Investors' Chronicle | Alpha

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Alpha shares analysis

2 December 2021

Getting under the skin of high dividends

This week we focus on dividends: will they/won't they, can they/can't they or could they/should they pay what our picks have distributed to shareholders in recent trading periods?

The stocks we examine this week have each paid in the last year what appear unsustainable dividends that aren't supported by earnings. High dividends (and high yields) arise for a range of different reasons: simple over-distribution, returning excessive capital or from unsustainable surges in key market segments. In two cases, much of the dividend was a special payment (typically a zero-sum game for investors) driven by step change which means they do not form core, reliable income. In the third case, the high yield reflects high risk.

- **Dunelm (DNLM)** – the UK homewares retailer is bucking an otherwise weak retail trend with sales more than 20 per cent above pre-Covid levels. This is driven by market share gains (partly self-help and partly drop outs from the likes of Debenhams) and a very sharp increase in online sales. Dunelm is in focus here because it is paying out large dividends uncovered by earnings. This is not a reckless policy, but rather a removal of excess capital through special dividends which appear, for now, capable of continuing. Sadly, as special dividends are a zero-sum game for investors, perhaps Dunelm should consider buy-backs instead.

- **VPC Specialty Lending investments (VSL)** – this is a highly specialised investment trust focused on non-prime, and thus, riskier, corporate debt. Investing in floating rate debt, VSL should see widening margins as interest rates rise, but conversely the risk of default is also likely to increase. This is a far more complex vehicle than most in the investment trust space and, overall, feels perhaps too risky for all but the boldest private investor. It is notable that VSL has paid an uncovered 8p dividend in each of the last three years, but does appear capable of sustaining this due to high free cash, so the near 9 per cent yield is real, but the stock does carry a lot of capital risk.

- **Ferrexpo (FXPO)** – an iron-ore mining stock with an apparent yield of over 20 per cent, is it too good to be true? Sadly, yes. The previous financial year benefited from hyper-normal market conditions with the price of steel rising four-fold, leading to bumper but non-repeatable profits. A new policy on dividends will see 30 per cent of free-cash flow paid out which could mean a still well-above-average yield of 6 per cent or more. However, income here will be volatile like the steel price that drives the group's trading: similar yields with better stability are available in the FTSE350.

Analyst: **Robin Hardy**

Dunelm – I will survive, and indeed thrive

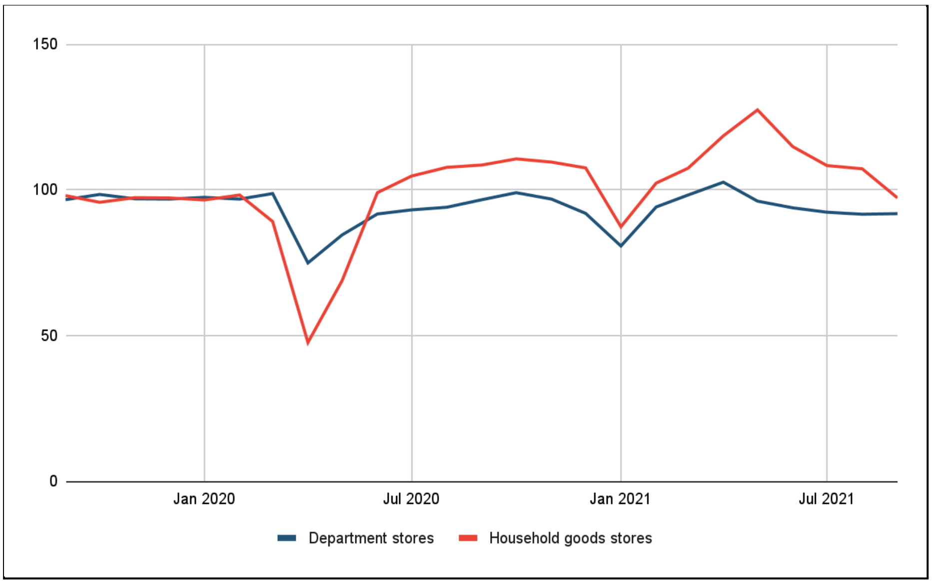
Source: FactSet

Dunelm (DNLM) is the leading player in the UK homeware retail sector – homeware is defined as items such as bedding, kitchenware, utensils, soft furnishings, lounge furniture, bedding and decorative items for the home: it holds a market share of c.9 per cent up from 7.5 per cent in just one year. Other players in the homeware space would include IKEA, John Lewis, Next and Argos along with larger format food retail outlets such as Tesco, ASDA and Sainsbury's. The DIY sector also strays in homeware retail. Dunelm's retail format is retail-park, shed-based rather than high street and it operates from more than 170 outlets across the UK. In addition to retailing, it also owns brands Dorma and Fogarty which manufacture bedding, pillows and duvets sold also by third parties.

Making progress against the herd

Many in the retail sector are struggling and the ONS reported for September 2021 that retail sales remained down year on year (by 0.2 per cent overall but non-food is weaker at -0.5 per cent and the household goods sector is worse still at -9 per cent). Overall, retail sales are around 4 per cent higher than pre-Covid levels by volume and 6 per cent higher by value. Again, household goods are faring less well with September 2021, some 1 per cent below February 2020. The weakness in this sub-sector has not been helped by the failure of House of Fraser and Debenhams, and by the well-documented loss of traction at John Lewis.

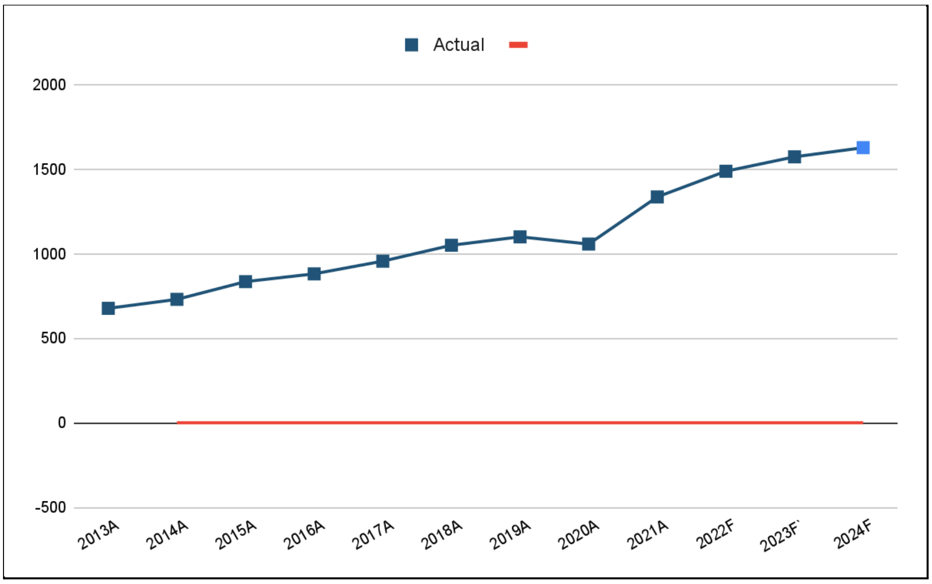
Figure 1: UK retail sales in selected non-food | Sept 2018 = index 100



Source: ONS

Dunelm's performance contrasts starkly to this with its latest quarterly figures (Q1 to end September 2021) reporting an 8.3 per cent year-on-year sales increase and, far more significantly, sales 48 per cent higher than the same period two years ago, pre-Covid. How has this been possible in such a tough climate?

Figure 2: Actual and forecast revenue - £m

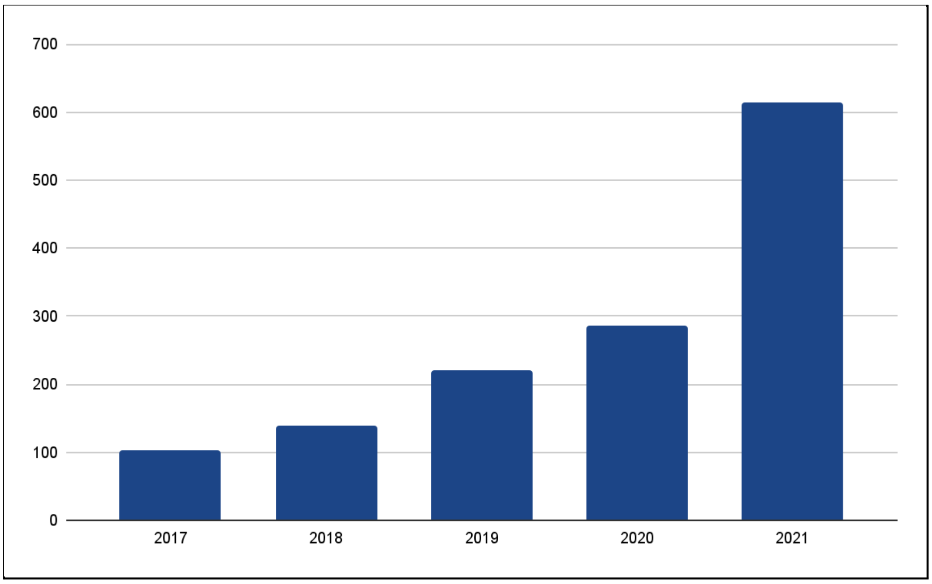


Source: FactSet

- **Market share gains** – In-store sales have been better than many competitors' experience due to market share gains. Part of this is where Dunelm has been picking up fallout from Debenhams and House of Fraser as well as John Lewis, but it would be unfair to say that this step up in sales just fell into Dunelm's lap from others' misfortune. Dunelm is also growing from its own actions. The range is broadening (such as introducing paints and wallpapers to compliment furnishing ranges) and products are being sold across a wider price range to extend the appeal to more customers. Dunelm does have a small problem that, if resolved, could be a positive driver. Some 40 per cent of sales arise from just 12 per cent of the customer base, which is an unhealthy skew. This is a marketing priority that it is hoped will bring better balance, gain more share and boost total sales.

- **Online sales** – the growth in home delivery and click-and-collect revenues has been the main driver. Digital sales have been very strong, albeit from a low base before Covid (10 per cent of sales versus national average for all retail > 25 per cent), and has become a key focus area. As the chart below shows, Dunelm has done exceptionally well growing its online sales and has done so without excessive cannibalisation of in-person shopping. For comparison, Next has also seen a steep increase in online sales but at the same time has seen a significant drop in in-store sales: for its latest half year, Next's online position is up 55 per cent but in-store sales show a 40 per cent drop versus 2019. Dunelm's in-store sales are 19 per cent down over the same period with online sales having close to trebled to stand at 46 per cent of total revenues (national average 28 per cent).

Figure 3: Growth in online and/or digital originated sales - £m



Source: Dunelm

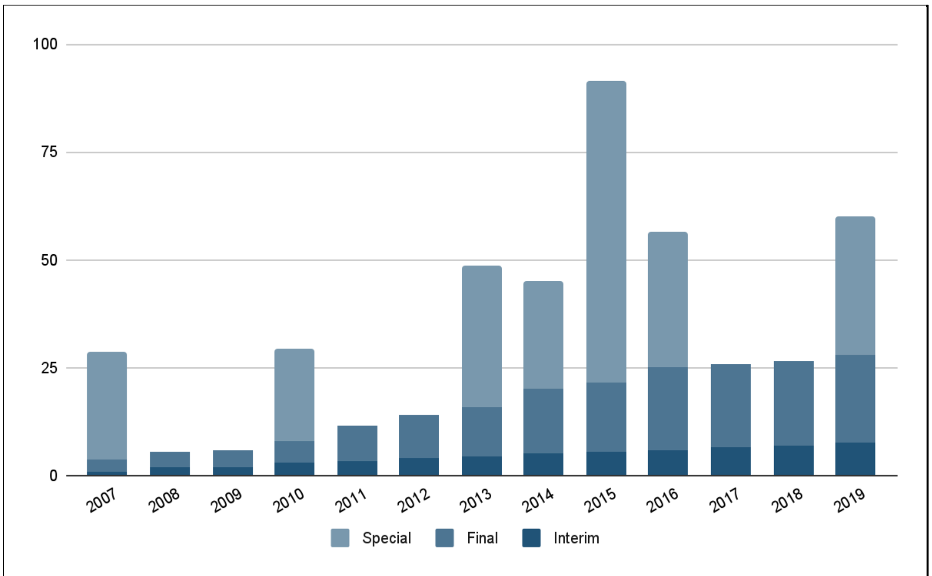
- **Clever marketing** – Rather than marketing the brand and hoping that customers shop at Dunelm, there has been a far more direct approach here. There has been a significant increase in social media marketing based largely on well -researched knowledge of the customer and their specific shopping habits. The aim has been to get each customer to access the broadest range of products and raise awareness of items they would not normally buy. There are regional Facebook pages managed by dedicated branch staff but populated largely by other customers which appear to be driving greater and more diverse sales per customer.

Dividends

The reason for Dunelm's inclusion in this week's report is because it fails a key test on the stock screen: dividend cover. In the 2021 financial year (to June) Dunelm paid 100p in dividends while only reporting 63p of earnings per share (EPS), so the payment looks uncovered: this is not typically a sustainable position. A key factor here was the payment of a special, catch-up dividend to (part) compensate for there being no dividend in FY2020: this special dividend was 65p with the 2021 ordinary at 35p. The 2021 ordinary was in line with the stated payout policy of c.50 per cent of EPS. Taken across the two years, however, the 100p of dividend stands against aggregated EPS of 106p, meaning that the payment was (just) covered by EPS and was materially above the 50 per cent payout ratio.

The issue of a high payout ratio is not a one-off and runs back as far as FY2017. In that year and in FY2018, the cover on the ordinary dividend (no specials were paid) was just 1.4 times.

Figure 3: Dunelm dividend history



Source: Dunelm

Dunelm has a long history of paying special dividends. Shareholders have received substantial special dividends in the last several years, almost to the extent that they might not be viewed as being special in nature, only in size. The problem is that special dividends have a nasty habit of eroding the share price by the same amount as the special dividend leaving shareholders with a cash gain but capital loss: a zero sum game for investors. I believe that buy-backs are almost always preferable, and are typically more tax-efficient.

So, is the board being reckless here paying out large distributions that are not covered by trading? Not necessarily. The reason is that Dunelm's dividend policy is not just to pay out 50 per cent of EPS; this is simply the core dividend which, as shown in figure 3 has been progressive. There is also a structured capital returns program to distribute what the board believes to be excess capital: this is the source of the special dividends. The view of the board, according to John Stevenson at Peel Hunt, is that if the historic debt to Ebitda (earnings before interest, tax, depreciation and amortisation) ratio is less than 0.25 at the end of the financial year, then there is excess capital on the balance sheet that should be paid out. At the last balance sheet date there was £130m of net cash, leaving the group comfortably ahead of the position from which it sees the need to distribute an excess.

Peel Hunt believes that there is scope for perhaps two additional special dividends of at least £100m or close to 50p per share in the next two to three years. Profits are rising moderately and the need for investment is lowering especially as the focus shifts from primarily growing store numbers to increasing both online sales and the average revenue per customer (ARPC). Historically the target was for 10-15 new openings per annum and going forward that is likely to be closer to 2-3 per annum, which leads to far higher cash conversion rates.

Conclusions

Dunelm does not cover its total dividends with its EPS, but the core dividend that investors can rely upon (that arising from the policy of paying out half of the post-tax profit) appears comfortably fundable going forwards. The total dividend is not covered by earnings, but by free cash flow and by the capital accumulation the board sees as surplus. However, as the greater part of the total dividends that can be expected over the next three years are likely to be special payments, this is less attractive for investors given the net zero impact they have on total returns. The core dividend provides a good yield at around 3.75 per cent so that is above the average for the FTSE350, but it is hard to see investors making much more than this in the near term as a total return.

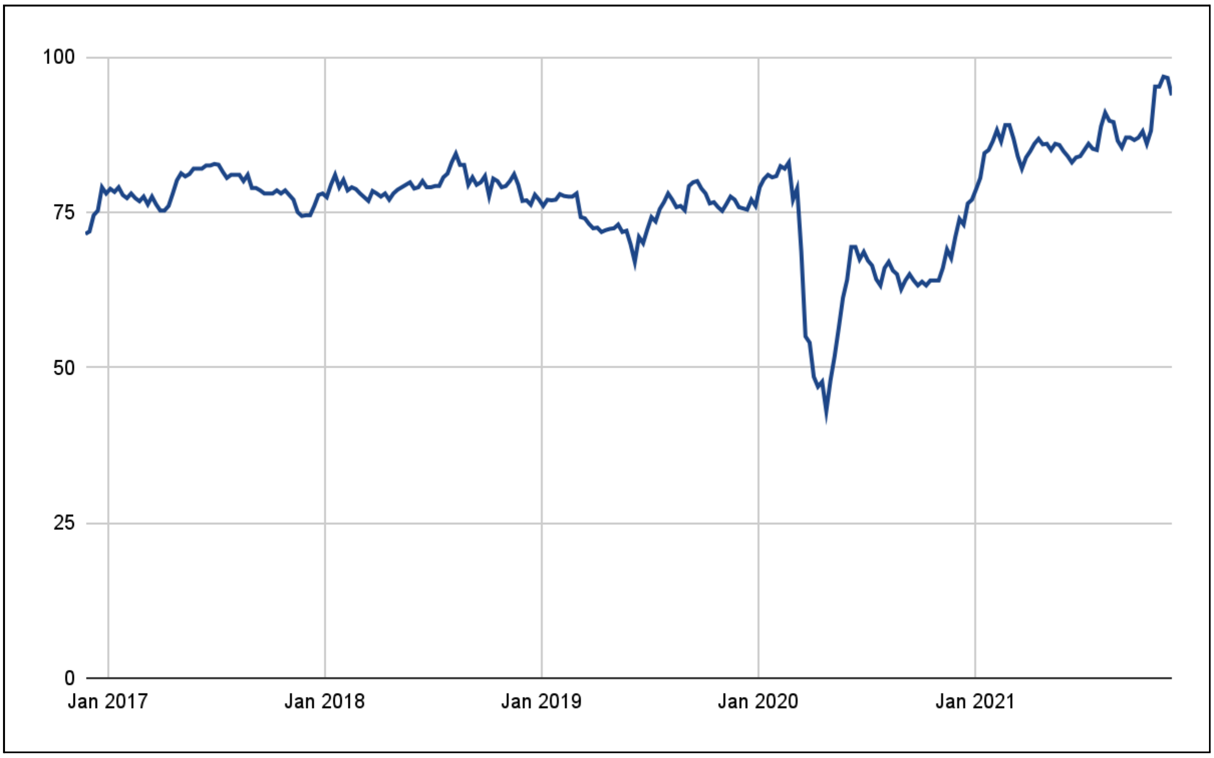
Why? Because the rating is relatively high with a year 1 price to earnings ratio (PE) of more than 18 times, which is 4 points higher than Next and 6 points higher than M&S. There is a decent earnings growth forecast, but it is in single digit percentages across the next three years. The expected compound annual growth rate (CAGR) for earnings is 7.5 per cent 2021 to 2024 and it is slowing. This sits less comfortably with the current rating.

The share price has rebounded well post Covid, but has stalled somewhat in recent months and still sits slightly below its level immediately before the market slump in March 2020: the UK General Retailers sector is 15 per cent above pre-Covid levels. This is despite EPS moving to a materially higher level than pre-Covid: 2019 EPS were 50p and 2022 forecast EPS are 70p, plus the balance sheet is materially stronger with net cash likely to exceed £200m in 2022 against 2019's net debt of £25m.

This means that even at the current high rating the shares have derated during 2021, with the share price failing to pick up on the various upgrades this year (consensus EPS for FY2022 have increased by c.15 per cent since May). In part that is likely to have been because the Year 1 PE ratio topped out at close to 30 times EPS in May: that is too high for a still primarily bricks-and-mortar retailer. Also, retail is still vulnerable to rising pressure on household spending due to general inflation and rising energy costs and with the arrival of the Omicron variant of Covid, further restrictions on store openings cannot be ruled out.

This is a good story but the rating simply feels too high. There is a well-funded, sustainable and reasonable core yield, but perhaps too much is being channelled into special payments that risk leaving investors with no net gains. If there is £200m that can be returned to shareholders, doing so via buy-backs rather than a special dividend could bump the share price by c.7½ per cent and provide a double digit total return at a constant rating. Based on a long history, however, that looks unlikely and special dividends are likely to continue.

VPC Specialty Lending Investments – complex, opaque, risky



Source: FactSet

VPC Specialty Lending Investments (VSL) help provide a lesson in the more esoteric end of the financial markets. This is an investment trust but rather than invest in listed shares it instead invests in debt instruments for small and larger, typically unquoted companies. It operates away from the mainstream of corporate lending, itself describing where it places investors' funds as "opportunistic credit investments" that have generally been originated by non-bank lenders, with a particular focus on 'fintech' businesses.

Higher risk, higher returns

The description of the types of investments in the trust already points to a higher-risk profile and this is confirmed by the average interest rate levied on the loans advanced to the 26 client organisations in place at the time of the last results. The weighted average rate of interest (or coupon – the use of this term suggests that the money VSL advances is more bond-like in character) was 10.26 per cent. The rule of thumb is the higher the risk in the loan (more practically the risk of default of the interest payments and/or the repayment of the principle), the higher the cost of funds. The cost of funds is measured against so-called 'risk-free rates' (RFR) of interest which would typically be LIBOR (the interbank lending rate being phased out and replaced by SONIA) of equivalent maturity or sovereign debt (i.e. Gilts or T-Bills). As most of the loans are in the US, the RFR yields against which structured debt is priced range from 0.09 to 0.17 per cent. Pricing at more than 1,000 basis points (a basis point is a hundredth of one per cent) above the RFR indicates high risk.

Debt ratings

Rating agency Standard & Poors (S&P) rates all commercial paper (bonds and other debt instruments) on an A to D scale. The highest (AAA) would be for sovereign debt, for example UK government bonds or 'gilts'. The 10-year gilt currently might give a gross redemption yield (the implied yield of coupons and return of the principle at market prices) of around 0.85 per cent. Lowest investment grade bonds (rated BBB) would yield 2.5 per cent and the highest non-investment grade (BB) would have to pay 3.3 per cent and for CCC paper, the yield is now 8 per cent. This further illustrates how far high the risk is deemed to be for the commercial paper in which VSL is investing. Looking at online commercial lenders such as Funding Circle interest rates range from 2.9 per cent to 12 per cent, plus an 'origination' fee of 5 per cent so again we are at the higher end of risk here.

Table 1: Investment grade for debt instruments

Investment grade	AAA	AA	A	BBB	
Non-investment grade	BB	B	CCC	C	D (already in default)

Source: S&P

Table 2: VSL's largest customers

Borrower	**Business type**
Applied Data Finance, LLC	Subprime credit broker
Caribbean Financial Group Holdings LP	Branch-based consumer debt
Perch HQ, LLC	Buys and operates D2C retailers mainly based on Amazon
Elevate Credit, Inc.	Non & Sub-prime lending - **NYSE listed**
Deinde Group, LLC	Political lobbyist
Heyday Technologies, Inc.	AI chat software for e-commerce
Razor Group GmbH	Buys and operates D2C retailers mainly based on Amazon
West Creek Financial LLC	Non-prime credit
Dave, Inc.	Financial banking app - USA
FinAccel Pte Ltd	Financial banking app - Singapore

Source: VPC Specialist Lending PLC

The risk of the lending undertaken is high. However, the way the lending is structured, in terms of the stress testings and the basis on which loan collateral is valued does look to be very aggressive, which could help mitigate the effective risk. Also the charging of sizable up-front 'origination' fees (typically 5 per cent of the loan) provide another cushion of de-risking.

VSL has, in addition to the debt portfolio, an equity fund that accounts for c.11 per cent of the net asset value (NAV), which is growing, and four special purpose acquisition companies (SPACs) that account for c.7 per cent of the NAV (but mostly uncrystallised value). VSL is invested in the debt and equity of several businesses.

Fund costs

The loan and equity portfolios are externally managed by a US investment house Victory Park Capital, which looks itself to be a substantial equity and/or debt investor in most businesses that are within the investment trust. The fund is managed on a quasi-hedge fund basis with a 1 per cent annual fee payable to the manager and 15 per cent of the annual total returns from the fund (if they exceed 5 per cent). This is lower than the more typical "2 and 20" basis of hedge funds but still feels high for an investment trust although the more specialist and esoteric a trust is, the more likely it is to charge a material fee – performance fees erode returns for investors and raise the cost of ownership. The whole, thorny issue of fees in investment trusts is discussed in more detail in this recent Investors' Chronicle article.

Changing risk climate

Lending to riskier customer profiles had not been too bad an environment until Covid, which is likely to have put businesses and borrowers with less robust credit ratings at greater risk of default. Covid is not dying back and now we have inflation and energy cost pressures for consumers, high wage growth and supply chain issues for businesses. Keeping up with loan payments, especially when the interest rate is in double-digits, is likely to become harder. Thus far there has been a higher, government-enforced level of forbearance by lenders which has allowed weaker businesses to avoid defaulting. In time, this forbearance will end and the underlying risk of default is likely to rise.

The company does stress that it 'over-collateralises' its loans to further de-risk. This means that other elements in the capital structure of the business taking out the loan have to bear the brunt of failure and that VSL's loans are (or should be) better protected. The loans made are also typically "senior" (they get paid back first in the event of a default) and are secured (specific assets transfer across and are available to sell following default). That loans are both senior in rank and are secured but still incur interest of over 10 per cent further underscores the risk profile.

Often, these protections are better than being a more straightforward creditor after default but when there are just cents on the dollar left in a business, sizeable losses can still be incurred. That said, there have been only very minor loan impairments in the last couple of years with just £112,000 written off against £293m of loans in FY2020.

Most of the debt in which VSL invests is floating rate – most businesses have been happy to not fix corporate debt costs for many years (since 2008 in practice) as there was very little to indicate that interest rates were likely to increase. That has now changed with the sharp increase in inflation pushing up market interest rates, even though few central banks have to date increased prime rates. This should be beneficial for VSL as its interest margin (the gap between what it charges and how much its own wholesale funds cost) can widen. As costs are likely to be relatively static, that would feed a high rate of drop through to profitability.

So, holding floating rate debt receivables in a rising interest rate climate might appear to be a positive, in reality it is something of a curate's egg. While the interest payable will rise, so does the risk of default. The businesses holding the loans are less likely to have substantial equity funding or large retained reserves, instead relying on debt finance for a major part of their capital. While some will be able to pass through higher costs to customers, others may struggle to do so.

Massive buyback programme

Table 2: Share buyback record

Financial year	Shares bought in '000s	Average price paid - £	Investment - £000
2021	4,371	0.86	3,741
2020	29,654	0.68	20,165
2019	47,808	0.73	35,043
2018	10,077	0.80	8,030
2017	10,927	0.78	8,567
2016	1,500	0.77	1,159
Totals	**104,337**	**0.735***	**76,705**

Source: VPC Speciality Lending Investments PLC Annual Reports | * average for all buybacks

Since December 2016, VSL has been very active in buying back its own shares. As the shares have, essentially, traded below their book value or NAV since day 1, deploying cash to buy the shares will have boosted the NAV. As the discount to NAV has lowered, it no longer makes financial sense to do this and the last repurchase was made in June 2021.

However, since the start of the programme some 104 million shares have been redeemed, more than a quarter of the shares originally listed. That VSL has been able to buy back over a quarter of its stock at an average 26.5 per cent discount is hardly a ringing endorsement of the asset quality or the market's view of the risk. This is further underscored by the stock still trading below NAV even after such a comprehensive redemption programme.

Will the dividend be maintained?

VSL pays a generous dividend that has run out at an unchanged 8p per share in the last three years: this drives a yield of 8½ per cent at the current share price (94p). Will this be maintained? This is a very complex financial machine and it is hard to determine how all of the moving parts are running. Most of the underlying debt and equity investments are not traded on public markets so, unlike an investment trust only holding listed equities, performance is opaque and investors can only see a value on the monthly, single-point NAV assessment from the board with no granular detail. The make up and movements within the NAV are only partially visible at the interim stage and only fully visible once a year in the annual Report & Accounts.

The asset classes in which the trust invests are generally riskier, but they appear to have been well managed to date with no material capital losses incurred to date. The business does seem to be shifting more towards equity investment rather than debt and this might alter (lower) the risk profile but that depends on the nature and profile of the businesses taken on. As above, however, rising interest rates and lower lender/creditor forbearance may increase risk even as the achievable net interest margin begins to widen.

Since inception (March 2015), investors have seen a total return of c.69 per cent, more than 100 per cent of which has come through the dividend: the share price is 7 per cent down, despite the high redemptions. This looks positive but must be viewed against the return that could have been made passively investing in the FTSE All-Share. In the same period, the All-Share has made a total return of around 45 per cent. So, a superior return has been made here, but is that additional gain enough against the additional risk?

Conclusions

The world is heading into choppy waters so the core income from interest on loans may be less secure. My conclusion would be that despite the allure of a high yield of more than 8 per cent this is both a risky and opaque investment that for its return relies almost totally on the dividend income: the NAV is growing but in capital gains that do not readily convert into free cash flow that can fund the dividend: they are simply book movements. This really feels like an investment for the professionals rather than private investors but if one is happy with very high levels of risk a very modest position might be acceptable.

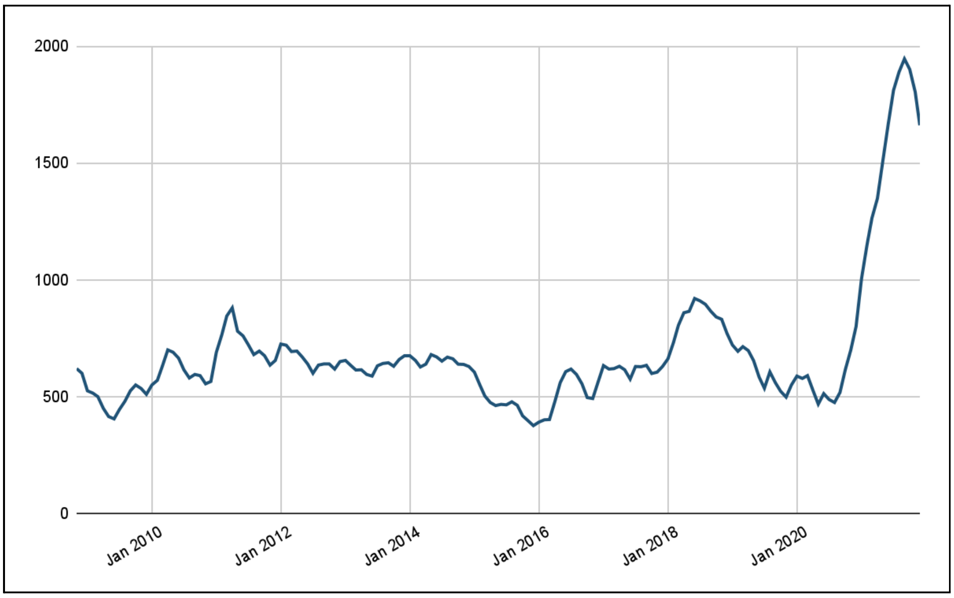
Ferrexpo – steel roller-coaster

Source: FactSet

Ferrexpo (FXPO) is a long-established mining and processing business with an HQ in Switzerland, mining assets in Ukraine and a full listing in London. It extracts basic iron ore bearing soil which is then refined (the market standard is to 62 per cent purity) and sold as iron ore pellets to the steel industry. Just over half of its materials are sold into mainland China and the next quarter goes to Austria and Germany. Steel demand and pricing are notoriously volatile embarking on long cycle swings but in mid-2020, the market price of finished steel exploded (see Figure 1) rising four-fold in nine months.

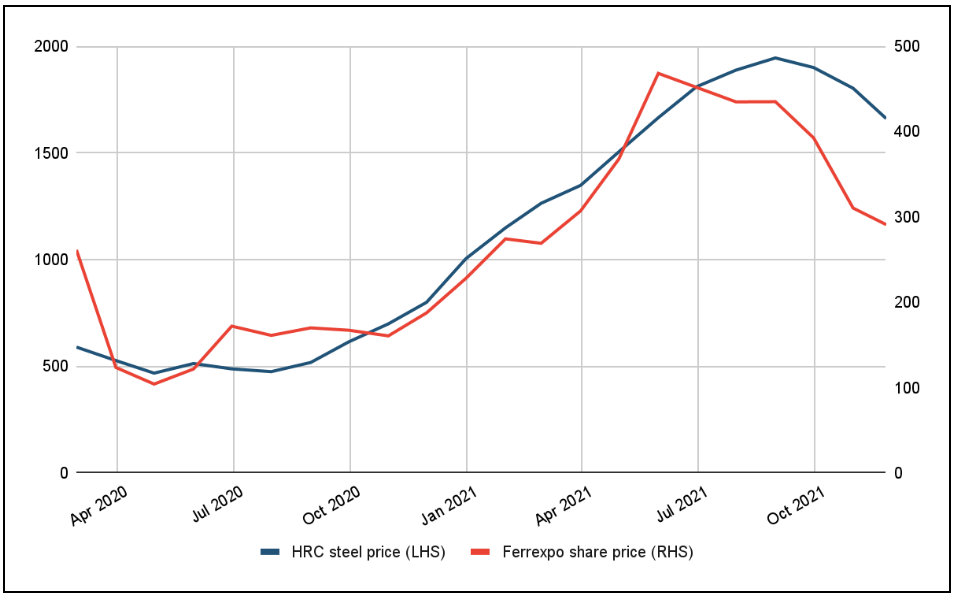
The price is edging back and is forecast to decline, slowly, through the next 12 months or so. The spot price for US Hot Rolled Coiled steel (HRC) is today $1,600/ton, but futures contracts for September 2022 are pricing at just $1,000/ton. Iron ore prices followed a similar trajectory, tripling between May 2020 and July 2021 but in contrast to finished steel price, ore has fallen back almost to where the surge began (see Figure 3).

Figure 1: HRC steel price – US$/ton



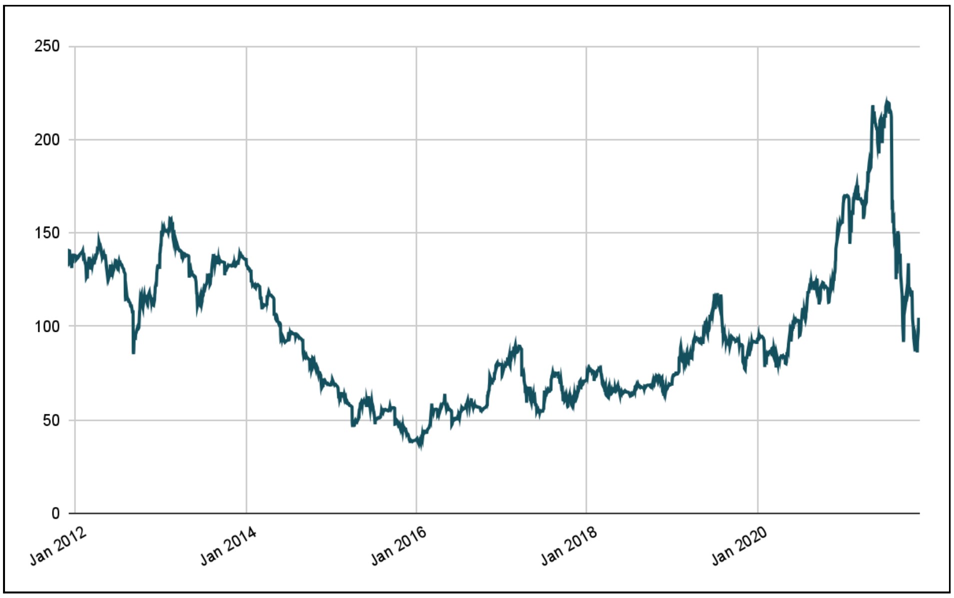
Source: FactSet

Figure 2: Ferrexpo share price and the steel price



Source: Factset

Figure 3: Iron ore price – US$/ton – spot price



Source: FactSet

The elephant in the room – the yield

The standout issue with Ferrexpo is the apparent yield – based on the current analysts' consensus of 72p per share and a share price of 272p the yield looks to be c.26 per cent. The figures do indeed appear to be correct – thanks to the surging steel and ore prices Ferrexpo is heading for a bumper period of trading with EPS forecast to hit 140p per share for FY2021, up from 84p with the dividend set to be paid out at c.50 per cent of the underlying EPS, so DPS of at least 70p per share (last year 63p). For FY2022, the consensus EPS drops back to 63p but sits in a very wide range, hardly surprising given the extreme volatility and rate of change in the finished steel and ore prices. DPS would follow, dropping to near 30p per share. That would still drive a high yield of c.11 per cent if the distribution basis assumption of half of EPS being paid out was correct. Unfortunately, that is not a correct assumption.

A new basis

On 16 November, the board held an analysts' meeting to lay out its updated shareholder returns policy. Rather than a more typical percentage of earnings basis, Ferrexpo's distribution policy will in future be to pay out 30 per cent of that year's free cash flow or FCF (its definition: "free cash flow comprises net cash flows from operating activities less net cash flows from investing and financing activities"). This will form a core dividend with periodic special dividends payable if/when the likes of the 2020 price surge occur.

This does make the outlook for the dividend a little less certain than when basing it on EPS as there are likely to be spikes and troughs in the investment demands of the business that are different from trading, That said, these can be managed to some extent across the cycle so that trading and capital investment demands are better aligned.

In the past three years, the dividend payout has significantly exceeded the 30 per cent of FCF level, largely due to a far lower requirement to pay down debt, which has been dropping steadily for the last five years. This is summarised below in Table 1.

Table 1: Historic dividend on key bases – yield adjusted to sterling share price

Financial year	**2018**	**2019**	**2020**
30 per cent of FCF	8.0¢	11.0¢	24.0¢
Actual paid	23.1¢	19.8¢	85.8¢
Actual without specials			46.5¢
Yield on equivalent	2.14%	2.94%	6.42%
Yield on actual	6.18%	5.30%	22.96%
Yield on core			12.44%

Source: Ferrexpo

The problem with specials

I have addressed the issue with special dividends and total returns for investors before. Institutional investors dislike specials (they would rather have share buy backs if there is truly surplus capital) and when the shares are marked ex-dividend for the special, the share price dips by the value of the dividend. This leaves investors with a cash gain, but a capital loss. This is because the cash that is being distributed is already owned by the shareholders and is only being converted from one form to another – it is not additional to what the shareholder already owns.

It appears likely that Ferrexpo is going to pay more specials in future given the feast and famine nature of the steel and allied industries. So, investors need to be looking at what the core, running dividend is likely to be, and therein lies a problem.

The cyclical nature of the steel price is likely to make the level of dividends here unpredictable and volatile. Where a business is in a cyclical market and has a 'mechanical' dividend policy (a set proportion of profits to be paid out) rather than a progressive dividend (where the board aims to grow the dividend every year or at least not to cut it). In a mechanical setup the dividend is likely to vary, perhaps considerably, especially if the need to make heavier capital expenditure comes at a time when the steel price, profits and free cash flow are on the downstroke.

What dividend can shareholders expect

We know the formula, we just need to have a decent estimate of the future free cash flow. While there are 7 analysts forecasting EPS, only 2 have published estimates for cash flow per share: this is likely to change in light of the new basis for setting the dividend. The consensus is erratic and spread across a broad and unhelpful range, which is only natural given differing macro views on global inflation, GDP growth, the state of the Chinese economy; and more narrowly, views on the steel market. One consistent theme in the forecasts is that the dividend is trending downwards.

Two things are notable on the market forecasts for dividends: 1) expectations have moved downwards recently in light of the new distribution policy; 2) forecasts still look too high - Peel Hunt, for example forecasts 80¢ of free flow in FY2023, but 40¢ of dividend, a half rather than the policy one-third payout ratio.

Nonetheless, if we take Peel Hunt's forecasts for cash flow and apply the board's one-third payout ratio, we get to the following:

Table 2: Viable scenario of Ferrexpo's dividend and yield

Financial year	2021	2022	2023
Forecast CF per share	172.0¢	104.0¢	80.0¢
Dividend at 30% payout	51.6¢	31.2¢	24.0¢
Dividend in £	38.8p	23.5p	18.0p
Yield at 285p share price	13.61%	8.23%	6.33%

Source: Factset, Investors' Chronicle. Forecasts from Peel Hunt plc

This still looks attractive, especially this year. However, 39.6¢ has already been paid out as an interim dividend, so if the step down in distributions begins with the final payment for FY2021 only around 12¢ may remain to be paid this year. However, some forecasts still suggest that the final dividend may match the interim at 39.6¢: that indicates a yield on the final dividend alone of 10.4 per cent. Our estimate might indicate a final-only yield of a more reasonable 3 per cent.

A very big caveat must be made. Even if there is a final splurge of large dividends here, the market looks to be treating these high, transitional rates of dividend payment as if they were specials: when the shares went ex-dividend of the 39.6¢ interim payment, the share price fell by at least the sterling value of the dividend. If the market is aware of the likely, future, re-based value of the dividend (so perhaps the 24¢/18p we estimate in Table 2) any sum above this risks being treated as if it was a special with income paid, but capital lost. That would neutralise the net impact of buying the shares now to catch any final excessive dividends.

If our forward look above in Table 2 is correct, a reasonable basis for the yield looks to be around 6½ per cent, which is high relative to the average for the All-Share (which is around 3.5 per cent), but less of a premium for a stock with very high cyclicality and less certainty as to the level of the dividend.

Conclusions

Should investors be drawn in here? Certainly not on the basis of the recent dividend history nor the short term, consensus dividend forecasts, as even if they are paid, they risk being rated as a special payment. Even the 'normalised' dividend yield that might be around 6½ per cent is far from assured, but on the basis of distribution policy and with debt repayment now much less of a call on the free cash flow, investors should be able to expect a return comfortably above the market average in Ferrexpo. That said, the same can be achieved across a number of other stocks in the FTSE350, most of which will be far less volatile.

A taxing issue

Another issue investors need to be aware of here is that because Ferrexpo is Swiss-domiciled, all dividends are subject to a withholding tax – Switzerland has one of the world's highest rates at 35 per cent. Some of this can be reclaimed under a bi-lateral tax treaty but only 20 of the 35 per cent. Holding the shares in a self-invested personal pension (Sipp) or an individual savings account (Isa) does not protect an investor from overseas tax, just UK tax. Some investors may be able to find routes to getting more of the tax back and rules against double-taxation should prevent excessive amounts of tax being paid relative to UK-originated distributions. That said, dividends from Ferrexpo held inside a tax-wrapper are almost certainly going to end up at least 15 per cent below the headline level and given the reported complexity of claiming a rebate, the net income could easily be only two-thirds of the gross. A helpful IC article from 2018 here on the issue of withholding tax on overseas income.

ISSN 0261-3115.