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How to Analyze Dividend Stocks

Key Takeaways

- Dividend growth stocks have outperformed non-dividend growers
- How to use the dividend yield as a guide to stock valuation
- Why the P/E ratio may be difficult to interpret at times
- Important considerations for financial strength and profitability
- Considerations for determining when to sell a dividend stock

What are dividends?

Dividends are a distribution of cash from a company to its shareholders

Balance Sheet ($A = L + OE$)

Assets

Cash

–Dividends

Equity

Retained earnings

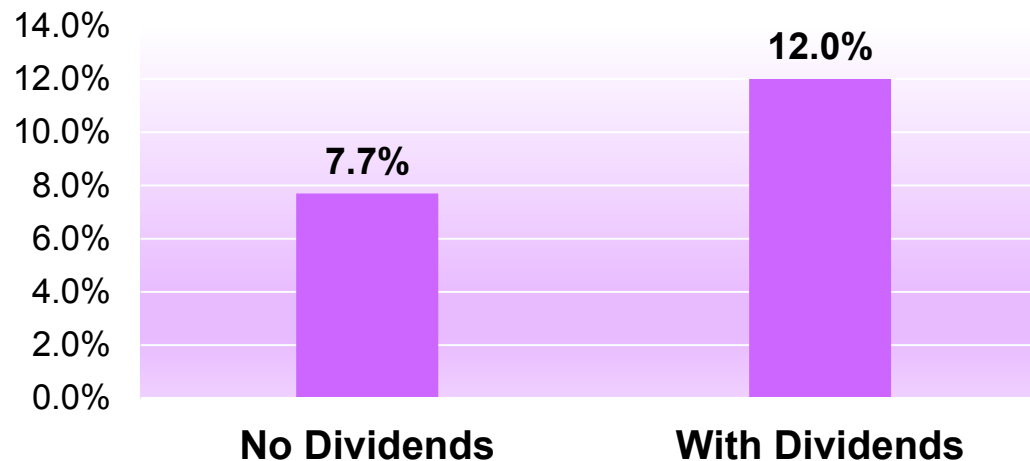
–Dividends

Why should you care?

1. Dividends increase total return

total return = **dividend yield** + price return

Average Annual Large-Cap Returns 1926 - 2016



Source: Duff & Phelps.

Why should you care?

2. Dividends align with shareholders' interests
3. Dividend-paying stocks mitigate downside risk
4. Dividends are a positive signal from management
5. Dividend stocks have outperformed

Dividend Strategies

Two main approaches

What we will talk
about today!



- **Dividend growth:** Look for growing dividend. Usually better quality, less risk, lower absolute yield when compared to high-yield approach
- **High dividend yield:** Seek high-yielding stocks. Usually lower quality, more risk

Valuation

Main valuation metric: **dividend yield**

$$= \frac{\text{annual indicated dividend per share}}{\text{stock price}}$$

Dividend Yield

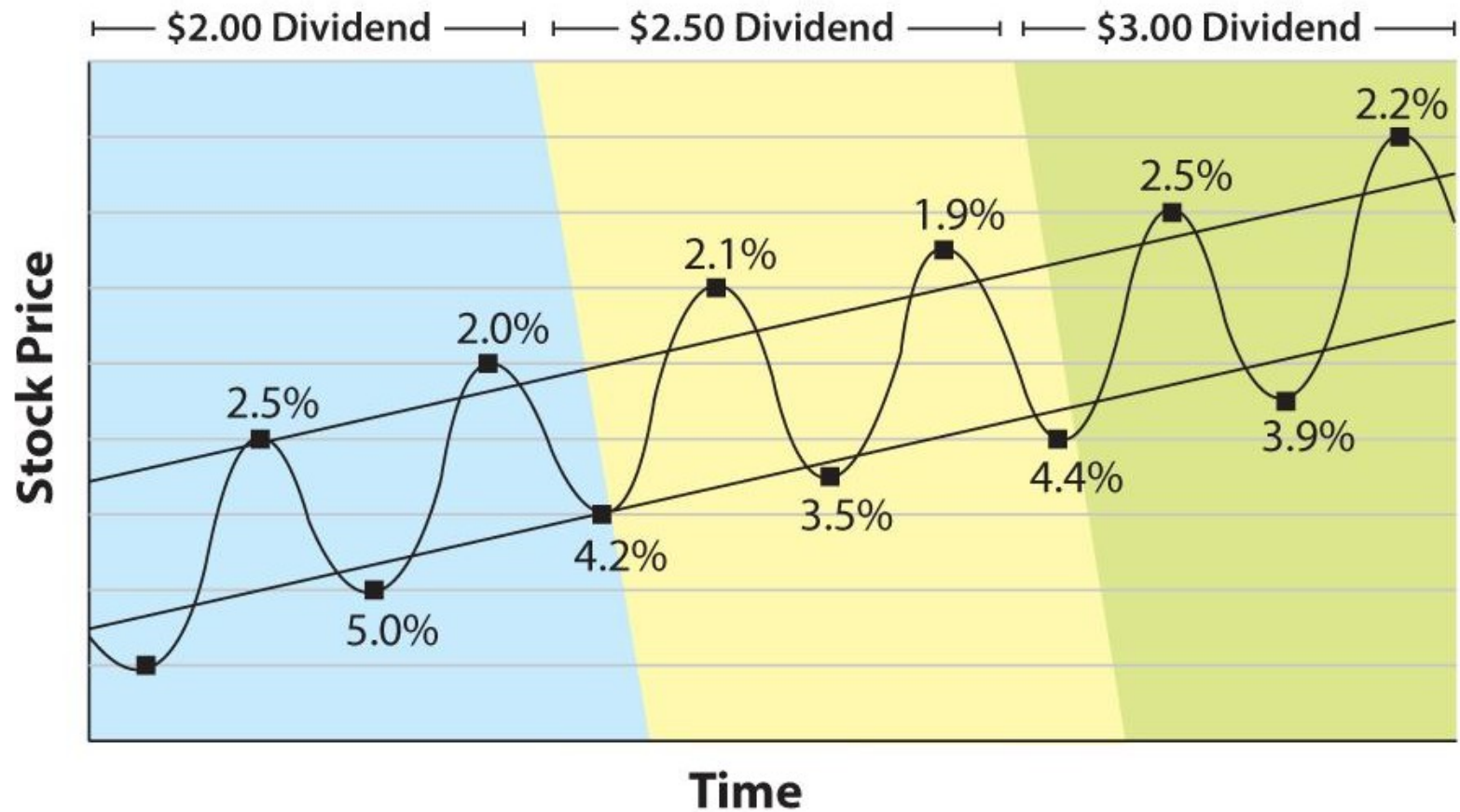
Holding dividend steady:

If price goes **up**, yield goes **down**

If price goes **down**, yield goes **up**

- Compare to stock's historical average and market
- Generally, we want yield above historical average yield
- High yield can mean high risk
- Shows what you pay for a given level of dividends

Dividend Yield



Peaks: $\frac{2.5\% + 2.0\% + 2.1\% + 1.9\% + 2.5\% + 2.2\%}{6} = 2.2\% \longrightarrow$ average overvalued yield

Troughs: $\frac{5.0\% + 4.2\% + 3.5\% + 4.4\% + 3.9\%}{5} = 4.2\% \longrightarrow$ average undervalued yield

756 exchange-traded stocks with yield above 5-yr average

Screen Editor - Stock Notebook #2 - Untitled

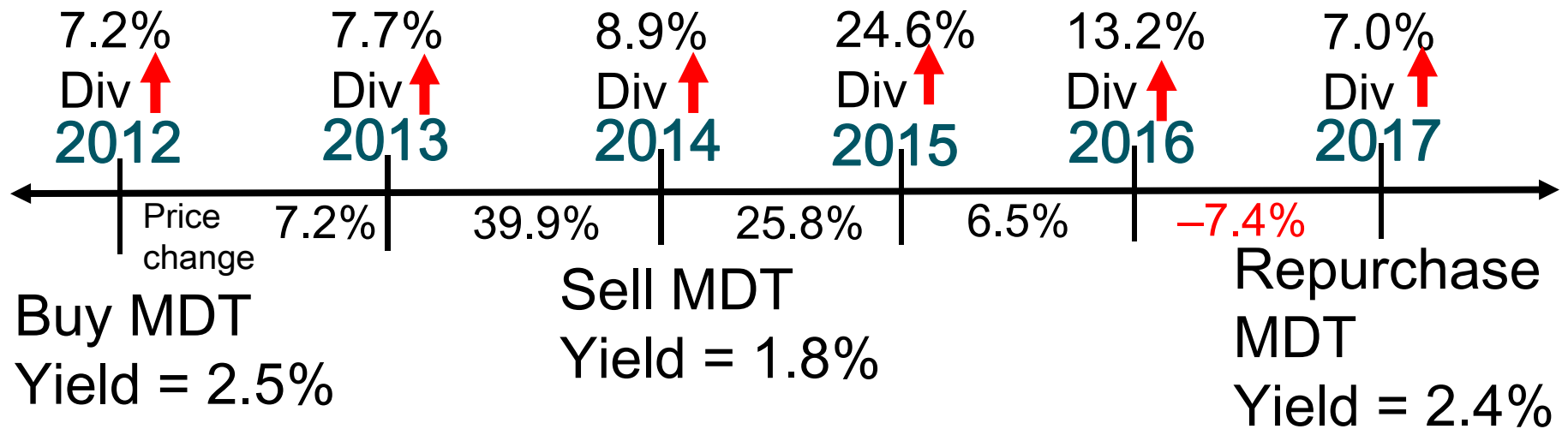
Name: Untitled Portfolio none: 6312 companies active

Description:

Conn	(	Field	Operator	Factor	Compare To (field, value, industry)	)	Count On	^
		ADR/ADS Stock	Is False				5871	
And		Exchange	Not Equal		Over the counter		4729	
▶ And		Yield	>		Yield-Average 5 years		857	

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Dividend Yield: Example



Medtronic PLC (MDT)


Current yield: 2.3%

Five-year avg. yield range: 1.7%–2.3%, 1.9% avg.

Valuation

Another common valuation metric is the **price-earnings (P/E) ratio**

$$= \frac{\text{stock price}}{\text{earnings per share}}$$

 12 trailing month or forward earnings

P/E Ratio: Example

Caterpillar (CAT)

2013	2014	2015	2016	2017
Price: \$90.81	Price: \$91.53	Price: \$67.96	Price: \$92.74	Price: \$124.67
EPS: \$5.75	EPS: \$3.90	EPS: \$4.18	EPS: -\$0.12	TTM EPS: \$0.15
P/E: 15.8x	P/E: 23.5x	P/E: 16.3x	P/E: nmf	P/E: 831.1x
Yield: 2.6%	Yield: 3.1%	Yield: 4.5%	Yield: 3.3%	Yield: 2.5%

Est EPS FY 2018: \$9.14

Forward P/E: 17.6x

Five-year avg. yield range: 2.6%–3.9%, 3.1% avg.

P/E Ratio

- Compare to historical average
- Compare to market
- The higher the value, the higher the price for a given level of earnings
- Value investor – wants lower
- Growth investor – doesn't care as much
- Forward looking (even the TTM version)
- Particularly difficult to interpret with cyclical stocks (normalized earnings are an alternative)
- Not meaningful if earnings are negative

Dividends

- **Growth:** Does the company grow its dividend?
- **Sustainability:** Can the company sustain its dividend payment in the future?
- **Consistency:** Does the company consistently pay its dividend?

Dividend Growth

- Analyze historical dividend growth
- Prefer growth above inflation
- Prefer increasing rate of growth, but consider economic conditions and earnings
- Dividend growth can't outpace earnings growth in the long term
- Dividend growth will boost dividend yield (holding price steady)

Dividend Sustainability

If a company can't sustain the payment – the “stickiness” of their dividends is questionable

-Payout ratio: earnings and free-cash-flow

-Financial strength: high leverage is bad

-Long-term earnings growth: dividends come from earnings

-Long-term competitive advantage: no demand = no profitability. Look at margins but also analyze non-quantitative aspects

Dividend Sustainability

Earnings payout ratio

$$= \frac{\text{dividends per share}}{\text{earnings per share}}$$

Free-cash-flow (FCF) payout ratio

$$= \frac{\text{dividends per share}}{\text{FCF per share}}$$

FCF = (cash from operations – capital expenditures)

This calculation is a “pre-dividend” calculation.

Payout Ratios

- Generally lower is better >> shows room to grow
- High payout (above 100%) isn't sustainable over the long term
- Compare to industry and historical average
- Check if company mentions “target” payout ratio
- Free cash flow is less easily manipulated by management
- Sometimes it can be affected by one time issues

Dividend Sustainability: Example

Mattel, Inc. (MAT)

	2014	2015	2016	2017
Earnings payout ratio	104.1%	140.8%	163.9%	216.1%
FCF per share	\$0.33	-\$0.10	-\$0.54	-\$1.14

Mattel cut its dividend 60% in June 2017, from \$0.38 per share to \$0.15 per share.

From the time of the cut to the end of February, MAT shares lost roughly 22%.

Dividend Consistency

- Record of paying and increasing dividends
- Have they ever decreased the dividend? Why?
- Long-time payers have done well, but stocks that recently implemented a dividend could also be committed to paying it
- Bottom line: Consistency shows commitment, but doesn't guarantee it

Profitability

Does the company make money?

- Analyze historical trends of company
 - If cyclical: peaks and troughs
 - Cyclical is okay but be aware of business cycle's impact on profits
- Analyze overall corporate/industry profitability to the best of your ability
- ROE, ROIC, earnings growth, margins

Earnings Growth & Margins

Earnings: historical, expected, earnings surprise

- Dividends can't grow without earnings growth
- Look at historical and expected earnings growth – pay attention to business cycle
- Consistently missing earnings estimates is bad

Margins: gross margin, profit margin, operating margin

- Higher margins are better (industry specific)
- Expanding margins signal competitive advantage
- Listen to management: Sometimes declining margins can mean the business model is changing

Earnings Growth & Margins: Example

Texas Instruments (TXN)

	2014	2015	2016	2017
Net profit margin	21.3%	22.6%	26.6%	24.4%
Operating margin	30.3%	32.9%	35.9%	40.7%
EPS growth Year-over-year	34.7%	9.7%	23.2%	3.7%
Dividend growth Year-over-year	13.3%	11.8%	31.6%	29.1%

Return on Invested Capital

Return on Invested Capital (ROIC)

$$= \frac{\text{net operating profit aftertax (NOPAT)}}{\text{Invested Capital (LT debt + equity)}}$$

$$\text{NOPAT} = \text{EBIT} \times (1 - \text{tax rate})$$

Return on Invested Capital

- Is the company efficiently allocating capital to profitable investments?
- Higher is better
- $ROIC > WACC^*$ means creating value: earning more for every dollar invested
- Different between industries – some invest more capital so it's more meaningful

*See formula at end of presentation

Financial Strength

- Ties into dividend sustainability – can the company actually support the dividend? What about during “hard times”?
- Companies with more significant capital needs are more likely to carry more debt as % of total capital
- Metrics are usually industry-specific
- Debt coverage, cash flow, interest coverage, debt to capital

Interest Coverage

Interest coverage ratio

$$= \frac{\text{earnings before interest and taxes (EBIT)}}{\text{interest expense}}$$

Interest Coverage

- Measures company's ability to meet its debt obligations
- Higher is better
- Good because increasing debt isn't *always* bad, what matters is if the company can pay its current obligations and if it's using the debt effectively

Interest Coverage: Example

Home Depot Inc. (HD)

	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>
Interest coverage	12.9	13.0	13.0	13.9
ROIC	21.4%	26.2%	28.0%	32.1%
LT debt to capital	54.0%	64.4%	76.7%	83.8%
Change in shares outstanding	-5.1%	-6.1%	-4.7%	-3.8%

Sector Medians in SIP

	Basic Materials	Capital Goods	Financial	Health Care	Services	Technology	Transportation	Utilities
Sec Div Growth 1Yr	2.3%	4.2%	4.3%	2.4%	4.5%	2.9%	4.2%	4.0%
Sec Div Growth 5yr	4.1%	6.8%	4.0%	2.7%	4.6%	3.7%	4.7%	4.0%
Sec EPS Growth Est	11.1%	15.0%	10.0%	12.2%	10.4%	14.8%	10.9%	6.0%
Sec FCF Growth 1Yr	2.8%	-2.9%	11.4%	8.3%	13.5%	12.1%	-16.1%	4.3%
Sec FCF Growth 5Yr	13.6%	15.0%	1.9%	8.4%	5.5%	10.9%	6.7%	-2.5%
Sec Payout Ratio Y1	15.6%	6.3%	29.3%	0.0%	17.7%	0.0%	10.3%	60.9%
Sec PE	21.0	22.9	17.9	25.3	22.7	28.6	20.5	19.0
Sec PE Avg 5Yrs	20.6	21.7	15.9	26.8	24.9	24.9	20.9	19.0
Sec ROE Y1	7.3%	8.8%	8.6%	-22.7%	7.8%	5.3%	8.0%	9.0%
Sec ROIC 5Yr Avg	6.5%	6.5%	13.9%	-2.9%	5.8%	3.7%	5.6%	6.0%
Sec Int Earned Y1	2.7	4.0	3.3	-6.6	2.2	0.3	2.7	3.4
Sec Yield	0.0%	0.0%	1.6%	0.0%	0.0%	0.0%	0.5%	3.3%
Sec Yield Avg 5Yrs	1.9%	1.6%	2.7%	1.9%	3.1%	2.0%	2.9%	3.6%

Name:

JM DI Screen



New

Portfolio none: 6312 companies active

Description:

Conn	(	Field	Operator	Factor	Compare To (field, value, industry)	)	Count On
		Industry	Not Equal		Misc. Financial Services		6033
And		Industry	Not Equal		Real Estate Operations		6087
And		Exchange	Not Equal		Over the counter		4729
And		ADR/ADS Stock	Is False				5871
And		Dividend, indicated	>		0		2445
And		Yield	>		2.1		1358
And		EPS Est Y0	>		0		3081
And		Dividend-Growth 3yr	>		5		1084
And		EPS Increases-Y7 to Y1	>		3		2425
And		Yield	>		Yield-Average 5 years		857
And		EPS Growth Est	>		3		1740
And		EPS Est Y0-Revisions up	>		EPS Est Y0-Revisions down		1647

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When to Sell

Think: changes regarding the growth, sustainability or consistency of the dividend

- Excessively high yield (can signal a cut)

- Yield below benchmark yield (market and company's historical range)

- Lack of increase (case by case) or growth consistently less than inflation

- Continuing poor fundamentals

When to Sell

- Dividend cut
- Change in dividend policy
- Significant business risk: legal/regulatory
- Overall poor business/growth prospects
- Continually negative FCF/inability to continue to pay dividend
- More attractive opportunity elsewhere: trade-off

Conclusions

- Decide if you want to be 100% quantitative or make exceptions
- Keep notes of why you added a stock to begin with
- Use the dividend yield as a guide to determine over- or under-valuation
- When using ratios, fully understand what goes into the calculation and what could distort it
- Remember, no company can have everything

AAll Dividend Investing

- Model portfolio, but has actual money invested
- 24 dividend growth stocks
- Equal-weighted portfolio
- Alert members of additions or deletions
- Reinvest excess cash into underweight positions
- Monthly publication
- Weekly email/commentary

www.aaiidividendinvesting.com

The End

Questions?

References

“2017 Stocks, Bonds, Bills and Inflation Yearbook,” Roger G. Ibbotson and Duff & Phelps. John Wiley & Sons, 2017.

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This report includes the charts displayed in the beginning of this presentation

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“Calculating Return on Invested Capital.” Michael J. Mauboussin and Dan Callahan, CFA. Credit Suisse. June 2014.

“Return on Capital (ROC), Return on Invested Capital (ROIC) and Return on Equity (ROE): Measurement and Implications.” Aswath Damodaran, Stern School of Business. July 2017.

“The Weiss Approach to Value in Blue-Chip Stocks.” Jaclyn McClellan. *AII Journal*. June 2016.

Data Source: AII *Stock Investor Pro*, data as of September 30, 2017.

References

Weighted Average Cost of Capital (WACC)

$$\text{WACC} = \frac{E}{V} * \text{Re} + \frac{D}{V} * \text{Rd} * (1 - \text{Tc})$$

Where:

Re = cost of equity

Rd = cost of debt

E = market value of the firm's equity

D = market value of the firm's debt

V = E + D = total market value of the firm's financing (equity and debt)

E/V = percentage of financing that is equity

D/V = percentage of financing that is debt

Tc = corporate tax rate

Picture source: Investopedia