BY JOHN KINGHAM

DIVIDEND HUNTER

UNEARTHING BARGAINS AMONG HIGH-YIELD STOCKS

Every now and then I like to take a look at the highest yielding stocks in the market. Not to buy them of course, because the dividend yield on its own is a crude tool at the best of times. Instead, I'm interested in finding out which companies have crashed and burned, and what lessons I can take (for free) from their various situations. One major recurring theme is the excessive use of debt, so this month I want to ram home the importance of avoiding highly indebted companies, using a series of embarrassing examples (embarrassing because management should know better). As a bonus, one of these companies may actually be a bargain.

In each of these five examples I'm going to look at the ratio of debt and pension obligations to the company's five-year average earnings. In my experience the debt ratio should be below four to be considered remotely prudent, whilst the pension ratio should be less than ten. Anything more than that is asking for trouble.

Carillion PLC (dividend yield 42%)

- **Share price: 44p**
- **5-Year average profits: £141 million**
- **Total borrowings: £689 million**
- **Pension liabilities: £3,378 million**
- **Dividend status: Suspended**

Carillion's **(LON:CLLN)** current dividend yield is an incredible 42%. Of course, that's based on last year's dividend and the dividend has since been suspended, so don't expect to invest and actually get that 42% payout. A suspended dividend is bad enough, but for existing shareholders the 90% share price decline since 2015 was probably far more painful.

So why exactly did things go so badly for Carillion? There are lots of reasons, but its financial obligations definitely made the situation much, much worse.

For a start, Carillion operates in the cyclical construction industry, where lumpy revenues from large and irregular projects are the order of the day. As such, it would be a good idea (in my opinion) for the company to keep debt levels and other fixed costs to a minimum.

However, in recent years Carillion threw that idea out of the window and loaded up with hundreds of millions of pounds of additional debt. Today its total borrowings of £689 million dwarf its recent average profits of £141 million by a factor of almost five to one. That puts Carillion comfortably outside one of my most important investment rules:

- **INVESTMENT RULE: Only invest in a cyclical company if its debt to average profit ratio is below four**

Those high debts are bad enough, but Carillion manages to combine them with an enormous defined benefit pension scheme as well. Its scheme has total liabilities of £3,378 million, some 24-times the company's average profits. This massively breaks another of my investment rules:

- **INVESTMENT RULE: Only invest in a company if its pension liability to average profit ratio is below 10**

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As a final nail in Carillion's coffin, the pension scheme has a massive funding deficit of more than £800 million. That deficit is effectively another form of debt, so the company's actual total "debts" are the previously mentioned £689 million plus that £800 million deficit. That's a total debt of almost £1,500 million, which is an astonishing ten-times the company's average profits. With debts like that it's no surprise the company has hit the buffers.

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Provident Financial PLC (dividend yield 17%)

- **Share price: 794p**
- **5-Year average profits: £209 million**
- **Total borrowings: £911 million**
- **Pension liabilities: £758 million**
- **Dividend status: Suspended**

Provident Financial (LON:PFG) has been in the news recently because it's had some serious problems. It's also one of Neil Woodford's holdings, and currently the media is very bearish about poor old Mr Woodford (although to be fair, he's neither poor nor old).

As with Carillion, the yield is extremely attractive, except you'll never receive that dividend because it has already been cancelled. The shares are also down an incredible 80% over the last six months or so.

How did things get so bad? Provident is a financial services business, which is a cyclical sector. So like Carillion, business volatility should be expected and debts should therefore be kept low. But once again, that wasn't the case.

At first glance, Provident's borrowings come to £1,852 million, almost nine-

times the company's average profits of £209 million. This is obviously much more than my debt rule will allow, but there's a catch; £941 million of those borrowings are actually retail deposits in its bank business, which doesn't really count as "borrowings". So ignoring those deposits, Provident's actual borrowings fall to £911 million. This is a mere 4.4-times the company's average profits, but that's still slightly above my preferred maximum.

Provident also has a defined benefit pension scheme, although at £758 million it's not very large, and is less than four-times the company's average profits. The scheme is also in surplus, which is of course very good news.

So in Provident's case I don't think excessive debts were a primary cause of its current problems, but the debts are still perhaps overly large for a cyclical business and very probably made the company's situation more difficult than it otherwise would have been.

Just as importantly, high levels of debt show that management are actively willing to take high risks, or are unaware just how risky debt is. Either way, that's not the sort of management team I'd want running one of my companies.

Petrofac PLC (dividend yield 12%)

- **Share price: 443p**
- **5-Year average profits: £305 million**
- **Total borrowings: £1,929 million**
- **Pension liabilities: N/A**
- **Dividend status: Cut by 42%**

Petrofac (LON:PFC) is a company close to my heart because I've been a shareholder since early 2014. Back then, this oil and gas services company (which, like Carillion and Provident, trades in a cyclical sector) had borrowings of just £824 million, about two and a half-times its then average profits of £330 million. There was (and still is) no defined benefit pension scheme, so its total financial liabilities were well inside my comfort zone.

For better or worse, I cannot realistically influence the management of companies I invest in, so they are free

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to do dangerous things like load up on excessive amounts of debt as they see fit. And that's more or less what Petrofac started to do after I'd invested.

Despite Petrofac being a cyclical business where profits have declined following the oil price collapse of recent years, management saw fit to more than double total borrowings to almost £2 billion. Debts are now over six-times average profits, which I think is dangerously high.

Given this massive increase in debt I must say it comes as no surprise that Petrofac has run into major problems. Annoyingly, but perhaps sensibly given the current situation, its dividend has been cut by 42%. This is yet another example of how increasing borrowings can boost returns in the short-term, but the end result is a very delicate structure which can break under the slightest amount of stress.

Perhaps I should have sold Petrofac when it first started to pile on debt in late 2014 and into 2015? That's one way to avoid holding highly indebted companies, but these things are rarely so clear cut, as I'm sure you know. Petrofac's decline was not inevitable and it's entirely possible that it could have avoided its current problems, in which case selling in 2015 might have been a mistake. However, if I do eventually sell Petrofac at a loss then I will definitely revisit the idea of selling companies when their debts become excessive.

Interserve PLC (dividend yield 10%)

- **Share price: 81p**
- **5-Year average profits: £14 million**
- **Total borrowings: £465 million**
- **Pension liabilities: £951 million**
- **Dividend status: Suspended**

Unlike Petrofac, which has so far lost me money, **Interserve (LON:IRV)** is a company whose share price more than doubled while I was a shareholder from 2011 and 2013. I sold out because the market was gradually becoming more and more optimistic about this support services business (which is also a cyclical sector) and its ability to generate excellent returns for shareholders. I sold out at just over 500p, which I thought was expensive, although the shares eventually went as high as 700p. Today the shares sit some 90% below that level and investors will never see the quoted 10% dividend yield because the dividend has already been suspended.

In terms of debt, when I invested in Interserve in 2011 its borrowings were £90 million, little more than double its then-average profits of £42 million. Fast forward to today and the company has debts of £465 million compared to average profits of just £14 million. To be fair, those average profits are low because of a heavy loss last year. Excluding that loss would increase recent average earnings to £48 million, but the company's debts are still extremely high at almost ten-times that amount.

On top of that, Interserve has a £951 million pension scheme. That's almost 20-times the company's average prof-

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its and is yet another massive red flag (back in 2011 I didn't look at pension liabilities, so I was blissfully unaware of this risk).

The pension scheme has a £40 million deficit and adding that debt to the company's existing borrowings of £465 million gives a total debt of £515 million. That's more than ten-times the company's average profits, and the picture is much worse if we don't exclude last year's loss.

From this distance it looks as if Interserve is yet another company that got itself into trouble by overreaching its true abilities, aided by an excessive use of borrowed funds. As usual, the CEO and CFO have left the building, but that is little consolation for shareholders who have collectively lost hundreds of millions of pounds in a short period of time.

Connect Group PLC (dividend yield 9%)

- **Share price: 103p**
- **5-Year average profits: £39 million**
- **Total borrowings: £151 million**
- **Pension liabilities: £532 million**
- **Dividend status: Not cut or suspended**

Connect Group (LON:CNCT), the ex-WH Smiths distributor of magazines, newspapers and other things, is slightly different from the rest of this list. For one thing, its 9% yield is not quite double digit, but more importantly its dividend is, for now at least, uncut.

With a dividend yield of 9% I think it's fair to say that the market expects the dividend to be reduced or perhaps even scrapped. So far though, management have not even hinted that this is a possibility. In fact, at the company's interim results in April the dividend went up by 3% rather than down.

Why is the market so negative? I'm sure there are lots of reasons, but an obvious one is that the company's core business of delivering physical magazines and newspapers in long-term decline.

Another cause for concern, or perhaps it's a cause for celebration, is Connect's decision to sell its Education & Care (E&C) business. Unlike the rest of Connect Group's businesses, the E&C business acted as a wholesaler and supplier of goods rather than just a distributor. The E&C business is being sold so that Connect can focus on its core competency of distribution, which I think is a very good idea. Another good idea is that more than £50 million of the cash proceeds will be used to pay down some of the company's debts.

At £151 million, Connect's current debts are just under four-times its average profits of £39 million. That gives the company a debt to average profits ratio of 3.9, which is just about acceptable according to my debt investment rule. But it's close enough that I would still classify Connect as highly indebted.

However, with the sale of the E&C business the company's debts should come down to about £100 million, which is much more reasonable. Disposing of the E&C business will also reduce operating profits by about £8 million, but this will be offset by a reduction in debt interest payments of perhaps £2 million. So the end result for post-tax profits will be a reduction of perhaps £6 million, or thereabouts. That will reduce normalised post-tax profits from 2016's £43 million down to perhaps £37 million, although of course there's always a lot of uncertainty about future profits.

With profits reduced to about £37m and debts reduced to about £100m, the company's debt to profit ratio will be about 2.7, which I think is quite reasonable.

How might this affect the dividend? Since the reduction in profits is around 15%, normalised earnings per share might drop from the current 17p to perhaps 14p, with the usual levels of uncertainty. The 2016 dividend was 9.5p, so that divided would still be covered 1.5-times over. Free cash is currently 15p per share, so that might drop to say 13p (with lots of uncertainty), which also still covers the dividend.

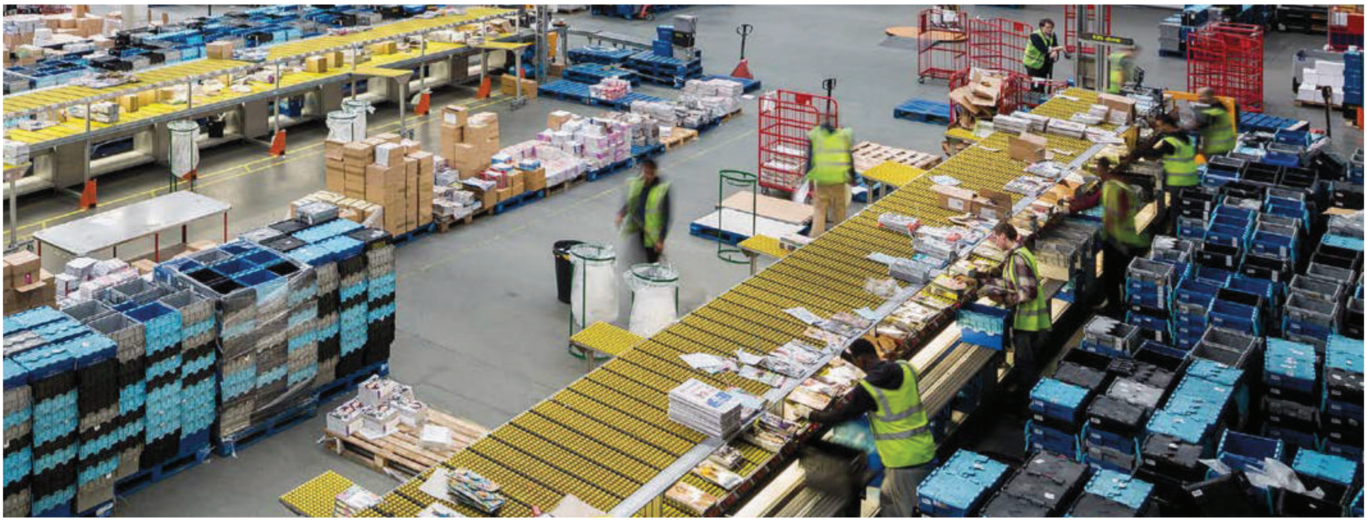
This is all a bit speculative, but in my opinion the dividend cover might be a bit thin, but it's not yet a situation which obviously demands a dividend cut.

So excessive borrowings are not a major problem for Connect, but its pension scheme might be. At £532 million its pension liabilities are more than 13-times its average profits of £39 million (the sale of the E&C business shouldn't make much difference to this ratio). Such a large pension scheme is a major risk because any future deficit could easily be large enough to cause the company serious problems.

However, the pension scheme's assets currently exceed its liabilities, giving the pension a £140 million surplus. In percentage terms that's a 21% surplus, which is very large. This means that despite its massive size, Connect's pension scheme is unlikely to be a problem in the near future.

This creates an interesting situation. Although Connect's pension scheme breaks my rule about large pensions, I think the short-term risks from the pension are relatively small. The company will also have reasonably prudent debt levels in the near future. On top of that, Connect does not seem to be facing an immediate crisis and yet its dividend yield is 9%. It's also the ninth highest-rated stock on my stock screen.

As you might have guessed, I'm beginning to think that Connect could make a sensible investment, albeit a slightly high risk one. Right now I'm undecided, but unless I've missed some hidden danger there's a good chance I'll put three or four percent of my portfolio into Connect Group at some point over the next few months.



About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

John is also the author of *The Defensive Value Investor: A Complete Step-By-Step Guide to Building a High Yield, Low Risk Share Portfolio*.

His website can be found at: www.ukvalueinvestor.com.