Warning Signs of a Dividend Cut

1. **Dividend payments that dwarf earnings.**

   Everyone knows that it is unsustainable to spend more than you earn. It is the same with dividend distributions. A firm is in an untenable position if it distributes more dividends than earnings over a prolonged period. A general rule of thumb for most companies is a payout ratio between 40-60%. Too low, and the yield will be lackluster. Too high, and the payout isn't sustainable. In the middle leaves room for economic downturns and future increases.

   Two metrics that will allow you to keep an eye on the situation are:

   - Payout ratios, measures dividend payments as a percentage of profits; and
   - Coverage ratios, a measure of a firm's ability to honor its dividend payments.

   For example, Skyworks Solutions (Nasdaq: SWKS) is paying out $2.24 in annual dividends, supported by $8.24 in earnings over the year, that is a *payout ratio* of 27.2% and a *coverage ratio* of 367.9%. This means Skyworks pays out 27.2% of net income to its shareholders and the firm covers $1 of dividend for every $3.68 of net income earned. On the flip side, Kraft-Heinz (Nasdaq: KHC) is paying out $1.60 in annual dividends, supported by $0.99 in earnings over the year, that is a *payout ratio* of 161.6% and a *coverage ratio* of 61.9%. If this trend continues longer, the dividend yield to shareholders will likely be decreased or cut entirely. In the case of poor ratios, before making a decision it is important to compare them with their industry and against previous years. For example, for years 2020 and 2019, KHC had *payout ratios* of 192.8% and 555.2%, respectively; and *coverage ratios* of 51.9 and 18.0%, respectively. Things appear to be getting better.

2. **Insufficient cash flows.**

   Be leery of one-time events that can be added to or subtracted from the bottom-line, especially non-cash items. These non-cash items include amortization, depreciation, and stock options compensation. Investors should familiarize themselves with the cash flow statement, which ignores the impacts of one-time events and explains the accurate amount of cash flowing in and out of the firm.

   Specifically, the bucket firm's use to pay dividends, buyback shares, or make acquisitions is called free cash flow (FCF). Most financial websites display a firm's free cash flow, which is operating cash flow less capital expenditure. This value is a quick and dirty way to assess whether the firm has sufficient funds to distribute dividends. For Kraft-Heinz, they reported $4,459 million in FCF against $1,959 million in dividend payments for 2021. However, this can be deceptive because in really, when you subtract the money leaving the company from the money coming in, less the effects of foreign exchange, Heinz is left with a positive $28 million in cash. A bit tighter situation than just looking at their FCF value.

   In the end, whether the FCF is positive or negative, a firm's cash flow statement should be on everyone's radar and efficiently analyzed (do not ignore it). You should know whether the firm's FCF is negative, and ask yourself: where is the money coming from to continue to support dividend payments?

3. **Excessive leverage.**

   Debt is a great tool for a firm, when used properly. For example, if a firm is generating 17% returns on invested capital (ROIC), it makes sense to borrow capital at 6% to expand and create value. However, too much debt is dangerous and what is invisible on the income statement loiters on the balance sheet. Unfortunately, firms are like people: they are all different. Financing and capital requirements vary from firm to firm and industry to industry. So, how much leverage is too much?

One evaluation tool is *debt-to-EBITDA*. Simply, a ratio of 2.0 means it would take the firm two years to repay loans using current annualized cash flows. Another evaluation tool is *debt-to-equity*. This is a measurement of the percentage of the firm's balance sheet that is financed by suppliers, lenders, creditors and obligors versus what the shareholders have committed. A third ratio to pay attention to is a firm's *current ratio*, a short-term liquidity meter. For instance, if a firm has $150 million in cash, accounts receivable and other assets, as compared to $45 million in notes payable and other current liabilities, then it has a ratio of 3.33. This means $3.33 is on hand to pay every $1 owed over the next 12 months. If this is inverted, i.e., the firm has $0.30 to pay every $1 owed, we are looking at a very distressed firm. Other debt ratios that are valuable include:

- Long-term debt to Capitalization - while a high capitalization ratio can increase the return on equity because of the tax shield of debt, a higher proportion of debt increases the risk of bankruptcy for a company.
- Total debt to Capitalization - describes to investors the extent to which a company is using debt to fund its business and expansion plans.
- Cash flow to debt ratio - reveals the ability of a firm to support its debt obligations from its operating cash flows.

It is important when using these tools to compare apples to apples, meaning don't compare Tesla to Main Street Capital. Lenders closely monitor a firm's *current ratio*, and at the very least, you should too!

Credit ratings provide useful information regarding a firm's ability and willingness to service its debt. A triple-A rating is the highest credit quality, and C or D is the lowest or "junk" quality. Within the credit spectrum, there are different rating degrees denoted by a plus or minus sign or a number depending on the credit agency. For instance, a "AAA" rating means there is a very low credit risk of default; a "BBB" represents a medium risk and the lowest investment-grade rating. Watch for credit downgrades indicating a weakening in the outlook of a firm's ability to service their debt.