INCOME OPPORTUNITIES FROM **DIVIDENDS**

Phil Oakley picks shares with high dividend growth potential

When people are looking for income shares it is understandable that they spend a lot of time scrutinising the ones with high dividend yields. The potential drawback with this approach is that they can pick shares with dividends that are not sustainable or where the prospects for dividend growth are quite limited.

Successful income investing with shares is about tapping into a stream of dividend income that can maintain and grow the buying power of your money in the years ahead. To achieve this you need to invest in companies where dividends are growing by more than the rate of inflation.

There are a number of so-called dividend aristocrat shares out there with outstanding dividend track records which have achieved this aim handsomely in the past and may continue to do so in the future (see my IC article 'UK dividend aristocrats', 24 March 2017).

However, there are a number of shares with no dividend history at all or a chequered one that may be better placed to achieve an inflation-busting income stream for investors. These kinds of shares can be found from the following types of company:

- Young companies that have reached a comfortable level of profitability to start paying dividends.
- Newly listed companies that have never paid a dividend to shareholders.
- Recovering companies that have gone through hard times and have restored themselves to a healthy state.
- Maturing companies that no longer require large amounts of cash flow for investment and so start paying cash to shareholders instead.

Once a company starts paying a dividend the initial dividend yield can be quite low and might still deter income-seeking investors. Yet the rapid rate of dividend growth that can come once payments have started might mean that the level of dividend income can quickly exceed that offered by shares that currently offer more substantial yields.

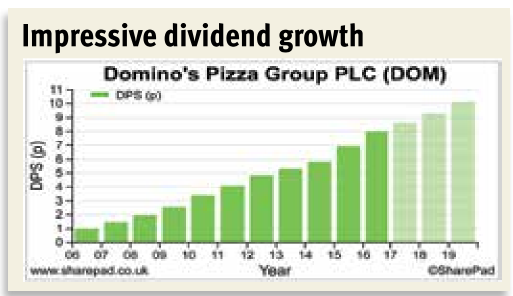
Investors need to focus on something called the yield on cost. This is the dividend per share received as a percentage of the initial cost per share. By selecting shares with high dividend growth potential, investors can create an impressive income portfolio with shares that they may have overlooked. This kind of strategy might be well suited to investors who are looking to retire within the next five to 10 years.

Yield on cost in action: Domino's Pizza

Before we consider some of the shares that might be able to achieve high rates of future income, let's take a look at how dividend growth can create a share with a high yield on cost.

Domino's Pizza (DOM) has been one of the most impressive dividend growth shares over the past decade with an annual rate of dividend per share growth of over 20 per cent.

Impressive dividend growth

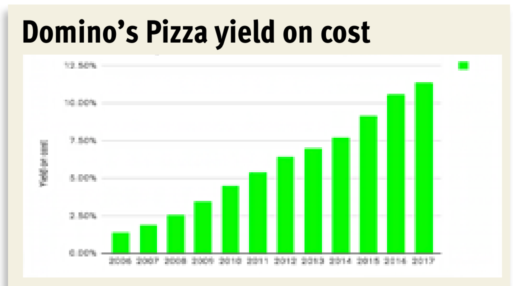


Ten years ago, the shares were priced at 75.5p each (adjusted for share splits) and were paying an annual dividend of 1.02p a share. Few income investors would have bought the shares for the dividend yield of 1.35 per cent on offer.

Yet those investors who bought back in 2007 and have held on to their shares are now expected to receive a yield on cost of 11.4 per cent based on an expected payout of 8.6p a share for 2017. At no point during the past decade could Domino's Pizza have been considered to be a high-yield share, but it is now paying a substantial income to its long-term shareholders.

In order to try to exploit the long-term potential of yield on cost from buying shares today investors

Domino's Pizza yield on cost



> 'Successful income investing with shares is about tapping into a stream of dividend income that can maintain and grow the buying power of your money'

Phil Oakley is a stock analyst for Ionic Information, makers of SharePad and ShareScope investment software. Read more from Phil, including his excellent Step-by-Step Guide to Investment Analysis at www.sharepad.co.uk/philoakley.

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might want to consider investing in growth shares. As Domino's shows, this kind of approach can work out well. Another way is to buy the shares of companies that are about to start paying a dividend for the first time – and possibly overlooked by investors looking at established high-yield shares – or those that are reinstating their dividends after a period of not paying them.

NEW DIVIDEND CANDIDATES TO CONSIDER

The following companies have just started paying a dividend and are expected to grow them over the next few years. This could make them candidates for a diversified income portfolio.

Premier Asset Management (PAM)

This company has been listed on the stock exchange for just over a year. It is a fast-growing investment management company with a number of high-performing investment funds. Current trading is good on the back of buoyant stock markets and inflows of fresh money into its funds. A large chunk of its expected growth in profits is expected to end up in shareholders' pockets, which could result in a very impressive yield on cost over the next few years.

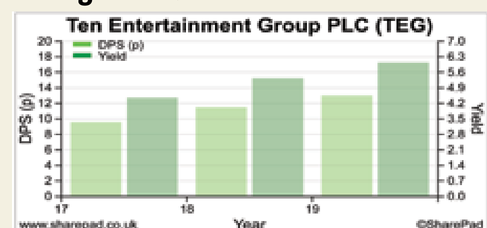
Impressive yield on cost

This share is not without risk. Fund performance can change quickly as can the direction of equity markets. If both hold up then income seekers could prosper.

Ten Entertainment (TEG)

This company listed on the stock exchange in April this year. The owner of bowling alleys trades under the Tenpin brand. It has a strategy to improve its existing bowling alleys by refurbishing them, as well as buying two to four new sites each year and rebranding them as Tenpin. The business is good at producing free cash flow, which should help it to pay a growing dividend and yield on cost to investors.

Strong free cash flow



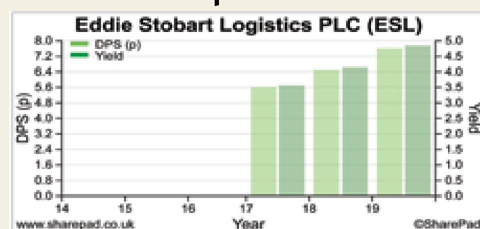
Eddie Stobart Logistics (ESL)

Moving goods from one place to another – commonly known as logistics – is a tough industry to make money from. There is lots of competition and a relentless pressure on prices from powerful customers.

Eddie Stobart – which listed on the Alternative Investment Market (Aim) in April – has carved out a reputation as one of the best in the sector. The company is doing well, especially in its targeted sectors of manufacturing and e-commerce. In the latter, Eddie Stobart has been able to win new contracts due to its delivery, returns and stock management services, which are vital to the health and customer service of internet retailers.

The company is also buying other logistics businesses to fuel its future growth. Backed by an ability to produce decent amounts of free cash flow, the prospect for dividend growth with an acceptable income return for investors looks good.

Best-in-sector reputation



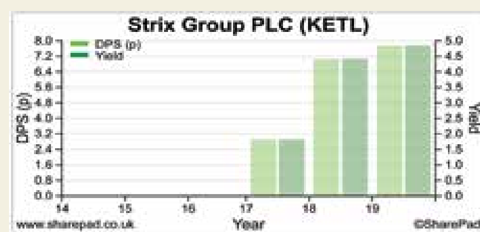
Strix (KETL)

Aim-traded Strix is the global leader in the design, manufacture and supply of kettle safety controls and other electronic control products. The business is steadily growing its sales and profits and has seen a particularly strong performance from its export markets.

The one major area of concern is China, where sales fell during the first six months of the year. The company also mentioned that its business was suffering some effects of local competitors copying its products. This trend will need to be watched.

The dividend yield of Strix shares is unlikely to attract much attention at the moment. This is because the company is only paying a small dividend this year. It is based on a commitment made at its recent IPO, which was reiterated at its interim results: "We remain committed to paying a total dividend which will equate to a 7 per cent yield (based on the IPO placing price of 100p per ordinary share) pro rata for the five months following Admission for the financial ▶

IPO commitment



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▶ year ending 31 December 2017." This means the expected dividend for 2017 is only 2.8p a share, but this is expected to increase to over 7p per share in 2018 according to analyst forecasts. This means a low yield on cost for 2017, but a much higher one can be expected in 2018. Strix is expected to be a good generator of free cash flow, which will allow it to honour its dividend commitments.

RETURNING TO THE DIVIDEND PAYERS LIST

Another source of dividend growth and rising yield on cost can come from companies that are starting to pay dividends again after a period of absence. In these cases, the reinstatement of a dividend payment is often seen as a big sign of confidence in the company's improved future prospects.

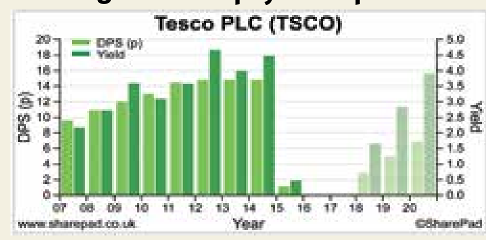
The prospects for dividend growth from this kind of company can be very good. This is because the first returning dividend can often be quite small as the company dips its toe in the water. If the recovery in profits gains traction then the company often feels confident enough to be bolder with its dividend payments.

Tesco (TSCO)

Last week I used Tesco as an example of a business that ran into trouble, leading to a dividend cut. It is now confident that its business is healthy enough to start paying dividends again.

Tesco has become more competitive in its core UK market and has slashed costs and investment (capex) in this business. As a result, profits and free cash flow have increased enough to pay a dividend.

Growing dividend payout expected



Analysts expect a growing dividend payout over the next few years, but Tesco still faces a number of challenges that could place pressure on its cash flows. Here are three of them:

- It still has a very large pension fund deficit that will need many years of extra cash top-up payments to get under control.
- Capex has been slashed in the UK, but this might not be sustainable. Supermarkets are capital-intensive – fixtures and fittings tend to wear out – and need to be kept in good condition to attract shoppers. Whether Tesco can keep capex at low levels relative to recent history remains to be seen.
- The acquisition of Booker might be blocked by competition authorities. Booker would be helpful to Tesco in improving its profit margins.

FirstGroup (FGP)

Bus and rail group FirstGroup got itself into a mess of its own making. Debt-financed acquisitions and a poorly performing US school business put a large amount of strain on its finances. Then the loss of rail franchises and a botched bid for the West Coast franchise meant that its dividend had to be scrapped.

Debt down and performance improving

The company has done a good job in sorting itself out, with debt levels coming down and business performance improving. However, the company has disappointed investors by not reinstating its dividend payments.

However, the belief is that FirstGroup will start paying dividends again, it's just a question of when. City analysts collectively forecast a 3.5p-a-share payout for the year to March 2018. Credit rating agency Fitch said in July that it was assuming payments would resume in the 2019 financial year.

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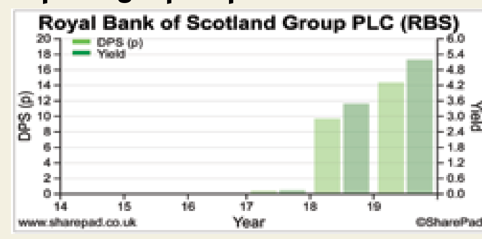
Royal Bank of Scotland (RBS)

Banks are very difficult businesses for outside investors to understand. As the financial crisis showed, you often don't know what they really own or owe until something bad happens. For many, this fact makes banking shares uninvestable.

For others it spells opportunity. That said, the fortunes of RBS in recent years have been enough to test the most patient investors as cleaning up the huge mess it was in has taken an age.

Improving capital position



The good news is that there might be some light at the end of the tunnel at last for RBS's long-suffering shareholders. The health of the bank is getting better, as evidenced by its improving capital position – the financial buffer it has built up to protect itself and its creditors from bad things happening to its loans and assets.

Its improved financial strength may actually pave the way for a resumption of dividend payments. However, there is still some uncertainty regarding the size of the fines it may have to pay to the US government for past wrongdoings.