



An educational review of basic investment concepts and techniques—in easy-to-understand terms.

Dividend Safety Signs and Warning Flags

Many investors have sought shelter from the stock market storm in more mature dividend-paying companies, since the income from these firms provides at least some positive return in an otherwise bleak environment.

But the economic downturn has tested even the most mature and stable firms, with some forced to cut dividend payments. Others have managed to maintain current levels for the time being, but could be forced to make cuts in the future.

What signs can you look for that indicate the safety of a company's dividend payment stream?

Investors in dividend-paying stocks typically seek stocks that are paying steadily increasing levels of dividend income, and have the cash flow and financial resources to continue to pay the dividends. There are a number of financial ratios and indicators you can use to evaluate this; the most common are listed below.

While these safety signs and warning flags are applied at the individual firm level, you should keep in mind that even the most well-managed company can be overwhelmed by changing winds within an industry. When you are evaluating a stock for its dividend payments, make sure you don't lose sight of the bigger picture in terms of the environment in which the firm is operating.

Since yield is dividend divided by price, high yields can be the result of either rising dividend payouts or, more commonly, falling prices.

Prices may drop if investors are expecting the dividend to be cut, or if they're expecting some other bad news to follow shortly. If the "market" is correct in this forecast, a high dividend yield indicates high risk.

On the other hand, to the extent this perception is incorrect, a high yield may be an indication of value if the company has the resources to turn its fortunes around.

What's a "high" yield? Dividend yields that are above the average for the stock historically or that are higher than the industry average are a warning sign of risk—but you must look at other indicators to determine if the market has correctly evaluated that risk.

Annual Dividend Payments

The history of annual dividend payments provides a good indication of management's commitment to paying dividends. Dividends paid with no interruptions over a significant time period indicates that a company can keep the payments going even during tough years; dividend increases during prosperous years (with no subsequent decreases) are an even more positive sign.

What Is the Level and Quality of Payments?

Clearly, dividend-seeking investors need to evaluate the dividend payments themselves, how steady they have been and how much you are paying for them.

Dividend Yield

A dividend stream may be important to you, but a critical question is: How much is the market demanding for that stream of payments?

This question can be answered by looking at the dividend yield, which is calculated by dividing the dividend per share by a firm's stock price.

While most companies don't change their dividend payouts frequently, stock prices do change all day long, so yields must be calculated each time you analyze a stock.

How Well Are Dividends Covered?

Dividends that are higher than reported annual earnings can be a warning sign that the firm is facing some difficulties, since firms pay dividends primarily from earnings. However, strong cash flow can help cover a dividend payment when earnings temporarily drop.

Several dividend indicators can help evaluate these issues.

Dividend Payout Ratio

The dividend payout ratio is calculated by dividing a firm's dividend per share by its earnings per share.

This ratio tells you how much profit the company is paying out to shareholders in dividends.

Any ratio above 50% is considered a warning sign. However, like all ratios, the payout ratio is industry-specific.

Very stable industries, such as utilities, have high payout ratios, which is considered normal. Generally, “growth” firms have lower dividend payout ratios because they retain most of their earnings in order to fund future expansion. In contrast, “mature” or more established firms tend to have higher payout ratios as their investment possibilities diminish.

A 100% payout ratio shows that a firm is paying out all of its earnings to its shareholders. Figures above 100% indicate that the payout is greater than earnings, a situation that cannot continue forever; negative ratios show that a company is paying out a dividend while losing money.

Dividend Coverage Ratio

This ratio shows how secure the dividend is based on the cash flow being generated by the company. This ratio can help you assess how easily the company can keep making its dividend payments. To calculate this ratio, you divide cash flow per share by dividend per share. The higher the dividend coverage from cash flow, the better.

A standard minimum is a dividend coverage ratio of 1.2, indicating 120% of the dividends are covered by annual cash flow.

Can Debt Be Repaid?

Heavier debt loads saddle a company with required cash outflows to bondholders, who must be paid before dividends can be paid to shareholders. However, leverage allows a company to grow faster and so may enhance the return on investor capital, even while increasing risk.

Since too much leverage strains the company’s ability to pay the debt back, creditors and dividend investors prefer companies with moderate debt levels. More assets relative to debt cushions a company during negative cash flow periods and should allow the company to maintain its dividend payment even during tough times.

Debt-to-Equity Ratios

The ratio of long-term debt to equity (or long-term debt to capital, which is debt plus equity) is a common financial leverage ratio that indicates the proportion of the firm’s capital that is derived from debt as compared to common equity. A high percentage of debt relative to equity indicates high risk. Here, look for ratios that are not above the industry average.

However, just because this ratio is low does not necessarily mean risk is low, because it does not take into consideration current liabilities.

The short-term debt coverage ratio allows you to quickly see if the company’s short-term debt obligations can be easily paid by using the cash that is being generated from company operations. This ratio is calculated by dividing income from operations (from the income statement) by current liabilities, or short-term debt (from the balance sheet).

Income from operations is an important measure of the ability of a firm to generate positive cash flow from normal operations without liquidating other assets to fund expenses and dividend payments. In addition to operating income, interest income on cash balances is another source of income. Other income items can include the sale of assets (i.e., products, patents, or even an entire operating division or subsidiary)—however, these are one-time income events and can distort an investor’s perception of the company’s ability to generate income, which is why operating income is a much more reliable indication of cash flow, and is therefore used in this ratio.

One rule of thumb for dividend safety is that the short-term debt coverage ratio should equal at least 2.0. This means that the company is generating more than twice the cash flow it needs from operations to pay off all of its short-term obligations. Taken by itself, this ratio would indicate that the dividend is pretty secure and would also indicate that there is sufficient operating income to offset a slightly lower liquidity position.

Liquidity: The Quick Ratio

The quick ratio is an important liquidity ratio that is computed by removing inventory from current assets (assets that are liquid), and then dividing the remainder by current liabilities (short-term debts the firm must pay within a year).

Since inventories are typically the least liquid of a company’s current assets and are likely to produce a loss if liquidated, it is prudent to look at the firm’s ability to cover short-term liabilities without relying on inventories.

The rule of thumb is that a company with a quick ratio of 1.0 or better indicates that it could cover all current liabilities with the liquid assets it has on hand, thereby reducing any need to cut its dividend. If the ratio were less than 1.0, you would want to assure yourself that the company is generating enough cash flow from operations to cover both its normal expenses and any short-term debt obligations that come due.

Interest Coverage: Times Interest Earned

Times interest earned, or the interest coverage ratio, is the traditional measure of a company’s ability to meet

Table 1. Dividend Safety Signs

Level and Quality of Payments	
Dividend Yield (dividends per share ÷ price per share)	A measure of the market value of the dividend income stream. Dividend yields that are above average for the company historically, or that are above average for the industry, may indicate higher risk, but you need to determine if the market has correctly evaluated this risk.
Annual Dividend Payments	Dividends paid with no interruptions over a significant time period are a positive sign; dividend increases during prosperous years (with no subsequent decreases) are an even more positive sign.
Dividends vs. Reported Annual Earnings	Dividends higher than reported annual earnings are a warning sign, since this level of payment cannot be sustained over long time periods.
Dividend Coverage	
Dividend Payout Ratio (dividends per share ÷ earnings per share)	A measure of how much profit the company is paying out to shareholders in dividends. The lower the ratio, the more secure the dividend. Any ratio above 50% is generally considered a warning flag.
Dividend Coverage Ratio (cash flow per share ÷ dividends per share)	A measure of how secure the dividend is based on the company's cash flow. The higher the better; minimum coverage should be 1.2, indicating 120% coverage.
Debt Coverage	
Long-Term Debt-to-Equity Ratio (long-term debt ÷ stockholder's equity)	A measure of financial leverage. A higher ratio indicates higher financial leverage and therefore more risk; look for levels that are within the industry norm.
Short-Term Debt Coverage Ratio (operating income ÷ short-term debt)	A measure of whether a company's short-term debt obligations can be easily paid using cash generated from company operations. Should equal at least 2.0.
Quick Ratio [(current assets – inventory) ÷ current liabilities]	A measure of liquidity risk. The higher the quick ratio, the better, but it should have a minimum of 1.0.
Times Interest Earned (earnings before interest and taxes [or earnings before interest, taxes, depreciation and amortization] ÷ the total interest payable)	A measure of a company's ability to meet its interest payments. Should equal at least 1.0. The larger and more stable, the better.
Growth Trends	
Year-to-Year Changes in Financial Ratios, Earnings, Cash Flow and Revenues	Look for positive values or values that are at least within acceptable ranges over time. Deteriorating values are a warning sign.
Dividend Growth Rate (compound annual increase in dividend per share)	An indication of past company strength and dividend payment policy. Look for a five-year average greater than average for the industry.
Earnings Growth Rate (compound annual change in earnings per share)	An indication of past company strength and the ability to generate earnings. Look for firms with earnings growth rates in the upper half of their respective industries.

its interest payments; it is calculated by dividing earnings before interest and taxes (or earnings before interest, taxes, depreciation and amortization) by the total interest payable.

Times interest earned indicates how well a company is able to generate earnings to pay interest on its debt, which must be paid before dividends can be paid out. The larger and more stable the ratio, the lower the risk of the company defaulting.

In addition, the higher this ratio, the more flexibility a company has in being able to meet its financial obligations and have money left over for dividends, expansion, etc. As this ratio falls, the risk of a company defaulting on its debt obligations increases.

A ratio of less than one indicates that the company's current earnings are not high enough to meet their current debt obligations, meaning that it will need to liquidate assets to make up for the shortfall, find additional funding—or even reduce or eliminate the dividend.

What Are the Long-Term Trends?

Trends can help you understand if a company's position is improving or deteriorating.

You can spot trends by examining all of the above ratios and indicators—as well as earnings, cash flow and revenues—on a year-by-year basis over the last five or 10 years, looking for positive values or values that are at least within acceptable ranges. Deteriorating values are a warning sign.

Two growth ratios can also help you identify positive trends.

Dividend Growth Rate

The dividend growth rate (the compound annual increase in dividends per share) over the last five years provides both an indication of past company strength, as well as the dividend payment policy of the firm. Growth rates that are below the average for the industry are warning signs, while those above the average are pluses.

Earnings Growth Rate

The earnings growth rate (the compound annual change in earnings per share) over the last five years provides an indication of the company's ability to generate earnings. Look for firms with earnings growth rates in the upper half of their respective industries. ▲

—*Maria Crawford Scott, Editor, AAIL Journal*