BY JOHN KINGHAM

THE DIVIDEND HUNTER

SUPER-HIGH YIELD INVESTING: ONLY FOR THE BRAVE

In recent months I've written about a range of dividend stocks from the high quality end of the spectrum: from Buffett-style stocks to consumer staples and consistent inflation-beaters. But being a dividend-focused investor is not only about buying into these high quality dividend growth companies. There is another side to the search for income – perhaps the dark side – which puts yield first and quality a sometimes distant second.

The pros and cons of super-high yield investing

Super-high yield investing involves buying shares where the dividend yield is close to or above twice the market yield. Of course this means taking on more risk, but the returns can be much greater as well.

Picture this: You decide to invest in a somewhat mediocre company which has a 6% yield. Most investors think the dividend is about to be cut, but what if they're wrong (a not unlikely scenario)? What if, instead of cutting the dividend, the company maintains it and copes admirably with whatever significant problems it was facing? In that situation it's easy to imagine the share price heading upwards as investors become less fearful and more optimistic about the company's future.

If a dividend cut was no longer on the cards then other investors might accept a more reasonable yield of perhaps 4.5% from this mediocre company. For the yield to fall that much the share price would have to increase by 33%, and if that happened over the course of a year then your one-year return would be 6% from dividends, 0% from dividend growth and 33% from capital gains.

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Such rapid gains might seem unrealistic, but it happens all the time; in fact I've been lucky enough to invest in some of these situations myself. For example, when I bought **UK Mail (LON:UKM)** in 2011 it had a yield of 8.6% because the market expected a dividend cut. The cut never came and within a year I sold for a total return of 32%. An even faster re-rating occurred after I bought N Brown in 2012 when it had a yield of 5.4%. Just eight months later the share price had increased by 47% and I sold for a total return of 52%.

However, many super-high yield investments will not work out so well (which is something I have learned from experience). The most obvious risk is that the dividend gets cut or suspended, both of which will decimate the yield and remove the key driver of short-term capital gains. So if you're going to go down the super-high yield route, as I occasionally do, you'll want to keep an eye on anything that might cause the dividend to be cut, including cash hungry demands from debts, pension deficits and capital expenses.

In the rest of this month's article I'll look at three companies that fit the following criteria: 1) Their yields are close to double the market average; 2) they haven't cut or suspended their dividend once in the last decade; 3) they haven't recently announced a dividend cut, rights issue or other major dividend-reducing event:

Brown (N) Group (LON:BWNG)

Share price: 192p
Dividend yield: 7.4%
10-Yr growth rate: 4.6%

"N BROWN IS GOING TO HAVE TO COMPLETELY UPDATE ITS BUSINESS IN ORDER TO BE A SUCCESSFUL ONLINE-FIRST, MULTI-CHANNEL RETAILER."

N Brown is a leading clothing company with a particular focus on market niches that are not always well served by traditional high street retailers. For example, the company's three main "power brands" and their related niches are: JD Williams (for the over 50s), Simply Be (for women regardless of size) and Jacamo (for men from size S to 5XL).

The company has been around for over 140 years as a mail order catalogue business, allowing customers to buy on credit and pay monthly rather than up front. But that business model is unlikely to thrive in the 21st century thanks to the Web, which is in many ways one giant catalogue. In order to survive for the next 140 years, N Brown is going to have to completely update its business in order to be a successful online-first, multi-channel retailer.

That transformation is already underway, but it won't be (and hasn't been) easy, and therein lies the main reason behind its massive dividend yield. The market doesn't like uncertainty, and there is an enormous amount of uncertainty about whether or not N Brown can successfully pull off this transformation. Like everybody else, I have no idea what will happen, so as usual I'll stick to what we do know, which is the numbers recorded in its accounts.

First of all I think N Brown's borrowings of £330m are a little high when compared to its average post-tax profits of just under £80m. This gives it a debt ratio of 4.3, whereas 4.0 is the most I like to see in a cyclical company like a retailer. Capital expenses have also been quite high and in the last couple of years capex has been even higher still as the company invests in back-office systems and physical stores. That high capex is one reason why the company's free cash flow has failed to cover the dividend for most of the last decade. For now that gap is being plugged with rising debts, but that cannot go on forever. N Brown needs to get its operating cash flows up and capex down in order to reverse the trend of rising debt. If it can do that then perhaps the dividend will survive unscathed.

Other than high borrowings, high capex and weak free cash flows, both Brexit and the devaluation of the pound could also turn out to be serious threats. However, I don't like to speculate about the future as there are so many possible outcomes, so I won't go into any Brexit-related "what ifs".

Despite these problems I am currently an N Brown shareholder, so of course I hope it can maintain its dividend, but as with any company there can be no guarantees.

Carillion (LON:CLLN)

Share price: 250p
Dividend yield: 7.3%
10-Yr growth rate: 1.8%

Carillion is a construction and support services business, helping its clients with the finance, design, construction, maintenance and operation of buildings and other infrastructure. Its profits are split about 50/50 between support services on the one hand (facilities management and other services) and construction and public private partnerships (PPP) on the other (PPP is typically an all-in-one contract to finance, design, build and maintain public sector properties such as hospitals).

The company has a long and successful history, but since the financial crisis revenues and profits have declined in most years, although the dividend has continued to go up. As a result, dividend cover has fallen to just 1.4 which is dangerously low. Carillion's revenues and profits must start to increase soon if its record of dividend growth is to be sustained for much longer.

A lack of top and bottom line growth is not enough to cause a yield of more than 7%, so there must be other risks to the dividend. For me, those risks come in the form of borrowings and defined benefit pension obligations.

Both borrowings and pension obligations are a potential risk because they can generate relatively fixed costs: interest in the case of borrowings and (potentially) deficit reduction payments in the case of pensions. These fixed costs are important because Carillion has a significant foot in the construction sector, which can be very cyclical. Generally it's a good idea for cyclical companies to keep their fixed costs low so they can more easily survive the occasional downturns they'll have to face.

In Carillion's case, I think its borrowings and pension obligations are unacceptably high. Currently it has borrowings of just over £660m, while its average post-tax normalised profits are just over £140m. That gives it a debt ratio of 4.7, which isn't insanely high but is a little higher than the 4.0 I'm comfortable with for cyclical sector companies. The scale of these borrowings is reflected in its debt interest payments, which are currently running at £35m or 25% of average post-tax profits (imagine having credit card interest equal to 25% of your post-tax income).

"CARILLION'S REVENUES AND PROFITS MUST START TO INCREASE SOON IF ITS RECORD OF DIVIDEND GROWTH IS TO BE SUSTAINED FOR MUCH LONGER."

However, an equally significant problem is its defined benefit pension scheme. Unfortunately, the Bank of England's near-zero interest rate policy is increasing the present value of future pension fund obligations (or liabilities). In many cases the result is liabilities that are greater than the scheme's assets, leaving a funding deficit which the company is legally obliged to fill.

This is where Carillion is today. Its defined benefit pension scheme has liabilities of around £2,700m and assets of around £2,300m, leaving a pension deficit of £400m. That is a huge amount given the company's average post-tax profits of £140m. Pension liabilities are about 21-times the company's earnings, which is a truly massive financial obligation.

To close that deficit the company is currently pumping about £50m a year into the scheme, and it has been agreed with the scheme's trustees that these payments can continue until 2027 if required.

I think this combination of £35m interest and £50m deficit reduction payments is a huge drain on cash for a company generating around £140m in post-tax profits. Unsurprisingly, the dividend has not been covered by free cash for most of the last few years.

For me the risks around Carillion are too high, and even if the dividend yield was 10% or 20%, I still wouldn't invest. There is a significant chance that it will have to cut its dividend and/or raise capital through a rights issue if its cyclical end markets suffer another setback.

Connect Group (LON:CNCT)

Share price: 140p
Dividend yield: 6.8%
10-Yr growth rate: 4.9%

Somewhat like N Brown, Connect is another company which must transform itself to survive, in this case away from its historic core business of delivering newspapers and magazines (it was previously known as Smiths News and demerged from WH Smiths in 2006). Since you're reading an electronic magazine you are probably all too aware that physical newspapers and magazines are being replaced by electronic versions, which of course require no delivery trucks.

To escape this structural decline, Connect has diversified both organically and by acquisition. There have been two major acquisitions in recent years: In 2012 the company acquired The Consortium, a leading supplier of products to the education and medical markets, for around £40m; and in 2014 it acquired Tuffnells, a leading B2B next-day parcel delivery business, for around £115m. These two acquisitions now generate about 30% of the company's profits.

On the organic side perhaps the most interesting new venture is Pass My Parcel (PMP), a same-day click & collect and returns service. This is a fast growth area of the delivery market, with more and more people expecting to be able collect or return their online purchases within a day or less. PMP doesn't currently turn a profit as it is focused on building scale, but the venture indicates a willingness to adapt and try new things.

From a financial perspective, Connect has a long and steady history of dividend growth at a reasonable pace, but as is the case with most super-high yield companies, there are risks, and those risks come primarily in the form of large borrowings and pension obligations (again).

Those recent acquisitions were paid largely with borrowed money, leaving the company with £151m of debt, which is four-times its average normalised post-tax profit of £39m. That's right on the limit of what I would describe as prudent, but not enough to stop me from investing.

However, on top of those borderline borrowings is the company's defined benefit pension scheme. With liabilities of £530m, the scheme is almost 14-times the company's average profits, which makes it far too large for my liking. Unlike Carillion though, there is a substantial surplus of around £140m, and that makes the pension far less risky, despite its size.

So far I think Connect is a borderline case, with borrowings and pension liabilities that are risky, but perhaps not excessively so. Other positive factors could still tip the balance in the company's favour. For example, Connect does not require large capital investments in order to grow; in fact capex has averaged just 23% of profits over the last decade. Its free cash flows are also very good and have easily covered the dividend in most years.

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As with N Brown, I think an investment in Connect is basically a bet on the company's ability to successfully transform itself away from a shrinking market, and at today's price that's a bet I would seriously consider taking.

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.

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