Investors' Chronicle | Alpha

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Alpha weekly shares analysis

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Assessing the case for income

Rating the income prospects of holding shares has been made very difficult in the pandemic. The Alpha dividend diamond screen has struggled to identify genuine income prospects as the raft of cuts made by companies in response to Covid-19 lockdowns and uncertainty, has skewed many backward looking measures. Fortunately, we've secured the services of analyst Robin Hardy to give an in-depth view and prognosis for the pay-outs of three companies that have caught our attention this week from either our screen or the news

Making the case for payout prospects:

- **Impact Healthcare Reit (IHR)**: The specialist real-estate investment trust rents properties to providers of residential care to the elderly. The pandemic has presented unique challenges to tenants, but the business model has shown signs of resilience and the long-term income case for IHR is solid.

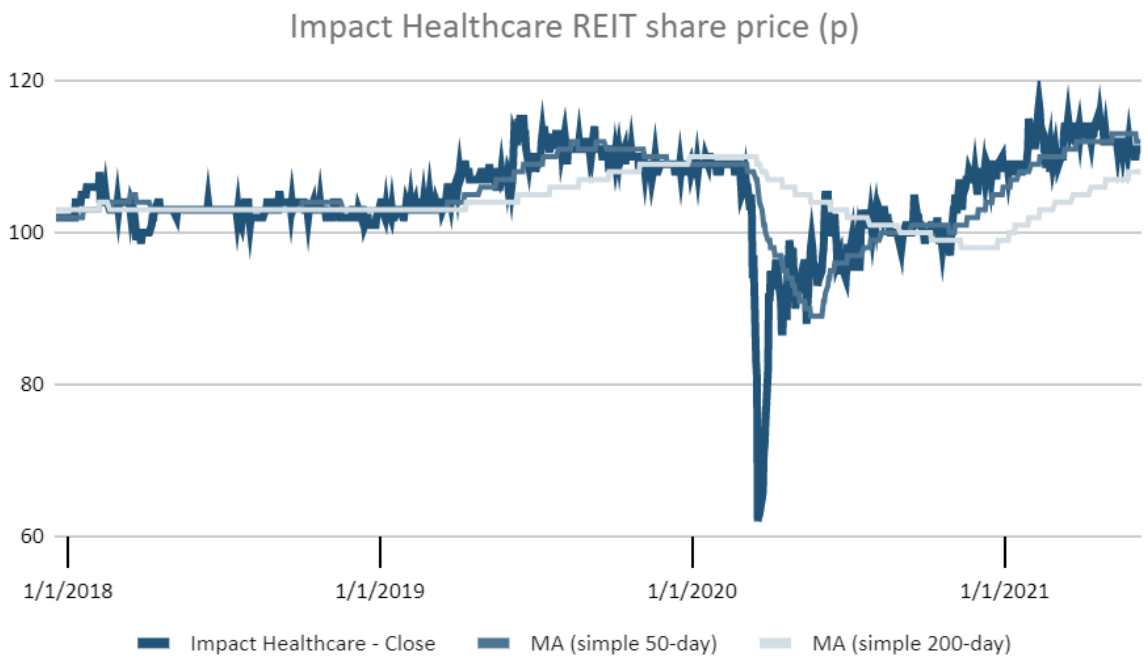
- Defence and aerospace business **BAE Systems (BA.)** was one of the larger companies to rank well on the Alpha dividend yield screen. While there is certainly a defensive case for holding the shares, the long-term income case is arguably compromised by the dilemma shareholders face in funding growth.

- Water company owner **Pennon (PNN)** has announced a special dividend and other uses for the proceeds from the disposal of its waste business. The special payment will cheer shareholders, but investors must consider the long-term prospects for the ordinary dividend, too.

Analyst:

Robin Hardy

Impact Healthcare REIT (IHR)



Source: FactSet

Before Covid-19, investors could comfortably look at real-estate investment trusts (Reits) as a stable source of income. As long as the portfolio remained well-invested and well-let, Reit rules prescribe minimum levels of dividend, which were both high and growing (Reits must distribute at least 90 per cent of income-driven profits plus all income received from other UK Reits). In return for this, Reits pay no corporation tax. Through active asset management, Reit managers could augment market-driven rental increases and yield-led asset value uplifts to accelerate returns. Investors often enjoyed double-digit annual total returns thanks to dividend and net asset value (NAV) growth.

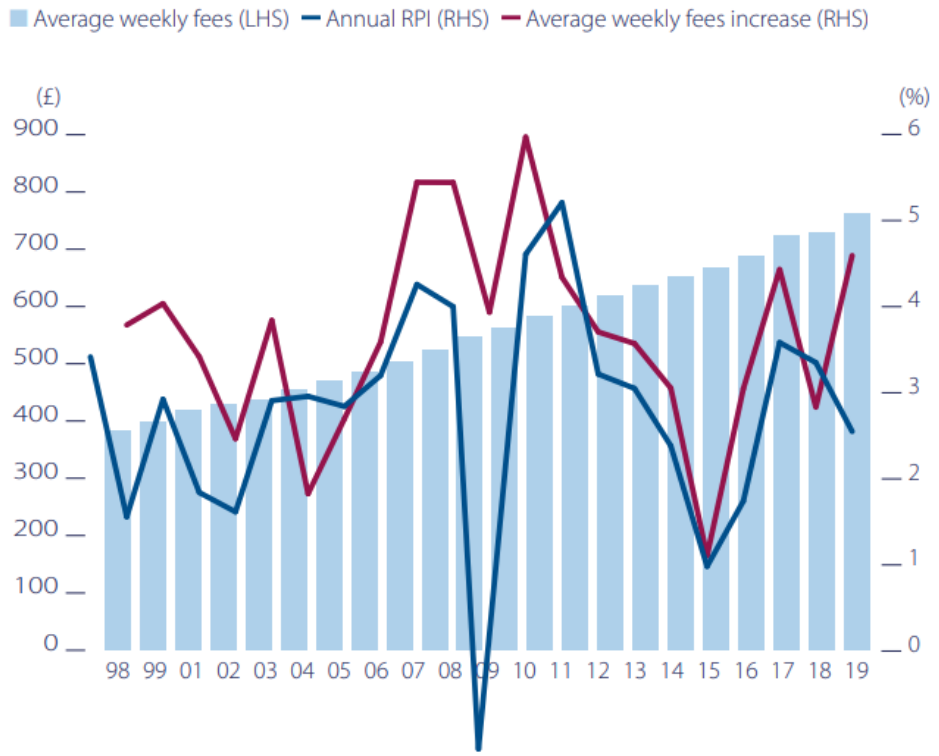
However, Covid-19 has brought a raft of problems to the real estate sector, both practical (lower tenant demand and rental pressures) and on valuations with yields on portfolios rising to reflect increased risk and the spectre of falling rents. The lower visibility for rents, rising expense ratios (as rents fall but portfolios remain physically the same) has undermined certainty for Reit income.

While **Impact Healthcare (IHR)** is a Reit, by operating in the long term, residential secondary care segment, many of the wider issues in real estate have been avoided. Covid-19 has arguably impacted the care home sector more directly than, say, office space. Operators have lost residents to the epidemic and have been unable to replace them due to government restrictions and seeing the pandemic inevitably drive up operating costs.

So, while investment in the care home sector has had strong, long-term attractions (primarily demographics and market consolidation scope), it has not been immune from Covid-19 gyrations.

However, at a time when there is considerable pressure on commercial landlords to agree to lowered rents, re-negotiate leases etc, Impact REIT's tenants, thus far at least, have been stable and none has sought to re-work its lease terms. 100 per cent of the rents due for 2020 were paid, with no changes to any terms or payment schedules. This positive trend continued through Q1 2021. That said, across the industry, occupancy has fallen from c.87 per cent to c.79 per cent nationally, but operators have largely offset this by pushing through a c.6 per cent increase in average fees. This indicates the underlying strength of this sector and is part of a well-established trend.

Average care home fee and inflation



Source: Impact Healthcare REIT, LaingBuisson database

Much of this stability is due to Impact's lease profile, which while fairly typical within this market segment is uncommon by industry norms. A typical commercial lease might run for 10 years (occasionally longer but not often) with a tenant-call break after five years and with rents reviewed every five years based on local market evidence. The rent can rise or fall depending on local market conditions.

In contrast, almost all of the Impact REIT's investment assets are signed to a 25-year lease term with no break clauses (three out of 11 tenants have 20-year terms) and the portfolio has a weighted average unexpired lease term (WAULT) of 20 years. All rents are index-linked and can only hold or rise, which creates very high revenue visibility for the real estate sector and also contributes to the high rental yield.

This unusual lease pattern helps to realise a gross yield for Impact REIT approaching 7 per cent. As there is no scope for more substantial market-led rent increases, the initial returns demanded by investors need to be higher than for, say, prime office space where rents have (historically at least) had scope to rise significantly.

There is also some greater risk in the nature of the occupier, typically smaller, private care operators. However, Impact REIT has been diligent in selecting only higher-quality and financially-sound tenants, which helps to de-risk the very long leases and also increases the potential for gains for more active asset management.

While Impact REIT offers high and visible income (yield 5.8 per cent), it has not thus far offered investors much in terms of share price performance. Since its 2017 IPO, the share price has essentially tracked the NAV, although it did follow the market slump in March 2020. The NAV is edging up slowly (from 101p in 2017p to now 109.5p), largely through the modest profit retention after dividends have been paid.

This slower pace largely reflects that this is still a young company focused more on expanding its rental base than one creating more value through asset management. In Impact REIT's case, asset management gains should come through capitalising uplifts on developments or forward-funded extensions on a pre-let basis on existing sites. Such schemes have long planning and build out timetables. Covid-19 has slowed things further, so Impact REIT is not delivering here yet.

There is also scope for Impact REIT to use more leverage. As the asset value expands, it can borrow more to invest and utilise the sizeable gap between the cost of debt and rental yields to create value. However, the balance sheet is already 18 per cent geared (in a sector where 35-40 per cent is seen as a safe upper limit) and with the value of the balance sheet only rising slowly, scope is more limited for now.

While there has been something of an investment hiatus here during Covid-19, the underlying care homes sector and property investment markets have stabilised and the board is again focusing on growing the rent roll. Despite halting new investment in 2020, the contracted annualised rent roll was £31.7 million by March 2021, up from £23.1m at

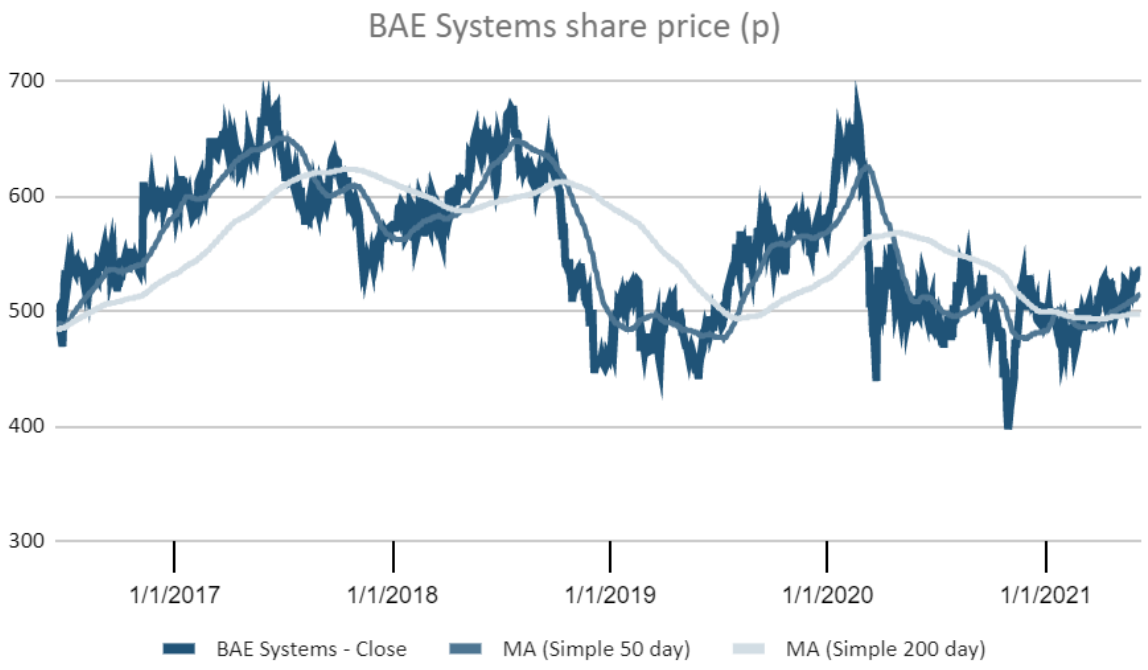
the end of 2019. A bigger revenue base de-risks the business, should widen net margins and increase longer-term scope for asset management gains and boost total returns.

The board is only targeting dividend growth of c.1.5 per cent in the current financial year, but this largely reflects that returns are still heavily driven by adding new rents and not extending existing ones through asset enhancements.

Rents should continue reliably to fund the 5.8 per cent yield available at today's share price. Impact REIT is still fairly early in its life and returns are likely to be led by dividends for now, but NAV growth should accelerate in due course.

The somewhat bond-like nature of the equity is likely to keep the share price and NAV in lock-step allowing total returns to rise. Sector yields in care homes are likely to remain at the higher end for real estate (Colliers believes even 'prime' care home assets can support up to a 6 per cent yield) meaning that income levels for investors can also remain above the market average even as the rental base expands. Longer-term total returns here could prove attractive and less volatile than for commercially-oriented Reits.

BAE Systems (BA.)

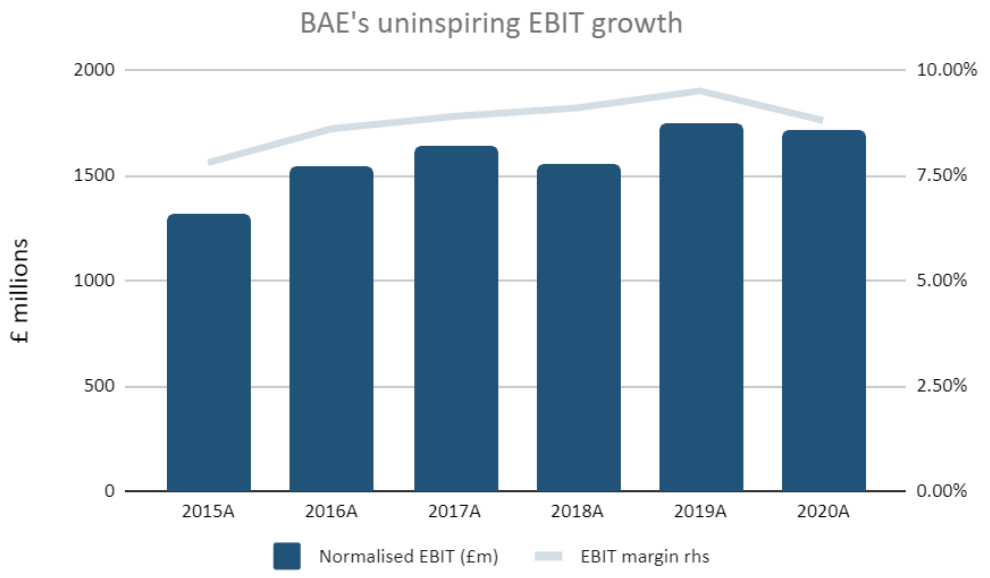


Source: FactSet

An income-oriented investor cannot help but reflect on the remarkable stability of trading at **BAE Systems (BA.)** and the dividend record. Payments have risen every year since 2003 (the 2019 final was suspended but a catch-up payment has now been made), but the rate of DPS growth is slowing. While the running yield is a decent 4.4 per cent, based on 2021 consensus (FactSet), it is ever-harder to see where a rate of growth in earnings and free cash flow might arise to put more sparkle into this. Since 2013, the compound annual growth rate (CAGR) of the dividend has been just 2.4 per cent.

BAE is a defensive stock operating with a very broad geographic spread in end markets, with almost all earnings arising from longer-term defence contracts. This looks attractive at a time when spending by its customers (governments) is elevated due to higher threat of terrorism and where there is an evolution into smarter warfare. As the UK Army recently suggested, it aims in future to fight smarter, but with fewer boots on the ground and increased total spending.

Repeating globally, this skews defence budgets away from wages and more towards technologically advanced hardware such as BAE's. This could result in faster group revenue and earnings growth even if total defence spending eventually flattens out. Furthermore, any near-term slowing now feels a little further out as President Biden does not look set to slash Trump's expanded spending as some feared. Broadly, however, BAE's end markets in the long run are likely to grow organically only by the rate of global GDP growth, a relatively pedestrian 2-2.5 per cent annually.



Source: FactSet

So, the group as it stands presents great stability in a solid core of its business, but there is not a great deal that is set to elevate BAE's still rather lacklustre rate of EPS growth. In the last 10 years, EBIT (earnings before interest and tax) growth has averaged just 0.4 per cent, EPS 3.5 per cent (reflecting lower tax rates) and dividends 3.1 per cent.

BAE is a relatively low returning business with EBIT margins of c.9 per cent and ROCE (return on capital employed) of 12.5 per cent, which are respectable and might suggest scope for self-help and improvement. However, returns have been at these levels for many years suggesting that this is where they are more likely to remain.

To accelerate growth in profits (and thereby dividends) more rapidly, BAE needs to expand by acquisition, something it has not really undertaken to any great extent for more than 10 years. It did debt-fund the near $2bn purchase of Collins (Military GPS) in mid-2020, which it declared immediately earnings and cash flow-accretive. This could have suggested a greater willingness to expand, but no sizeable deals have followed and this move feels a little opportunistic than strategic: Collins' GPS business had to be sold to avoid antitrust issues arising from its acquisition by Raytheon.

BAE Systems: DPS growth over time

Year to Dec	Total DPS	Y-o-Y change
2003	9.2p	
2004	9.5p	3.3%
2005	10.3p	8.4%
2006	11.3p	9.7%
2007	12.8p	13.3%
2008	14.5p	13.3%
2009	16.0p	10.3%
2010	17.5p	9.4%
2011	18.8p	7.4%
2012	19.5p	3.7%
2013	20.1p	3.1%
2014	20.5p	2.0%
2015	20.9p	2.0%
2016	21.3p	1.9%
2017	21.8p	2.3%
2018	22.2p	1.8%
2019	23.2p	4.5%

Source: BAE Saystems

BAE does not produce quite enough free cash flow for the group to meet all of its core financial commitments and have enough left over to fund growth spend. It has to spend over £2bn every year in tax, interest, replacement capex, dividends, pensions deficit funding and working capital expansion and in 2020 only made an Ebitda (earnings before interest, tax, depreciation and amortisation) of £2.7bn.

To alleviate this there needs to be expansion. Debt to Ebitda is manageable at c.2x, so the balance sheet is not overly stretched, but is not best placed to debt fund a major expansion in the form of a series of acquisitions. That means that any such hypothetical moves can only be equity funded. This is likely runs up against some lack of appetite as the total shareholder return (TSR) over the medium term is modest (<6 per cent pa in the last five years and mostly dividends).

Combined with low value creation, the ROCE of 12.5 per cent tallies against approximately 8 per cent WACC (weighted average cost of capital), it would be hard to inspire investors to back equity-funded expansion. Backers would likely demand a sizeable, dilutive discount on any new shares. Overall, this suggests that BAE will struggle to accelerate growth and, in turn, its dividend.

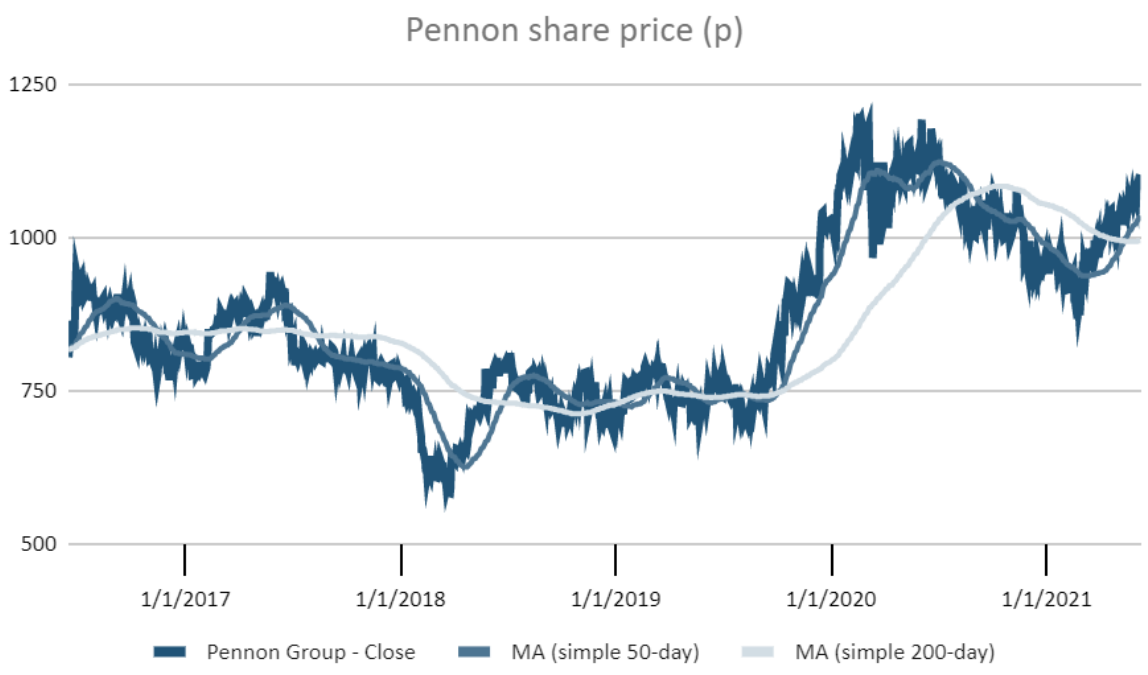
BAE also carries currency risk and with sterling strengthening against the US dollar, there is additional pressure on earnings (but not cash flow as this is mainly a translation rather than trading issue). EBIT has a sensitivity of a +/-10¢ movement in $/£ moving EPS by c.2p (or 5 per cent) and with $/£ up c.17¢ since last July, the only moderate dividend cover of 1.7x FY2020) looks set to drop in FY2021. While trading is reported to be either stable or good in constant currencies, two of the group's five business segments face a drop in consolidated sterling sales of >5 per cent in FY2021.

If BAE is struggling to grow its returns in real terms, is it then more of a bond proxy? It offers returns well above those in the true bond market and the share price has been relatively steady over five to 10 years: the shares have a Beta (measure of a stock's volatility in relation to the overall market) either side of 1x. While this might be OK for those leaning more towards capital preservation, it is unlikely to tick enough boxes for an equity income investor.

All told the board is still fairly bullish on free cash flow, guiding to £1bn FCF in FY2021 (up from £600m), but £4bn in 2021 to 2023, so average of £1.5bn in 2022 and 2023. This is helped by the recent US acquisition and the action it took to head off (for now) pressures from the pension fund (£1bn, 10-year bond issued to reduce the £1.9bn deficit). The prospects perhaps look a little brighter on the ability to push the dividend a little harder, but this still looks like hard work.

BAE's dividend appears pretty safe. It is likely to advance albeit slowly, but is dull and with the return of inflation, the c.2.5 per cent growth seen in recent years would need to improve to sustain real income levels. Defence spending is unlikely to react and track upwards with inflationary trends, meaning the longer-term nature of contracts and potentially rising internal costs could squeeze margins as well as deflate real income levels. I would have to conclude that better growth and equally good income can be found elsewhere.

Pennon (PNN)



Source: FactSet

South West Water owner **Pennon (PNN)** agreed the sale of its waste management arm Viridor some 15 months ago and closed the sale to private equity buyer KKR in July 2020. Only now has it decided what it is to do with the £3.7bn sale proceeds. The money is to be deployed as follows:

Use of proceeds	£m
Special dividend	1,500
Bristol Water EV	425
Share buy back	400
Debt pay down	1,100
Pension top up	50
PLC warchest	100
Green initiatives	100
Total	3,575

Source: Pennon

Aside from the special dividend, these are broadly accretive actions for investor,s but with greatest impact likely to fall in the medium term (aside from immediate reduction in finance costs), especially at the newly acquired Bristol Water. Analysts see Pennon as having paid a fairly full price for this business and having to prove that significant value can be created. This has been achieved before (Bournemouth Water in 2015), but Bristol is understood to have struggled to make good returns in the last pricing cycle (Asset Management Period or AMP 6) and AMP 7 (running to 2025) has tougher pricing restrictions. This complementary business does add resilience and focuses the group better on its core skills which should, in time, help improve the quality of earnings.

Income investors might be pleased with the £1.5bn/355p per share special dividend, but large one-off income distributions such as this may not always be such a net positive development. First, there is unlikely to be a net increase in a shareholder's value in holding Pennon shares. They already owned the cash distributed as it was bound up in the equity valuation. This is reflected in the shares rising only by c.65p on the announcement, the move being driven by the other actions announced.

When the ex-dividend date arrives (5 July) the share price should be expected to drop by the amount of the special payment leaving an investor's total return unchanged.

Second, in this case the payment is funded by gains from a large corporate disposal and if some or all of those proceeds exit the business, future returns and growth could be undermined. Ideally, surplus capital would be reinvested to grow EBIT and dividends driving long-term value creation.

Third, distributing rather than investing can indicate that acquisitive growth opportunities are or will remain limited. As a regulated utility, relying on primarily organic growth and internal efficiencies is likely to limit future growth.

In addition to the cash distribution, investors will also benefit from the proposed £400m share buy back, although this is to take place over several months and may be cancelled if another acquisition opportunity arises. By permanently lowering the shares in issue, EPS will increase but the extent will depend on whether and at what price stock is redeemed. As EPS rises, and assuming the same rating is applied to the shares, the share price would be expected to rise.

So, why has Pennon not just made a £1.9bn special dividend instead of splitting up the capital return? While retail investors are more inclined to view special dividends favourably, institutional investors do not always feel that such distributions create shareholder value, but that buy backs do. The distribution mechanism also provides different tax treatment of the monies involved as the dividend is taxed as income and the buyback as capital gain.

A further twist for investors is the share consolidation. This has no effect other than to cosmetically change the share price and all reported per share numbers (EPS, DPS etc) and going forward holders will have two new shares in the company for every three shares currently held, but hold the same investment value.

The intention here may be to try to keep the headline share price close to the current level at around 1,100p. Ex of the special dividend, the share price would drop to nearer 750p, but the consolidation would raise the headline share price back to around 1,120p. This is largely cosmetic but can help maintain confidence for retail investors.

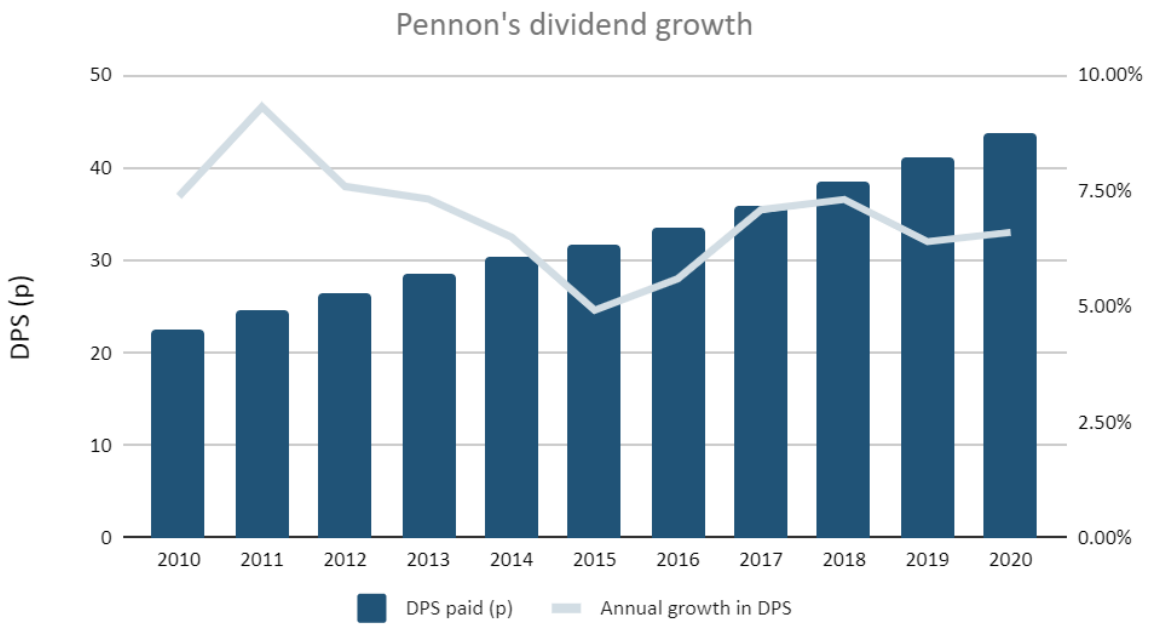
Should income-oriented investors buy Pennon shares in light of these various actions arising from the Viridor disposal? Buying for the special is a zero-sum game as the ex-dividend share price is likely to be lower by an amount equal to the dividend. The buy back would have a positive impact on the shares but the extent is unknown. As stated above, the consolidation is purely cosmetic and will not boost income levels. The monies retained within the business and the new acquisition should help drive up the equity valuation but not core dividend as these are paid on a prescribed formula basis of CPIH + 2 per cent..

Is core dividend income from Pennon attractive? There are complications as the ultimate, settled share price is unknown. However, assuming that post-consolidation the shares trade still at around 1,100-1,150p, the adjusted, re-based dividend will be 2020/21's

32.61p + 3p: so 35.61p indicative for the full year 2021/22. The resulting yield of 3.2 per cent is decent but below the FTSE All Share average (3.7 per cent) and is likely only to rise by the prescribed amount. However, it is guaranteed to rise by 2 per cent in real terms so is something of an inflation hedge.

So, as an income investment there is a moderate attraction, the buyback should help the share price, but the board needs to show value in the Bristol acquisition and ideally find further expansion. If growth is accelerated, Pennon could pay more than the formula level of dividend. Overall, total return growth would have been higher if the surplus capital was put to work and while investors can expect moderate total returns here, that is likely to be unexciting.

Pennon dividend history - pre-Viridor disposal re-base, pre-consolidation



Source: Pennon

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