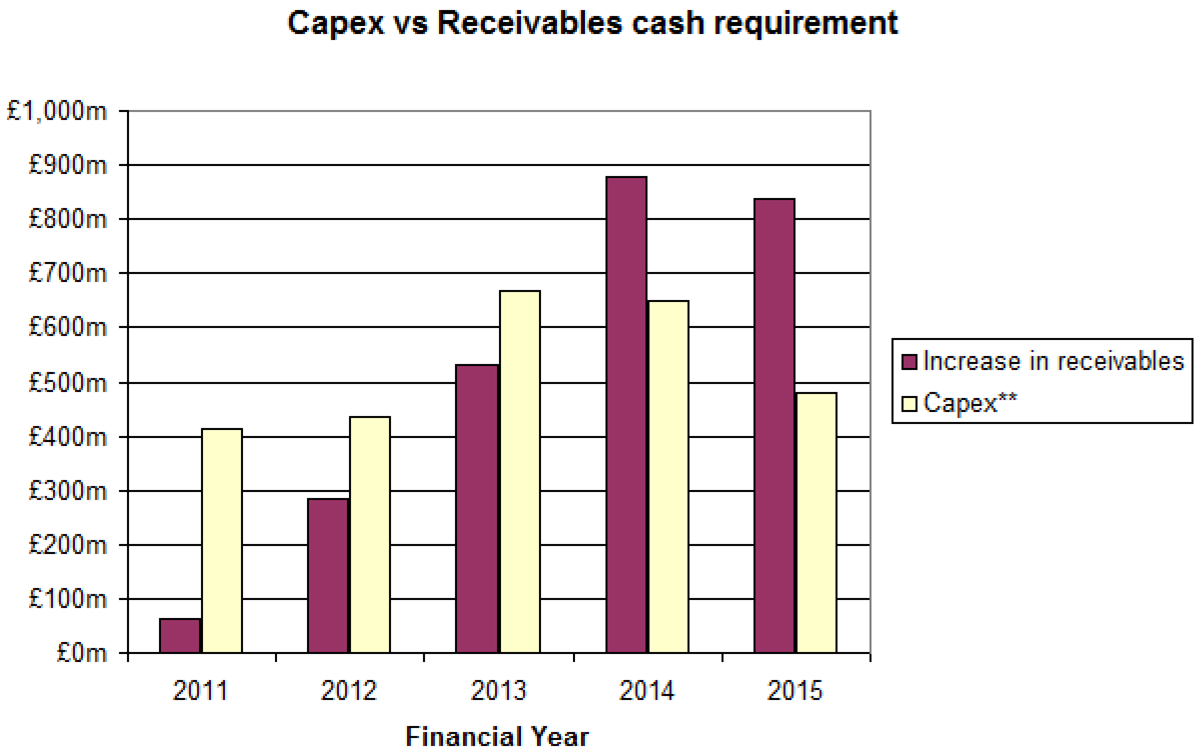
Assessment of long-term contractual arrangements

…estimated revenues and costs are inherently imprecise and significant estimates are required to assess: engine flying hours, time on wing and other operating parameters; the pattern of future maintenance activity and the costs to be incurred; and life cycle cost improvements over the term of the contracts.

ROLLS-ROYCE

Growth in receivables (revenues on which cash has yet to be received and prepayments for goods/services not yet received) has become a bigger drain on cash than Capex!
:

.



TESCO

Sources of cash can matter as much as cash itself:

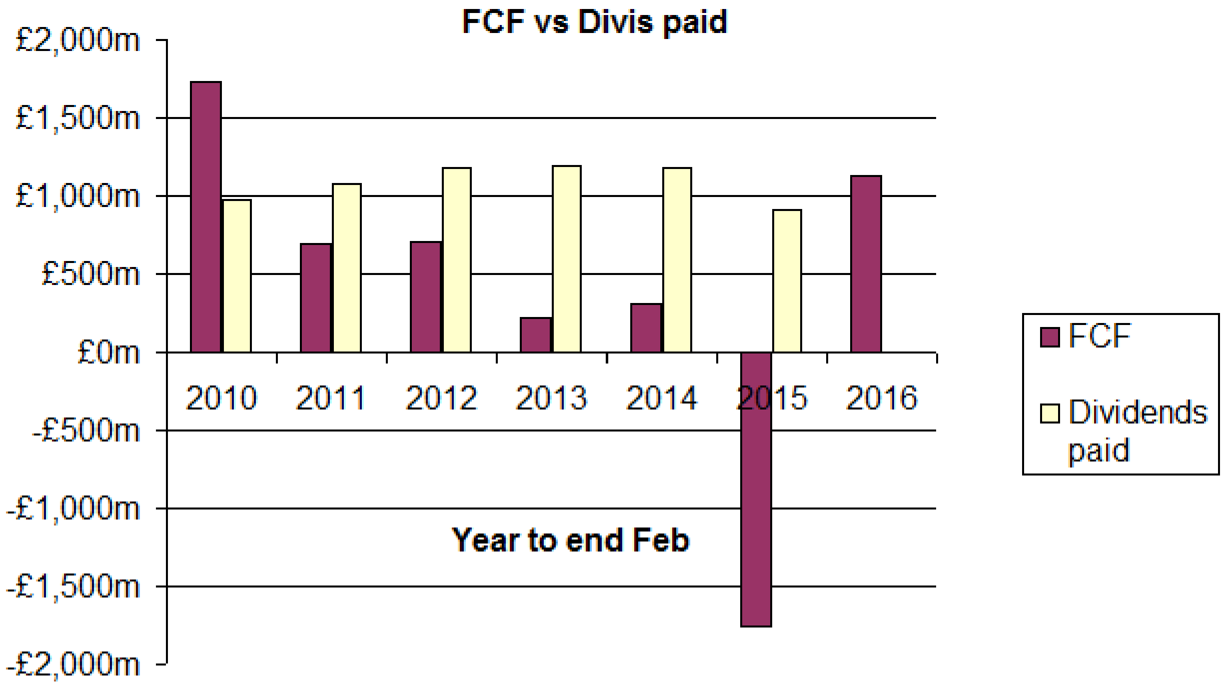
The trajectory of net debt and dividend cover give little serious cause for concern prior to the 2015 dividend cut.

Year to end Feb	2010	2011	2012	2013	2014	2015	2016
DPS	13.1p	14.5p	14.8p	14.8p	14.8p	1.2p	nil
Dividend cover	2.0	2.0	2.4	2.7	2.0	8.1	na
Net Debt	£7,929m	£6,790m	£6,838m	£6,597m	£6,597m	£8,481m	£5,110m

Source: Company, Iconic Information/Sharepad

TESCO

But free cash flow tells a different story:



source: Company

TESCO

Where's cash coming from? Sale-and-leaseback and rising payables.

Year to end Feb	2010	2011	2012	2013	2014	2015	2016
Net Operating Cash*	£4,745m	£4,239m	£4,408m	£2,837m	£3,185m	£484m	£2,126m
Capex**	£3,018m	£3,551m	£3,708m	£2,619m	£2,881m	£2,244m	£1,004m
FCF	£1,727m	£688m	£700m	£218m	£304m	-£1,760m	£1,122m
Dividends paid	£968m	£1,081m	£1,180m	£1,189m	£1,184m	£914m	£0m
Change in payables***	£453m	£976m	£679m	-£112m	£509m	-£449m	£260m
Proceeds from disposals****	£1,820m	£1,906m	£1,141m	£1,351m	£568m	£244m	£350m
Net Debt	£7,929m	£6,790m	£6,838m	£6,597m	£6,597m	£8,481m	£5,110m

source: Company

*Tesco includes interest paid and received in net operating cash

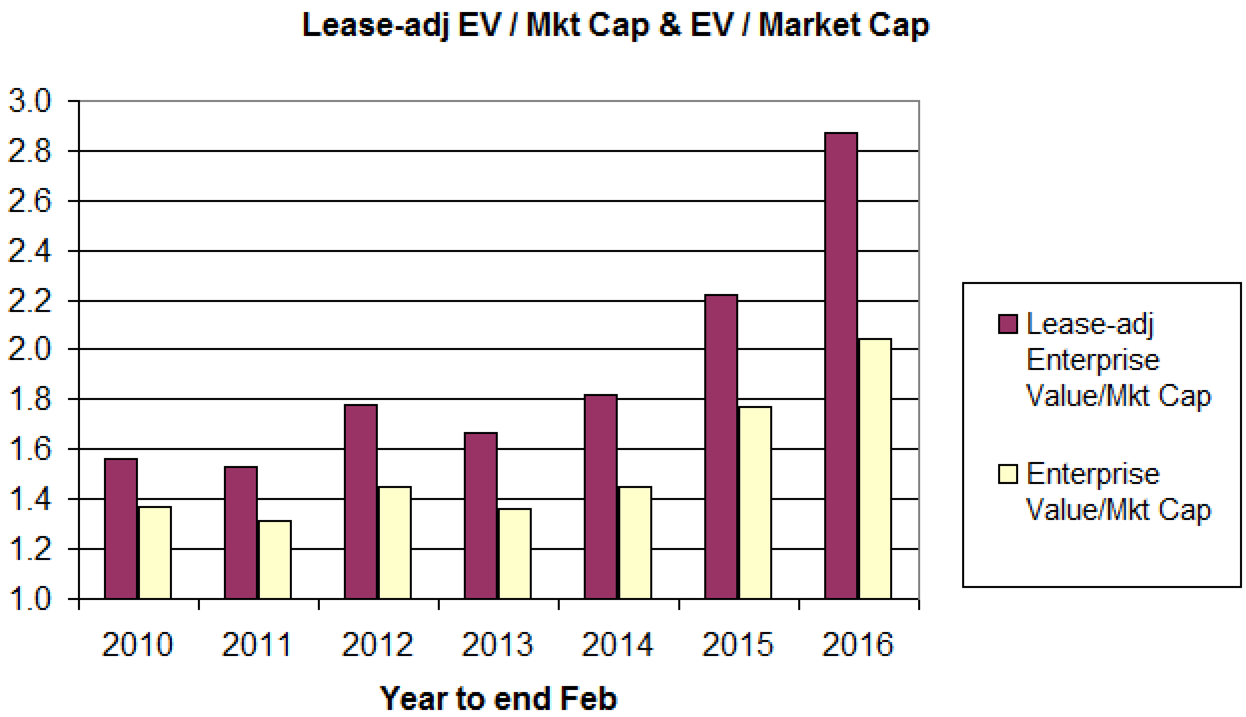
**Purchase of: property, pland and equipment; investment property; non-current assets; and intangibles

***Excludes Tesco Bank

***Proceeds from: property, plan and equipment; investment property; and non-current assets held for sale

TESCO

Sale and lease backs create a new off-balance sheet liability:



source: Iconic Information/Sharepad

Easy Income

A simple focus on fundamentals can work.

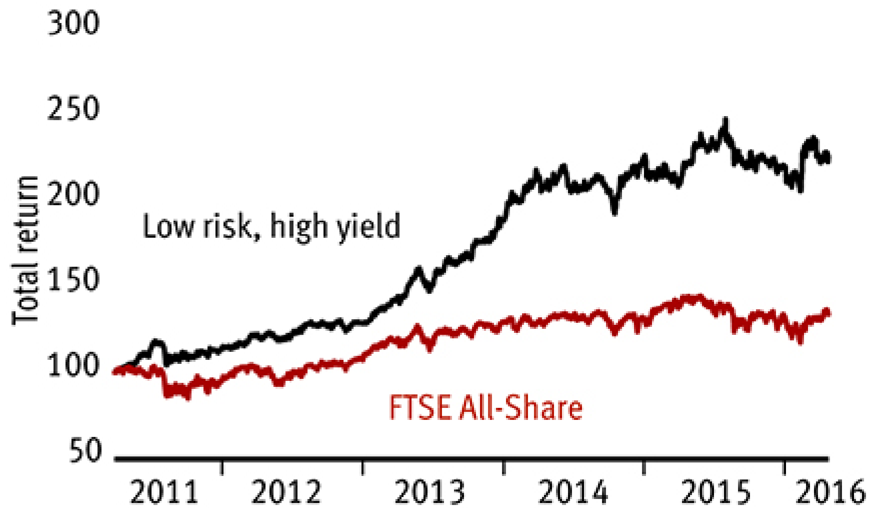
Low Risk High Yield screening criteria:

- ■ A dividend yield of 3.5 per cent or more.
- ■ A one-year beta of 0.75 or less.
- ■ 10 years of unbroken dividend payments.
- ■ 10 years of positive underlying earnings.
- ■ Underlying EPS higher than five years ago.
- ■ Underlying dividend higher than five years ago.
- ■ A return on equity of 12.5 per cent or more.
- ■ A current ratio of one or more.
- ■ Market capitalisation of more than £100m.
- ■ Dividend payments covered 1.5 times or more by earnings.

Portfolio reshuffled yearly

source: Thompson Datastream/Morningstar

Total returns (29 Mar 2011 - 25 Apr 2016)		Alt* 2014 and 2015 screen
High-yield low-risk	125%	137%
High-yield low-risk with 1.5% pa charge	109%	120%
MI Chelverton UK Equity Income B Acc	99.7%	-
Unicorn UK Income B Inc	83.9%	-
Evenlode Income B Inc	82.7%	-
Ardevora UK Income A	76.3%	-
Troy Trojan Income O Acc	71.9%	-
IA UK Equity Income median return	54.1%	-
FTSE All-Share	33.9%	-



Appendix

Large dividend-paying companies that have made significantly cut their dividend over the last two years: Shares in companies that three years ago were dividend payers with market caps of over £500m, which have since cut their dividend payment by 25 per cent or more. Companies that were already making significant dividend cuts before the start of the three-year period have been excluded from the analysis.

Fundamental factors tested:

- Dividend growth
- Turnover growth
- EPS growth
- FCF growth
- Operating cash flow growth
- Dividend cover
- FCF dividend cover
- Fixed charge cover
- Net debt/cash profits (EBITDA)
- Capex/sales
- Altman Z-score
- Lease-adjusted ROCE
- Lease-adjusted CROCI
- RoE

The Alman Z-score aims to predict bankruptcy and was devised by accountancy professor Edward Altman in 1968. A score of below 1.8 signals distress, a score between 1.8 and 2.99 is Altman's grey zone, and companies scoring above 2.99 are considered safe.

The Z-score formula is:

Z = 1.2X1 + 1.4X2 + 3.3X3 + 0.6X4 + .999X5

Where:

- X1 = Working Capital / Total Assets
- X2 = Retained Earnings / Total Assets
- X3 = Earnings Before Interest and Taxes / Total Assets
- X4 = Market Value of Equity / Total Liabilities
- X5 = Sales / Total Assets

Tesco's total indebtedness

Year to end Feb	2016	2015	2014
Net Debt (ex Tesco Bank)	£5,110m	£8,481m	£6,597m
Discounted operating lease commitments	£7,814m	£9,353m	£9,419m
Pension deficit, IAS 19 basis (post-tax)	£2,612m	£3,885m	£2,559m
Total indebtedness	£15,536m	£21,719m	£18,575m

source: Company

High Yield Low Risk picks

Name	TIDM	Mkt Cap	Price	Fwd NTM PE	DY
British American Tobacco	BATS	£77,048m	4,147p	18	3.7%
Chesnara	CSN	£389m	308p	17	6.2%
Headlam	HEAD	£427m	506p	15	4.1%
Hiscox	HSX	£2,807m	985p	17	4.1%
Sthree	STHR	£427m	334p	14	4.2%
The Go-Ahead	GOG	£1,100m	2,563p	15	3.5%
XP Power	XPP	£315m	1,658p	16	4.0%

source: S&P CapitalIQ