2 Dividend Growth Champions

Description

Dividend champions can produce marvelous investment results for long term investors. As fellow Fool writer Robert Baillieul pointed out recently, a modest dividend yield at the time of investment can grow to a high yield over time. Simply stated, an initial dividend yield of 5%, with the dividend growing at 10% per year, will become a 13% yield after 10 years, based on the value of the original investment.

Apart from the dividend income, investors in such stocks could also expect that the capital value of the investment will grow over time, most likely in line with the growth in dividend and profits.

The secret to achieving this great result is obviously that the company must be able to grow the dividend over time. A focus only on historical performance will not suffice.

I have previously identified my criteria for the selection of dividend champions. These criteria are:

1. A track record of consistent and growing dividends
2. A rock-solid balance sheet
3. A moderate pay-out ratio

The **S&P Canadian Dividend Aristocrats Index** (^GSPTXDV) identifies companies that have increased or maintained their cash dividend payments for at least the past five years. Currently the index has 66 members. This list satisfies the first selection criterion above (although a 10-year record would better) and indicates at least a credible historical record of dividend payments. This establishes the dividend-paying pedigree of the company.

However, we are really interested in the future – will these companies be able to maintain and grow their dividends over the *next* 5 to 10 years? The second and third criteria provide some guidance in this regard: a solid balance sheet and modest pay-out ratio that leaves room for inevitable unfavourable business conditions will provide some flexibility for the company to maintain its dividend even in difficult times.

A quantitative screen applied to the 66 companies in the Aristocrats Index provides some interesting names for further consideration. First, if all companies with a current dividend yield of less than the current yield on the 10-year Canadian Government Bond are removed, a group of 31 companies remains. The screens for the pay-out ratio and balance sheet strength, further reducing the group to a dozen companies which fulfil the criteria stated above.

The challenge then is to apply an analytical framework to determine which of the companies will deliver the required growth over time. My work has produced a number of companies that not only meet the quantitative criteria but also have a business model that should produce dividend growth in the years ahead.

The final list makes for interesting reading and I intend to write about a number of the candidates on the list in a follow up article as well. Two companies are mentioned below:

Telus (TSX: T)(NYSE: TU) has a great track record of growing dividend payments (+9% per year over the past five years), a solid balance sheet, and excellent free cash flow generation — indicating a comfortable dividend cover. High profit margins and a business model that should continue the generation of a high level of profitability are also great qualities. This is a prime candidate for a core holding in a long-term income portfolio.

The second candidate is **Toronto Dominion Bank** (TSX: TD)(NYSE: TD). This bank also has an excellent dividend paying track record (+9% per year over the past five years), is well capitalised, and has good levels of profitability. The obvious risks for this retail-focussed bank are a slowdown in its Canadian consumer-lending activities and a collapse in the housing market. This will impede its ability to pay dividends.

However, as mitigating factors one has to keep in mind that the mortgage portfolio is largely insured and secondly that the bank has substantial operations in the U.S., where it has considerable room to improve.

Foolish bottom line
Dividend-based investment can produce great results. However, the key to success is to uncover those companies that will continue to grow their dividends ahead of the rate of inflation. A dividend track record is useful to establish pedigree, but balance sheet strength and dividend cover can provide some protection in difficult times.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:TD (The Toronto-Dominion Bank)
2. NYSE:TU (TELUS)
3. TSX:CDZ (iShares S&P/TSX Canadian Dividend Aristocrats Index ETF)
4. TSX:T (TELUS)
5. TSX:TD (The Toronto-Dominion Bank)

Category

1. Investing

Date
2025/08/22
Date Created
2014/03/29
Author
deonvernooy