Should Investors Even Care About Dividends?

Description

Imagine a world where dividends don't exist. Instead of paying out a chunk of earnings to investors each year, companies are free to use that money to reinvest in their businesses. A company that formerly paid out 40% of its earnings in dividends and reinvested 60% of its earnings would be free to take all its earnings and use them to grow its business.

Say most companies can return 10% of their invested capital. Instead of investing 60% of earnings back into the business to return 10%, the company invests 100%. This company would, in theory, generate a 4% increase in net income compared to a company that divided earnings between reinvestment and dividends. Over time, this would compound into a significant difference.

If investors needed income from such an investment, they could just sell a few shares. Sure, there are tax implications on a sale, but dividends are also taxed. Additionally, an investor looking to avoid tax could just sell a few losing stocks along with a few gainers, trying to keep gains to a minimum. It would work, assuming there are a few duds in the portfolio.

It's very easy to see the problem in my world without dividends. Most mature Canadian companies can't identify enough opportunity to invest all of their retained earnings, so they're almost forced to spend the rest on dividends and share buybacks, much to the delight of most investors.

Take, for instance, **Telus** (TSX: T)(NYSE: TU). The company has made massive investments in its network, and is now reaping the rewards. The company pays out approximately 70% of its net earnings on dividends, and spends additional money buying back shares each year. These moves help boost the share price, since investors translate dividend increases and share buybacks as bullish signals.

However, what if Telus had a better use for its earnings? The company made $1.3 billion in 2013, and currently sits on about $7.5 billion in debt. I understand that interest rates are low, but you can at least make the argument that Telus should pay off some of its debt. Even at 4% interest, $7.5 billion in debt will set back the company $300 million per year.

In the energy patch, acquisitions happen all the time. Unlike mergers in other sectors, a company looking to buy another one doesn't have to worry about things like intangibles or whether something is a good "fit." Buying oil assets is very much a numbers game.

Each year, **Husky Energy** (TSX: HSE) pays out $1.20 per share in dividends, good for a 3.6% yield. The company currently has 983 million shares outstanding, which means investors pocket $1.18 billion each year in dividends. What if it used that cash to acquire a competitor?

Over the last decade, shares in **Pengrowth Energy** (TSX: PGF)(NYSE: PGH) are down more than 45%. Investors have had to deal with poor results, weak natural gas prices, and a cut in the company's monthly distribution. Shares have rebounded over the past couple years, as the market is optimistic about the company's move away from natural gas and into oil production.

The company's current market cap is $3.75 billion. If Husky suspended its dividend for four years and offered the $4.75 billion saved for Pengrowth, let's argue that it could acquire the company. Pengrowth is projecting funds from operations of just under $500 million in 2014, and is projecting to pay $250 million in dividends.

If Husky immediately added $500 million in funds from operations from a $4.75 billion purchase, that's an instant 10.5% return. That's even after paying a 25% premium to acquire the assets. There are plenty of opportunities in the energy sector to acquire smaller chunks of assets that wouldn't require such a premium.

I understand why investors love dividends. It's great to get paid now, especially if you're at a point where current income is important. Despite this, a quarterly payout shouldn't be the most important reason to buy a stock. I view a dividend as a bonus. If a solid company with growth prospects and a fair valuation happens to have one, great — but if it doesn't, the stock should still warrant investigation.

CATEGORY

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