By John Kingham

Dividend Hunter

Can a 15% Dividend Yield Ever Be Sustainable?

Very few stocks ever have a dividend yield of 15% or more, and if they do then the dividend has probably already been cut or suspended. For example, if I sort my watch list of dividend-paying stocks by yield, I get Provident Financial and Capita at the top, with yields of 20% and 17% respectively. In both cases the dividend has already been suspended, so the true yield (at least for now) is zero, rather than the historic yield quoted above. However, there is a third company on my list which has a yield exceeding 15%. That company is Connect Group (LON:CNCT) and, so far at least, there has been no mention of a dividend cut or suspension.

So just how sustainable is Connect’s dividend, and can investors seriously expect to get a dividend yield of around 15%? (You’ll have to be quick through. When I started writing this article, Connect’s share price was 63p, giving a yield of 15.6%. By the time I’d finished writing the price had gone up 10% to 70p, taking the yield down to 14.1%)

A no-growth company desperately seeking diversification

To understand Connect Group, we need to go back to 2006, when it was called Smiths News and was the newspaper and magazine distribution arm of WH Smiths. Following its demerger from WH Smiths, Smiths News became the UK’s leading distributor of newspapers and magazines by some margin.

A dominant market leadership position is usually a good thing, often leading to better brand awareness and economies of scale which in turn can drive attractive returns on capital as well as growth. And that was true in this case, but by 2009 it was clear that the attractiveness of the company’s leadership position was more than offset by the unattractiveness of its core business of distributing magazines and newspapers.

The reason, as you’re probably aware, was the invention of the iPad and other tablet computers, which enabled people to read magazines, newspapers and a million and one websites from a single convenient and highly mobile device.

From that point onwards, the slow decline of the newspaper and magazine delivery business was both inevitable and obvious, so the company began looking for new ways to generate revenue beyond its traditional core business. Eventually this
search evolved into a concrete strategy to diversify the group into other specialist distribution markets, primarily through acquisition but also through organic opportunities where possible.

The first significant move away from newspapers and magazines came in 2009 with the acquisition of Bertrams, at the time the leading UK book wholesaler with a market share of 45%. This acquisition added around £4 million of operating profit to the existing business's operating profits, which were around £30 million at the time. It also added around £6 million of debt to the company's balance sheet, taking total borrowings close to £54 million (a not excessive figure in my opinion).

In 2011, management stated that their new goal was to increase operating profits from outside the core newspaper and magazine business (which was still called Smiths News) to at least 30% of the total by 2014. That was an ambitious target and there was no time to waste, so the Bertrams acquisition was followed by the acquisition of Dawson Books, a leading supplier of books to universities and other educational institutions. This increased the size of Connect's book distribution business, but also increased the company's debts by £15 million to £67 million.

As a side note, can I just say that moving from the dying magazine and newspaper delivery business into the physical book delivery business does not strike me as a sign of towering genius (have management never heard of Amazon?)

After that, management began to push the acquisition accelerator even harder, paying £40 million in 2012 to acquire The Consortium, the UK's leading distributor of exercise books, stationery and other consumables to the educational market. This larger acquisition added about £8 million of operating profit, taking Connect's non-core operating profits to around £16 million, about 28% of the group total. Of course, this acquisition also had to be paid for, so the company's debts took a £40 million hike to £105 million. By this stage the balance sheet was becoming stretched, with debts now almost four-times average post-tax profits.

Quite sensibly, management decided to take a couple of years off from making new acquisitions and instead spent time understanding, integrating and developing the companies they had already acquired. They also decided to launch two new businesses: Pass my Parcel and Jack's Beans.

Pass my Parcel was (and is) one of a growing number of "click and collect" businesses. It enables customers to order goods online and have them delivered to a local store for collection, or to return goods via those same stores. The key to this business's prospects is that from day one it's had Amazon onboard as a major customer. Jack's Beans is something completely different, although if management were after diversification then this certainly looks like diversification to me. This start-up provides coffee vending machines (and the coffee of course) to small retailers using Connect's existing distribution capabilities. While these start-ups are interesting, they're both tiny and neither has yet had any meaningful impact on the group's top or bottom line.

After that brief lull, management were back on the acquisition trail in 2014. Their new goal was to generate at least 50% of profits from outside the core newspaper and magazine business before the end of 2016. A giant leap towards that goal was taken at the end of 2014 when the company acquired Tuffnells, a leading B2B parcel delivery company specialising in items of irregular dimension and weight.

The Tuffnells acquisition was the biggest to date by a long shot, costing some £113 million and requiring additional borrowing of £50 million and a £55 million rights issue. This took

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the company’s total debt pile to £165 million, which took its debt to average profit ratio above four, and in my opinion that’s somewhat excessive. As well as debt, acquiring Tuffnells also added £15 million of operating profits, taking total operating profits from non-core operations to around £27 million, or about 40% of the group’s £68 million total.

The 2014 Tuffnells deal marked the end of Connect’s acquisitive phase which I think was the sensible thing to do. In my experience, it’s very hard to make lots of large acquisitions in a short space of time and not make a mess of it. What often happens is that many companies are acquired, overall profits and revenues grow and everything looks great. But the complexity of the business grows, debt interest grows and focus declines. Eventually, what looks like a well-oiled and well-integrated machine turns out to be a house of cards which collapses at the first sign of difficulty.

All of that applies to Connect Group and its debt-fuelled acquisitions, to varying degrees. For a while, the acquisitions drove revenue and profit growth, or at least maintained them as the magazine and newspaper business stagnated. But it soon became clear that the acquired book and education businesses were going nowhere. From the outside at least, it seems as if meaningful synergies between the core business and those two businesses were few and far between. Growing debts were also a problem and, following the Tuffnells acquisition, the company repeatedly stated a new goal of debt reduction in the medium term.

So, what was Connect to do, having built up excessive amounts of debt acquiring a bunch of non-core companies which were not producing the hoped-for returns? The answer, of course, was to offload those companies as fast as possible, and that’s precisely what Connect did as part of its new strategy to re-focus on its core competencies.

**Focus almost always beats diversity**

First to go was the company’s Education & Care business, made up mostly of The Consortium. This business was sold for £57 million, producing a 10% annualised return over the ownership period. The proceeds from this sale were very sensibly used to help reduce the group’s debts to £89 million, a much more sensible amount. More recently, the book business has been sold for £6 million, leaving Tuffnells as the only significant acquisition to survive this cull.

With Tuffnells, the plan is to achieve full integration with the magazine and newspaper delivery business, rather than running them as two separate companies. The idea is that Smiths News and Tuffnells can work better together, sharing their infrastructure of trucks, drivers and depots, as well as systems and processes, to the benefit

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of both. This integration programme is expected to take a couple of years in total, focusing on cost reductions from greater scale, better utilisation of existing infrastructure and a greater range of delivery options for customers (in terms of both timeslot and location). This will hopefully lead to organic growth and, thankfully, further acquisitions are off the table for now.

Where does this leave Connect? As far as I can see, what we have is a very stable but slowly declining core business (newspaper and magazine delivery) which generates lots of cash. With sensible cost-cutting measures, it should be able to provide the company with a stable (if slightly declining) base of revenues, profits and cash for a long time. In addition, we have a specialist parcels business, which is perhaps a quarter of the size of the core business. The B2B parcels business should have a brighter future than the newspaper delivery business, although how much impact this might have on the overall group is up for debate. The final pillar is the integration of these two businesses, which may or may not provide the kind of synergies which management are hoping for.

So that's a long and perhaps slightly meandering look at Connect's past, which hopefully provides some useful context for any discussion of its present and future. I also think it shows how hard it can be for a company to expand beyond its core business, which is why corporate diversification is frequently a bad strategy. But enough of the past; let's have a look at Connect's current situation and its future prospects, especially as they relate to its dividend.

**Is Connect's 15% dividend yield safe?**

There are many factors which can affect the safety of a company’s dividend, so I’ll just address the main ones here:

**Cyclicalit**: Perhaps the biggest threat to a company’s dividend is the cyclical of its core business. In this case, Connect has a defensive core business based around a dominant leadership position in the magazine and newspaper delivery market. This business is defensive because people will typically keep buying magazines and newspapers even in a recession. The Tuffnells parcel business is less defensive, but at around 25% of the Group I don’t see this as significant to the cyclicality of the company as a whole. Overall then, I don’t see cyclical as a major threat to the dividend.

**Debt levels**: Even the most defensive companies can become very risky if they carry too much debt. In this case, Connect was getting ahead of itself a few years ago when acquisition-based borrowings reached £165 million. However, cash from the sale of the book and education businesses has been used to reduce debts to £89 million, less than three-times the company’s average post-tax profits. I think this is a reasonable amount of debt and does not represent a significant threat to the dividend.

**Pension liabilities**: As well as borrowings, another important liability is a company’s defined benefit pension scheme. If a scheme is large then there is the potential for a large pension deficit, which companies are legally obliged to reduce. In this case, the last actuarial review stated Connect’s pension scheme liabilities as £641 million, its pension assets as £619 million and therefore its pension deficit as £22 million (you’ll find different figures in the back of the annual report, but these “actuarial” figures are the ones used to calculate the company’s deficit reduction payments). To give you some context, the company currently generates post-tax profits of around £30 million on average each year. Cash is already being funnelled into the pension fund in order to reduce the deficit at the rate of about £5 million per year, which is a significant but not life-threatening diversion of cash.

The bigger threat is simply the size of the pension fund and the potential size of the deficit. At £641 million, those liabilities are almost 20-times the company’s average post-tax profits. In my opinion that makes the pension a serious threat to the dividend. For example, a 10% deficit (a fairly typical amount) would give a £64m deficit, which by law the company would be obliged to reduce, typically by cash payments. Personally, this large pension fund is the biggest problem I have with the idea of investing in Connect. Having said that, if the deficit goes away at the next actuarial review (which it might easily do given changes to asset valuations and interest rates) then the risk to the dividend in the short-term would be minimal.

**Dividend cover**: The obvious metric for dividend safety is dividend cover, in terms of either profit or free cash flow. In terms of reported post-tax profits, the dividend is still covered, although only just. Using adjusted profits (which
strips out one-off items such as the cost of integrating the Smiths News and Tuffnells businesses) gives a dividend cover of 1.6, which is not terrible, but it isn’t brilliant either; a dividend cover of two or more is where most companies like to be. Turning to free cash flows, these also cover the dividend, although only just. Neither of these dividend cover ratios is particularly healthy, so I would say this is a sign that the dividend is currently under threat and that there is little margin for error.

What does this mean for the dividend? I think it would be reasonable to expect management to trim the dividend given the lack of strong cover, but these ratios don’t suggest that the dividend should be suspended or cut drastically, by say 50% or more. On the other hand, if the dividend was not covered by free cash in future years then management might decide to borrow in order to maintain the dividend. Given the company’s current low debt levels that might be a reasonable course of action, but only as a temporary measure until growth could be restored.

Future business prospects: A company can be ticking along nicely, with low debts and good dividend cover, but if it’s operating in a market where technological progress has made existing products obsolete (such as those sold by Kodak, HMV or Blockbuster) then the company and its dividend will be under serious threat. To some extent, this is the situation faced by Connect and it is perhaps the most serious risk of all.

Connect’s core newspaper and magazine business is declining by a few percent each year, although so far that has been largely offset by increased efficiency and reduced costs; but that cannot go on forever. Most of the last decade was spent trying to diversify away from the core business into other niche distribution markets, but that strategy has largely failed. I think its book and education distribution acquisitions failed to add anything because those businesses were competing against Amazon, the one company no sane person would ever want to compete against.

However, the remaining businesses either don’t compete with Amazon or are able to deliver parcels for Amazon, thereby benefiting from Amazon’s success. For example, Amazon does not do newspaper delivery to newsagents or parcel distribution along the B2B supply chain and Pass My Parcel (Connect’s click and collect business) and Smiths News both have agreements to help deliver Amazon’s parcels.

Of course, it isn’t all about Amazon, but at least the company is no longer diversifying into businesses which are likely just as doomed as its newspaper and magazine distribution business.

A safe 15% yield? In your dreams, but that doesn’t make Connect a bad investment

Overall, I would say there’s a good chance that Connect’s dividend will be cut at some point in the next few years. However, I don’t see any obvious reason why the dividend should be suspended or cut drastically. If the dividend was cut by 50%, here’s what would happen: 1) It would free up about £10 million per year which could be used to reduce debt, pay down the pension deficit or fund the integration of Smiths News and Tuffnells; 2) the dividend would be covered twice over by both profits and free cash flows; and 3) at the current price the yield would still be around 7%. To me that looks like a very attractive proposition, and if I can get over my dislike of large pension schemes then I would be willing to invest in Connect Group, probably at anything under 100p.