

3 Dividend Stocks That Could Dramatically Grow Their Payout Ratios

Description

When many investors analyze a stock as an income investment, the first thing they look at is dividend yield. After all, a 5% yield offers a better return than a 3% yield, right?

Research shows this may be wrong over time. A report by Manulife Asset Management found that the key to returns over time is not dividend yield, but dividend growth. The report noted that a stock with a 3% yield and 12% growth rate provided three times more income over a 15-year period than a stock with a 5% yield and no growth.

One of the most effective ways to find dividend growth is to look at stocks with low and rising payout ratios combined with growing cash flows and a commitment to dividends. In Canada, **Canadian National Railway Company** ([TSX:CNR](#))([NYSE:CNI](#)), **TransCanada Corporation** ([TSX:TRP](#))([NYSE:TRP](#)), and **Magna International Inc.** ([TSX:MG](#))([NYSE:MGA](#)) all fit the bill.

Canadian National Railway

Canadian National Railway is North America's second-largest railway and easily one of North America's most efficient railways. In 2014 the company had a payout ratio on earnings of about 26% compared with a peer group average of 29.5%.

Canadian National Railway recently announced an objective to move its payout ratio up to 35%, a move they can easily afford to make. The company enjoys strong and growing free cash flow, with the record free cash flow of \$2.2 billion in 2015 (about 18% of total revenues).

The company only pays out 37% of free cash flow at the moment, leaving plenty of room for upside. Even if the company sees no earnings growth, simply paying out 35% of 2014's earnings would result in a 31% dividend increase from 2014's annual dividend and a 5% increase from 2015's estimated annual dividend.

The company, however, is expecting earnings for 2015 to be 15% higher than 2014, and 10% growth in 2016 is not unreasonable.

Magna International

Magna is one of the world's largest auto-parts manufacturers. Currently, they have a very conservative payout ratio, with a policy to pay out at least 20% of earnings. For a company with projected earnings growth of 14.5% annually for the next three years, Magna certainly has the potential to pay out at higher portion of its earnings.

Most importantly, the company generated \$1.3 billion of free cash flow in 2014, paying out only \$329 million in dividends. Currently, the company is focused on share buybacks as a means of returning cash to shareholders. But as strong cash generation continues, it is likely the company could re-visit its payout policy as a means to deploy excess capital.

TransCanada Corporation

While TransCanada Corporation currently has a strong dividend yield of about 4.9%, part of the reason for this is that TransCanada has a low cash flow payout ratio relative to its peers. Pipeline shareholders place a high value on payout ratio, and the low payout ratio results in a lower earnings multiple for TransCanada, and therefore a weaker share price and higher yield.

Currently, TransCanada pays out about 41% of its estimated 2015 cash flow. This is compared with **Enbridge**, which pays out about half, and American players like **Kinder Morgan** that pay out nearly all of their cash flow.

The reason for TransCanada's low payout is because it currently has a massive \$46 billion capital program, and many of the major projects in this program (like Keystone, Energy East, and its LNG pipelines) are awaiting approval.

TransCanada's CEO has indicated that when these projects are approved, the company would be willing to boost its payout. This makes sense, as the company would not want to boost its payout before it has clear visibility into future cash flows.

Once TransCanada has better visibility into the status of these projects, a payout boost could be in order.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
2. NYSE:MGA (Magna International Inc.)
3. NYSE:TRP (Tc Energy)
4. TSX:CNR (Canadian National Railway Company)
5. TSX:MG (Magna International Inc.)
6. TSX:TRP (TC Energy Corporation)

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