Lark Research, Inc.

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Income Builder

HIGHLIGHTS:

- Dividend stocks have become popular, but their popularity has driven yields to new lows and valuations to new highs, raising risks for investors. Despite those risks, I focus here (and in future) on stocks with high dividend yields (>4.5%) (p.1)
- All high yielding stocks face the risk of a dividend cut. The decision to invest depends upon an analysis of industry trends and the company's ability to manage risks successfully. (p.3)
- General Motors (GM): Since adding this high yielder (4.8%) near the market bottom in Feb., the stock is up, but not as much as the overall market. Given recent trends, I am more concerned about the prospects for GM and the auto industry. (p.2,4)
- Covanta Holding (CVA) is the largest U.S. owner/operator of Energy from Waste facilities. The decline in power and metals prices has limited earnings growth, putting the dividend at risk, but new projects (and eventually a rebound in prices) should boost profits over the next few years. (p.3).
- Potential tax bill. Model portfolio stock sales taken in May have generated a large potential capital gain for 2016. It is possible to reduce that gain by selling current loss positions, but I have decided to hold on for now. (p.4)
- ACTION THIS ISSUE: Adding 1,000 CVA shares and 10 of its 6.375% Notes due 2022. Holding GM.

High Yielding Stocks

By Stephen P. Percoco

With the steady decline in U.S. Treasury yields, many investors have been on a never-ending quest to preserve and maximize their income from investments. Those who seek yields that exceed the rate of inflation have been forced to take on more risk.

Traditional dividend-paying stocks with higher perceived levels of safety, such as food products companies and utilities, have been bid up sharply in price over the past couple of years. Their yields are now at historic lows and their earnings multiples at record highs. Investors considering buying in at these levels must be willing to accept lower yields with greater downside risk.

Last December in Bulletin 1438, I noted that after six years of double-digit gains, the water utility sector was trading at lofty levels. With an average dividend yield of 2.7% and forward P/E of 22.5, these stocks were at the high end of their historical valuation ranges. On that basis, I declared that there was little value left in the sector and moved to pare back my overweight position.

Since that time, water utility stocks have extended and accelerated their gains. At mid-year, the Dow Jones Water Utility Index was up 34% (vs. the S&P 500's 2.7% gain). The Index has fallen back since then, but it was still up 23% for the year (as of August 12), compared with the S&P's 7% gain.

With this year's rally, valuations of water utilities have become even more stretched.

The sector now offers an average dividend yield of only 2.2%, a record low, and trades at 26 times forward earnings, a record high. Even if one were to assume that the core business risk in water utilities is low, investors in these stocks now bear the risk of loss should valuations move back to historical norms.

Similar prospects now await investors in other income-oriented equity sectors that have traditionally been viewed as safe.

Yet, it is not just safe stocks that have been bid up in price. Riskier high yield bonds and stocks have also benefited from the search for yield.

Despite the higher risk in higher yielding securities, I will focus on them here and in future Bulletins. There are still, I believe, better opportunities in these sectors (within the context of a diversified portfolio). The focus here should also help to inform our overall effort to deliver superior returns across the entire model portfolio.

Dividends are the real deal. Studies have shown that they account for 40% of total return on average and as much as 70% during extended bear markets.

Accounting rules give companies flexibility in calculating profits, but dividends over long periods of time are proof of performance. (Of course, dividends too can be deceptive, especially over shorter time frames, if they are paid out of capital rather than income.)

Stock buybacks are a form of financial engineering. In my mind, they are justified only when a stock is trading at an unusually large discount to its intrinsic value. Dividends, on the other hand, are a nondiscriminatory way of distributing shareholder wealth.

This Bulletin focuses on higher dividend paying stocks, currently defined as those yielding 4.5% or more

In this segment of the equity universe, it should be obvious to experienced investors that the higher the yield, the greater the risk of a dividend cut.

However, the nature of that risk differs across companies. With some high yielding stocks, the business may be a steady performer that pays out a high proportion of its profits.

In other cases, a dividend that was once appropriate may now no longer be feasible as a result of declining profitability, which may be due to cyclical, secular or individual company factors.

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There often are common characteristics among high yielding stocks in certain sectors. For example, energy MLPs typically base their distributions on their definitions of distributable cash flows (DCFs), which are usually well above earnings.

Yet, DCFs often do not take into account the high levels of capital expenditures that most MLPs incur to grow their businesses. Investors have generally assumed that these MLPs will maintain their access to capital markets so that they can continue to grow over time in order to sustain their distributions. However, the MLP sector was thrown for a loop in 2014 and 2015 when the decline in oil and natural gas prices crimped profits and then cut off access to capital markets, forcing many MLPs to shelve expansion plans.

Although the Alerian MLP Index has performed in line with the S&P 500 so far this year, it is still down 42% in price since its peak in the summer of 2014 (compared with the S&P 500's 9.5% gain). Its yield, which was around 5.2% at the August 2014 peak, rose to 12% for a short stretch in February 2016 and now sits at about 7.2%. At that high level, there is still considerable concern about whether MLPs will be able to sustain their distributions.

Oil & gas is another industry that has suffered from the fallout in commodity prices. A recent hot topic has been whether the large integrated oil companies (i.e. Exxon, Chevron, etc.) can sustain their dividends. Dividend yields on XOM and CHV are below my 4.5% threshold, which suggests that the market is less worried about their ability to keep paying their dividends. However, the stocks of several foreign integrated oil & gas giants, such as BP, Royal Dutch Shell (RDS-A/RDS-B) and Total (TOT), as well as a smaller integrated, Murphy Oil (MUR), do qualify as high yielders.

Consensus estimates currently anticipate that about half of the 13 integrated oil companies will report losses in 2016; but earnings are expected to improve sharply in 2017. Chevron looks expensive to me; but BP and Shell are attractive relative to their current cash flows. Several refiners, including HollyFrontier Corp. (HFC), PBF Energy (PBF) and Western Refining (WNR) also look cheap at these levels and their dividends appear to be reasonably well covered.

Some companies have made high dividend payouts a key part of their "contract" with shareholders. In most cases, those companies do not offer much earnings growth. Indeed, their financial performance is often volatile, with good earnings years and bad ones; but the dividend provides an above average return which keeps (longer-term-oriented) shareholders happy and less concerned about stock price volatility.

Examples include Ericcson (ERICY) the telecom equipment supplier, with a 6.3% yield, National Presto (NPK), the appliance maker, with a 5.5% yield; GlaxoSmithKline ADRs (GSK), the British pharmaceuticals giant, with a 5.0% yield; brokerage firm BGC Partners (BGCP) with a 7.0% yield and investment manager AllianceBernstein (AB) with a 7.3% yield. Although the dividend yield is a prime attraction for their stocks, many companies with similar profiles have had to cut their dividends during periods of extended weakness in their businesses.

Owning dividend-paying stocks through a passive investment vehicle, such as an ETF, may be acceptable as a core investment when the portfolio constituents offer average yields of around 3%; but it is probably not wise to own an ETF of very high dividend yielding stocks unless the economy is in or heading into an uptrend. High dividend-yielding stocks are usually much more sensitive to broad economic trends, so it makes sense to hold a broadly diversified basket of them only when good times are approaching. In an uncertain or deteriorating economic environment, it is more prudent, I believe, to try to select individual stocks that may have a better chance of bucking the downtrend. That may be true generally for all stocks (in a downturn), but it is especially important for riskier, high-yielding stocks.

The holy grail for dividend investors is to find an investment that offers a very high yield whose payout is nevertheless rock solid. In today's market, such investments probably do not exist.

It is fair to say today that there is a near-perfect negative correlation between yield and safety. The higher the yield, the more imminent the dividend cut (or the higher the risk that the dividend could suddenly be cut sharply, perhaps to zero). As with many investments, investors must determine the level of yield that best matches their tolerance of risk. Stocks yielding around 4.5% may not be in danger of an immediate dividend cut, but they almost certainly face risks that put the dividend at risk over time.

The goal, therefore, is to find those high yielders whose prospects are sufficiently favorable (or not as negative as the market fears) to allow them to continue paying their dividends, when a cursory analysis flags the risk of a dividend cut. Some companies with high dividend payout ratios may be in a strong enough position to sustain or grow their profits even in a weaker economy.

That said, I have yet to find a stock among the high yielders that I am certain can continue paying its dividend for the foreseeable future. At best, I might be reasonably certain that the dividend is safe for a year or so. Improved disclosure *might* help boost confidence about dividend sustainability; but I suspect that many companies choose not to make more complete disclosures because that would reduce investor confidence.

Despite current market conditions, I believe (or maybe hope) that it is still possible to achieve better performance by being as diligent as possible in security analysis. Competent analysis will certainly not eliminate risk, but it should help to mitigate it.

General Motors (GM): GM's stock has underperformed the broader market this year. Year-to-date (through August 12), the stock is down 7.2%, compared with the S&P 500's 7.0% gain. (On a total return basis, GM is down 4.8% vs. the S&P's 8.3% gain.)

I added GM to the portfolio in late February, near the market bottom, when it was trading at $29.63. Since that time, GM's total return is 9.7%, but that is still less than the S&P 500's 13% total return.

The stock market is concerned that the U.S. auto sector is at or near peak production and facing an imminent decline. Auto sales continue to rise, but at an ever slower pace. So far in 2016, sales are running slightly above last year's record pace of 17.5 million, but pent-up demand has been satisfied and rising inventories of used cars are beginning to push prices down, drawing buyers away from the new car market. There are also some troubling signs, including a rise in dealer incentives and a recent uptick in defaults on subprime auto loans.

Concerns about peak production are clearly reflected in the valuations of auto stocks. GM is trading at only about five times projected 2016 and 2017 earnings. By comparison, forward multiples for the broader market are in the mid– to high

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Covanta Holding Corporation (CVA)

Its Decision to Sharply Boost the Dividend Now Faces a Test

Covanta Holding, through its subsidiaries, is the largest owner and operator of Energy from Waste (EfW) facilities in the U.S. The company accepts waste from its customers, mostly municipalities, and burns it to produce electricity. It also recovers iron and non-ferrous scrap metal in the process.

The U.S. currently generates 275 million tons of waste per year. About 11% of that is processed by EfW facilities. Covanta accounts for about two-thirds of the EfW total.

Growth opportunities in the U.S. are limited. Most EfW facilities are located in densely populated areas, such as the Northeast, where the less costly option of landfills is limited. The EPA has deemed EfW to be superior environmentally to landfills (in part because methane from landfills has 8 or more times the greenhouse gas effect); but EfW has been held back by the high cost of building new plants and local NIMBY opposition. Still, EfW is growing outside the U.S., especially in China, which has increased its EfW capacity from two to 14 million tons since 2000 and plans to increase the percentage of waste processed by EfW plants from 1% in 2005 to 30% by 2030.

In recent years, Covanta has pulled out all stops for growth. It has entered into service a C$264 million, 140,000 metric ton-per-year EfW facility near Toronto. In 2013, it acquired a 1,050 ton-per-day EfW facility in Camden, NJ for $49 million. That same year, it entered into a contract with New York City to transport and dispose of an estimated 800,000 tons per year of waste from marine transfer stations in Queens and Manhattan beginning in 2015. (Estimated costs for equipment and facility upgrades on this contract are $150 million.) It also acquired two strategically located waste transfer stations in New Jersey.

In 2014, Covanta began construction on a €500 million, 600,000 metric tons per year, 58 MW facility in Dublin, Ireland, scheduled to begin commercial operations in late 2017. It also accepted a contract to operate a 3,150 ton-per-day EfW facility in Pinellas County, FL.

Covanta recently opened a metals processing facility in Fairless Hills, PA to reduce operating and marketing costs for metal retrieved from its EfW facilities in NY, NJ and PA. In 2015, it acquired four environmental services businesses for $69 million.

Also in 2015, the company agreed to divest most of its investment in China. It anticipates the receipt of $100 million later this year from the sale of 90% of its equity investment.

To provide some certainty to shareholders during this transition period (and also presumably to keep pressure on management to perform), Covanta's Board of Directors instituted a $0.30 annual dividend in 2011 and raised it steadily to $1.00 by 2014.

Covanta's growth strategy is ambitious, but sensible since its new projects align reasonably well with its core competencies. (In my mind, the NYC contract is questionable, unless the company plans to feed the city's waste to its nearby EfW facilities.)

Covanta was tossed a curveball, however, when prices for electricity and metals began to drop in 2014, just as it was ramping up its development projects. Consequently, the company's earnings have fallen well short of the $1.00 annual dividend for the past three years.

Although it has been able been able to generate sufficient free cash flow (defined as cash flow from operating activities minus maintenance capital expenditures) to cover the dividend, it remains to be seen whether it will be able to generate sufficient earnings (and cash flow) to pay the dividend in the long run.

With the recent spurt in project development, Covanta's leverage is high—debt is now 85% of total capitalization—and will likely get higher in the quarters ahead. However, that high leverage is mitigated somewhat by its use of non-recourse project financing, which totaled $350 million or 13% of total debt outstanding as of June 30.

CVA Valuation Metrics (8/12/16)

Recent price	15.14	
52-week range	12.48	- $ 20.94
Dividend	1.00	
Yield	6.6%	
Payout ratio	307.3%	
Shares outstanding	130	million
Market cap.	1,966	million
	EPS	**PE**
2015-16 (ttm)	0.33	46.5
2015-16 (ttm Non-GAAP)	(0.15)	#N/A
2016E	(0.13)	#N/A
2017E	0.32	47.3
	Per Share	**Multiple**
Free cash flow (CVA definition)	1.26	12.1
Book value	3.70	4.1
Tangible book	1.08	14.0
Sales (ttm)	12.90	1.2

The company has identified two instances of material weakness in its controls, one for its calculation of state income taxes and another for its accounting for construction costs on its recently completed facility in Canada. Both have not yet been resolved.

Some investors are betting against the stock. Barron's shows a short interest of 10.7 million shares (equal to 8% of the total outstanding and about 10 times average daily trading volume).

Covanta should have the ability to sustain the dividend for at least another year or so, barring a significant change in business conditions. It had $409 million of liquidity (i.e. domestic cash and availability under its revolving credit facility) at the end of June. The annual dividend requirement is currently $133 million.

According to my projections, Covanta will report a loss of $0.13 per share in 2016. Earnings should improve as more new projects come on line. I project EPS of $0.32 in 2017, which is above the consensus estimate but still below the dividend. If achieved, it would put CVA well on the path to $1.00.

Unless the company announces new projects, its total capital expenditures should begin to drop back significantly. Newly completed projects should help to boost earnings, but it is unlikely that the company will be able to sustain a $1.00 annual dividend indefinitely without a rebound in electric power and scrap metal prices. (Any benefit from higher power prices would be achieved over time, however, due to hedging.)

I am initiating a position in Covanta of 1,000 shares. Besides the common, Covanta also has three series of senior unsecured notes outstanding, rated Ba3 by Moody's and B by S&P. I favor the 6 3/8% Notes due October 2022 which traded most recently at 102.55 to yield 5.9%. That equates to a 460 basis point spread over Treasurys. I am also adding 10 of the 6 3/8s to the fixed income portfolio.

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teens. Consensus estimates do not anticipate an imminent decline in GM's earnings. Earnings projections for 2017 are even with 2016 at about $5.80 per share.) This suggests that the market thinks that the auto industry will hover at peak production levels for a while.

Year-to-date, GM has seen its profits surge. Operating income for the first 6 months more than doubled from $2.0 billion to $5.0 billion on a 7.8% increase in revenues to $79.6 billion. EPS rose at a faster rate from $1.28 to $3.12 due in part to share buybacks.

In the U.S., the improvement in sales was due to an increase in wholesale sales (i.e. to dealers), offset partially by lower fleet sales (which are less profitable). Retail sales of GM cars and trucks declined modestly during the quarter, as the company lost market share. Although its own inventories, measured in days, were flat, dealer inventories have most likely increased this year. Margins year-to-date have improved primarily because of higher unit volumes and continued efforts to reduce operating and administrative costs.

Outside the U.S., the company is seeing a modest turnaround in Europe, further improvement in Asia (and in China), but continued weakness in South America.

On the basis of the strong second quarter results, management increased its full year EPS guidance range by $0.25 to $5.50-$6.00. At the midpoint of that range, the stock is trading at 5.50 times projected 2016 earnings.

As of June 30, 55% of GM North America's financial receivables are from subprime borrowers (which GM defines as those with FICO scores below 620). That is down from 60% at December 31, 2015. Based upon GM Financial's disclosures, I estimate the company's sub-prime exposure on financing receivables at roughly between $10 billion and $15 billion. At the same time, GM has been relying much more heavily on leasing. Its total lease portfolio has surged from $11 billion in 2014 to $23 billion in 2015 to $31 billion in June. The majority of the increase is from purchases of vehicles already on lease. This obviously raises the company's exposure to residual lease values. It has also helped to raise GM's debt from 57% of total capitalization at the end of 2014 to 63% at the end of June.

All of this raises anxiety levels for investors, which is reflected in GM's valuation. For now, though, with its increased profitability and more than $20 billion in cash, the company should be able to continue paying its $1.52 annual dividend (which equates to a 4.8% dividend yield). I make that assertion based upon the view (or hope) that GM's balance sheet will soon stop expanding at a faster pace than revenues. I will continue to hold my position for now, but with a (mental) stop loss level of $25.

Portfolio Income Tax Exposure. As a result of the portfolio repositioning that I initiated in December 2015 (Bulletin 1438) and especially with the portfolio sales taken in May 2016 (Bulletin 1442), I have generated a significant potential capital gains tax exposure, estimated at $54,700 or about 5% of the model portfolio's total value of $1.05 million as of June 30, 2016. I am generally of the mind to pay Uncle Sam when I have the ability to do so. Nevertheless, I am aware that some subscribers may want to reduce their tax liability. According to my records, there are limited opportunities within the model portfolio to do so at this time. As of June 30, the portfolio was carrying unrealized losses in excess of $1,000 on only six positions: American Express ($3,000), Arlington Asset Investment ($2,200), Atwood Oceanics ($2,900), Imperial Oil ($4,600), Sears Holding ($5,300) and the New York Times Company ($7,400). That represents total potential losses of $25,400 or less than half of the total capital gains exposure. I have already pared back positions in some of these stocks. I consider certain names to be core positions that I intend to continue to follow and own going forward. (I may, however, trade around these core positions over time to express a view on future performance.) I have therefore decided to continue to hold all of these loss positions for the time being, but my view may change in the remaining four-and-one half months to the end of the year.

Portfolio Changes

Bulletin 1445, August 15, 2016

COMMON STOCKS Company	Ticker	Action	Existing Shares	Change in Shares	Recent Price (8/12/16)	Safety Rating	Performance Rating
Covanta Holding Corp.	CVA	Buy	0	1,000	15.14	D+	1
General Motors	GM	Hold	300	0	31.57	C-	2

BONDS	Type	CUSIP	Action	No. of	Recent	Coupon	Yield	Maturity	Call Date/	Ratings
Covanta Holding	Senior Notes	22282EAE2	Buy	10	102.55	6.375%	5.87%	01-Oct-22	01-Apr-17 103.19	Ba3/B/WD

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