PERENNIAL INVESTMENT PARTNERS

What's News at Perennial?

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The hunt for yield… but at what cost?

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Lee is a Partner and the Head of Perennial Growth Management. He is responsible for the management of Perennial Growth Management's Australian equities portfolios and manages a team of six investment management professionals.

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One of the most important themes identified by Perennial Growth Management throughout the February reporting season, and one that we will follow closely, is that we are seeing companies trying to keep shareholders onside through 'cost outs' and the cutting of capital expenditure programs to support dividends, when they should be re-investing for growth in order to defend their profits.

For too long companies have been taking the easy option, paring back the growth plans of their businesses and returning cash to shareholders whose primary motivation is supplementing their dwindling income owing to low returns on fixed income investments. This is a classic example of low interest rates being counterproductive to the growth that they should be stimulating.

Many investors are currently focused on ASX Top 20 stocks, which comprise 65% of the market. The yield on that basket of stocks is a bit over 4% however the average payout ratio is 85%. Within that average some companies pay out 100%. Many of these stocks are running out of tricks – they haven't invested for growth so their earnings won't be sustainable and you can only cut costs so much.

Investors have been chasing yield because of the very low interest rates on offer in the bond and bank bill markets. While this thirst for yield is understandable in such a low interest environment, we believe it is time for investors to become more discerning when buying a company purely for its dividend yield. Investors should be wary of the sustainability of the underlying dividend yield.

Companies that are paying a high portion of their earning out in dividends and have not invested in their business or are facing cyclical earnings pressures are vulnerable to a cut in dividends. Woodside Petroleum is a very good example of this problem. The stock is currently sitting on an historical yield of 8.8%. The company currently pays out 80% of its earnings by way of dividends. The 80% payout ratio was re-affirmed at the companies full year result in February. The market was pleased with the maintenance of this policy and rallied accordingly. The problem lies in the collapse in the oil price and the resulting cyclical pressure on earnings. While the company will likely maintain its payout ratio, this does not mean the dividend will be maintained. In fact on current consensus numbers, the dividend is likely to fall 58% which will result in a 3.7% yield. We believe this collapse in dividend is not yet being factored in by the market. Indeed given the current state of the oil market, the dividend cut is at risk of being even greater than that forecast by the market consensus.

We believe the market should be looking for companies that can grow cash flows and hence dividends. For example, Incitec Pivot, the Australian multinational corporation that manufactures industrial chemicals, fertiliser and explosives, currently trades on a 3% yield. However the company's payout ratio is a conservative 52%. Management have also been investing to grow the business. The main investment project is a world class ammonia plant in Louisiana, USA. The returns from this investment are expected to drive dividend growth. We estimate the dividend will grow strongly over the next three years and this dividend growth will result in a yield above 4.5% (based on the current share price).

With interest rates expected to stay lower for longer we believe a forward looking approach is critical when assessing a company's dividend yield, in order to ensure that yield does not come at the expense of future growth.