UK **DIVIDEND** ARISTOCRATS

To be a successful dividend income investor, you need to know what to look for in a dividend share and what to avoid, says SharePad's **Phil Oakley**

In these times of low interest rates on savings accounts and bonds, it is not really surprising that many investors have flocked towards dividend-paying shares. The attractions of a higher income return on their investments and the possibility of a growing income stream to boot are easy to understand.

That said, dividend investing is not as simple as buying shares with the highest dividend yields and hoping for the best. Like other forms of investing it comes with its dangers and pitfalls.

With the changes to pension saving rules and increases to the annual stocks-and-shares individual savings account (Isa) allowance, many investors are looking to dividend-paying shares to give them an income to live on for the rest of their lives. This makes the choice of dividend-paying shares for your portfolio an important one.

The attractions of dividends

Dividends are a slice of a company's profits that are paid to shareholders. They are also an important part of the total return that you get from owning a share – even more so if you reinvest them and tap into the powers of compound interest.

The great thing about dividends is that they represent a tangible return from a share, which once paid cannot be taken away. The same cannot be said for share prices, which can be up one day and down the next.

It is this flow of cash that has made dividend investing so popular with private investors. But dividends have other things going for them too.

They tend to be much more stable than share prices and therefore can reduce the volatility of a portfolio (how much its value moves up and down), which can take some of the fear out of stock market investing and make for a better night's sleep.

But it is their use as a source of income that has made them popular in recent years. Here are some things that you can do to help steer yourself towards reliable dividend-paying shares and keep you away from bad ones.

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Try to understand the company that pays the dividend

Investing is not just a numbers exercise. You can be a better investor and reduce your risks by taking a little bit of time to understand the company that pays you a dividend. This is easily done by visiting a company's website and reading its annual report or some of its investor presentations.

Companies need profits and cash flow to pay dividends. This comes from selling products or services to customers at a competitive price and having plenty of money left over after all the costs of providing them have been paid. To sleep more soundly, it is a good idea to try to understand how a company makes its money and ask yourself whether it can continue to maintain or increase its profits in the future. Don't just buy a share on the basis of a dividend yield number you've seen on the internet or in a newspaper.

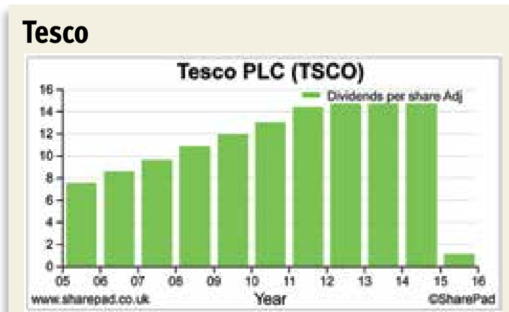
Some companies, such as utilities – especially water, electricity, gas and telecom networks – have very stable and predictable profits and cash flows, which have made them a favourite amongst dividend investors. Other favourites are companies with strong consumer brands, which make them difficult to compete against and in turn protect their profits.

Companies whose profits tends to move up and down with the economy, such as manufacturers or housebuilders, tend to have less reliable dividends over the long run. Technology companies can be very risky too if their products are replaced by something that is better and more up-to-date.

Read what the company is saying about its dividend payments. For example, is it paying special one-off dividends that make the yield look high at the moment only for it to fall back in the following years? Has it set a target rate of dividend growth or a proportion of profits it will pay in dividends over a set period of time? Ask yourself whether dividends can keep growing afterwards.

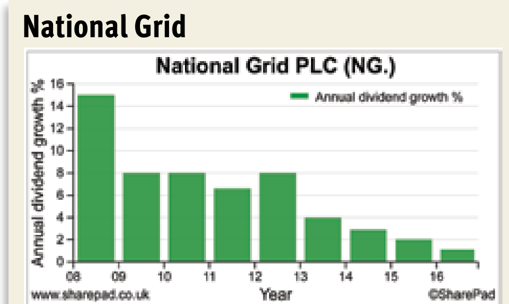
Keep an eye out for dividends where the growth rate has been slowing down or where the dividend has been at the same level for many years. This may

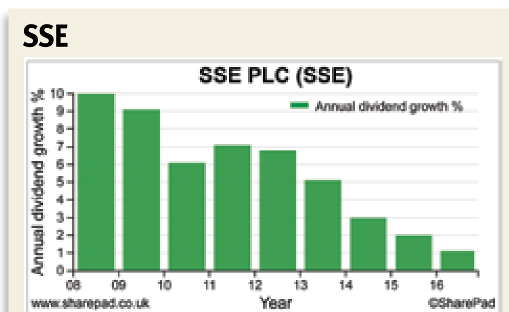
be a sign that future dividends could be lower. **Tesco (TSCO)**is a good recent example of this.



While water and electricity companies have been firm favourites among dividend income seekers in the past their recent track record has been patchy. Water companies and electricity network businesses such as **National Grid (NG.)** and **SSE (SSE)** are regulated businesses. These companies are subject to regular reviews of the prices they charge their customers by industry regulators.

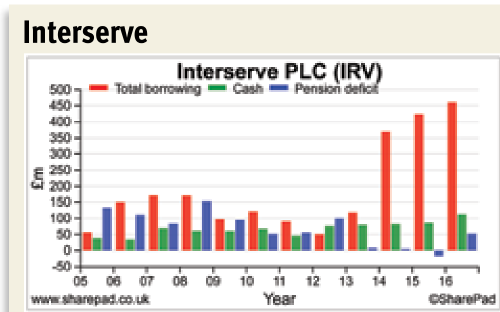
In recent years, price cuts imposed by the regulator have forced water companies to cut their dividends. Could the same happen at SSE and National Grid in the future? Dividend growth at both companies has slowed to a trickle.



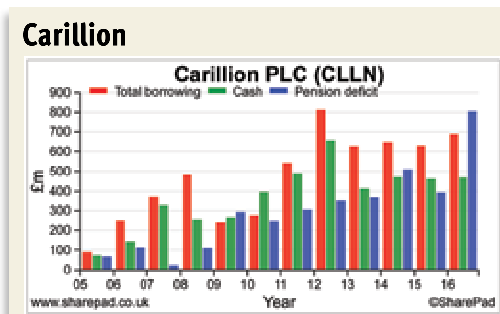


It is usually a good idea to stay away from companies with lots of debt or big pension fund deficits. Interest on debt, and pension fund shortfalls, have to be paid before shareholders get a penny in dividends. A fall in profits can mean there is not enough money left over to maintain dividend payments.

Some support services companies have been victims of high debts and pension fund deficits in recent years. **Interserve (IRV)** has seen its debts balloon and had to cut its dividend when its business ran into difficulty.



Carillion (CLLN) has suffered from rising borrowings and a rising pension fund deficit. Its dividend has barely grown for the past few years and it would not be a surprise to see it cut if trading turns down.



Be wary of very high dividend yields

Just like a high-interest savings account, high dividend yields can look very tempting. Unfortunately, in many cases, they are a sign of a company in difficulty. The high yield is telling investors that the dividend may be at risk of being cut or that future dividend growth is likely to be low or non-existent.

Beware high yields

Name	Forecast yield (%)	Forecast dividend cover (%)	DPS growth (%)
Card Factory (CARD)	8.9	0.8	191.8
Carillion (CLLN)	8.7	1.8	4.6
Redefine Int'l (RDI)	7.9	1	-9.4
GAME Digital (GMD)	7.9	1	-0.6
Direct Line Insurance (DLG)	7.9	1.1	83.6
Ashley (Laura) Holdings (ALY)	7.4	1	-52
Lancashire Holdings (LRE)	7.3	1	340.4
Aberdeen Asset Mgmt (ADN)	7.3	1.1	0
Barratt Developments (BDEV)	7.2	1.4	116.4
Connect Group (CNCT)	7.2	2	3.2

Source: SharePad

Some companies, such as **Lancashire Holdings (LRE)** and **Direct Line (DLG)**, have high yields because they pay out most of their profits as dividends. It is also possible that a yield is enhanced by a special one-off dividend that won't be repeated in future years. ▶

▶ Check out the dividend cover

Dividend cover tells you how many times a company's profits – in this case its earnings per share (EPS) – covers the annual dividend per share. The higher the amount of dividend cover the safer a company's dividend is seen to be – profits can fall by a larger amount before the dividend has to be cut.

Dividend cover of over two times used to be seen as the benchmark for a safe dividend. However, it is not as simple as that. Companies in sectors such as utilities have very secure profits, which allows them to pay out a higher proportion of their profits in dividends. For these companies, dividend cover might be as low as 1.2 or 1.3 times without the dividend being at risk.

Mature companies, which aren't capable of growing their profits by very much, may also decide to pay out most of their profits to shareholders. Dividend cover for these shares will often be low and future dividends are unlikely to grow by much.

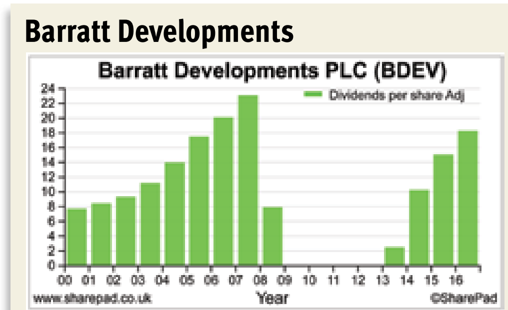
Other companies, such as real estate investment trusts (Reits) have to pay out most of the rental income from their properties as dividends and will therefore have low dividend cover ratios.

If you want to give yourself more comfort that a company's dividend is safe, then you should see if it is producing enough free cash flow to pay it. You can calculate a company's free cash flow dividend cover by comparing its free cash flow per share with its dividend per share. Companies where free cash flow dividend cover is consistently less than one (free cash flow per share is less than the dividend per share) often have to cut their dividend payments.

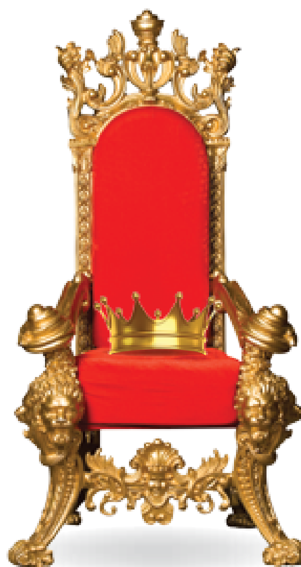
Study a company's dividend history

A company's dividend history can be very telling about how safe its dividend might be in the future. Companies like **Barratt Developments (BDEV)** (that have cut or scrapped their dividends in the past – perhaps in a recession – might do so again. This is more likely in economically sensitive sectors – known as cyclicals – such as housebuilding or manufacturing where profits tend to move up and down with the fortunes of the economy.

Barratt Developments



Look to see how many consecutive years a company has paid a dividend for. If a company has been able to pay a dividend for many years this could be a sign that it has a very robust business that is able to withstand competition and the ups and downs of an economic cycle.



Better still is a company that has been able to grow its dividend in good times and bad. The ability of a company to grow its dividends over a long period of time is a hallmark of quality. Dividend growth is also important to you as an investor.

Dividend growth is what turbocharges the returns from shares to investors. As well as pocketing a growing stream of income, the share price often moves up to take account of that growth and gives investors a capital gain on top. Without growth and the hope of more growth in the future, shareholders would end up getting most of their returns from a flat dividend payment much like they would from owning a bond.

Companies that have grown their dividends in good times and bad can only usually do so because they are very good businesses.

Searching for UK dividend aristocrats

The UK stock market has plenty of companies with excellent track records of long-term dividend growth. Companies such as **Spirax-Sarco (SPX)**, **Halma (HLMA)**, **Bunzl (BNZL)** and **Cranswick (CWK)** have grown their dividends for more than 20 consecutive years.

The problem for income seekers is that the shares of these companies have risen to high levels, which gives them very low dividend yields. Companies such as SSE or **Vodafone (VOD)** have high yields, but low rates of expected dividend growth.

Trying to get a trade-off between a reasonable starting dividend yield, a great track record, dividends backed by free cash flow and the expectation of further growth is not easy. Below is a table of shares that meet the following criteria:

- A starting dividend yield of at least 2 per cent.
- At least 10 consecutive years of dividend growth.
- An annual dividend growth rate of at least 5 per cent for the past 10 years.
- Free cash flow dividend cover of at least 1.0 times for the past 10 years.
- Expected dividend growth of at least 5 per cent.

Dividend aristocrats

Name	Years of growth	Yield (%)	Forecast DPS growth (%)	FCF dividend cover	FCF dividend cover 10-year average	DPS 10-year % change (annual)
Inmarsat (ISAT)	11	5.4	9	1.1	1.1	12
PayPoint (PAY)	11	4.2	49.8	1.8	1.7	15
Imperial Brands (IMB)	19	4	9.9	1.6	1.8	11.2
St James's Place (STJ)	13	3.1	21.5	12.6	7.7	24.6
Computacenter (CCC)	10	2.9	16.7	1.7	3.3	10.1
Babcock Int'l Group (BAB)	15	2.8	7.8	1.7	2.2	17.2
Atkins (WS) (ATK)	13	2.6	8.1	1.5	2.2	9.5
Diageo (DGE)	17	2.5	5.7	1.3	1.3	6.6
WH Smith (SMWH)	10	2.5	9.6	1.8	2.4	21.6
Beazley (BEZ)	12	2.4	9.5	3.1	6.5	8.1
Sage Group (The) (SGE)	23	2.2	17.3	1.7	2.3	14.1
Mears Group (MER)	19	2.2	6.4	2.1	2.4	15.5
Compass Group (CPG)	15	2.1	7.6	1.7	2	12.1
Spectris (SXS)	23	2	5.8	2.9	2.8	11.5

Source: SharePad. DPS = dividend per share. FCF = free cash flow.