# When to Buy Your Favourite Dividend Stock

## Description

Stocks that pay out consistently growing dividends make great investments. Even if the stock price falls in the short term, the price is going to appreciate in the long term.



This is because a business becomes more valuable to shareholders as it pays out higher dividends over time. But when should you buy such a business?

I will use **Canadian Utilities Limited** (TSX:CU) as an example because it has increased dividends for over 40 years in a row.

**Long-term trend of higher earnings**

Dividend-growth stocks that increase their dividends year after year tend to have growing earnings to support dividend growth. Simply put, for dividends to remain healthy, there must be earnings growth.

From 2000 to 2014 Canadian Utilities increased earnings per share (EPS) at an average rate of 6.6% per year. For 11 of the last 14 years, the utility posted higher earnings than the previous year. During that period it increased dividends per share at about 4-10% a year, or an average rate of 6.3%, which aligns well with the average EPS growth in that period.

**Healthy payout ratio**

The payout ratio is typically the percentage of earnings that is paid out as dividends. Businesses in different industries tend to command a different payout ratio.

For example, utilities like Canadian Utilities tend to have higher payout ratios than, say, grocery stores such as **Loblaw Companies Limited**. Loblaw's payout ratio is around 30%, while Canadian Utilities's payout ratio is around 50%.

So, if your favourite utility has a payout ratio of 90%, you might want to reconsider buying it because that would mean it's paying out 90% of its earnings and only retaining 10% to grow its business.

Further, if its earnings drop, that would mean there’s little margin of safety to maintain the dividend payout without borrowing money. And generally, it’s bad practice to borrow money to pay dividends because it weakens the balance sheet and interest must be paid on the loan.

**Yield puts a floor and cap on share price**

Since 2008, the highest yield Canadian Utilities has experienced was around 3.8%, while the lowest was around 2.5%. This indicates that its shares are a great buy around 3.8%. If you see it at 2.5%, it’s not such a good time to buy.

Lower prices and dividend growth lead to higher yields. Usually, a combination happens. So, when a dividend-growth stock such as Canadian Utilities gets close to its historically high yield, that indicates the shares are cheap.

On the contrary, if it yields close to 2.5%, that indicates the shares are expensive. Depending how much of the stock you hold in your portfolio, you might want to ignore the overvaluation or sell at least a portion of it to rebalance your portfolio.

So, at the same time a historically high yield puts a floor on the share price, a historically low yield puts a cap on the share price.



This method works especially well for dividend stars like Canadian Utilities, which has increased dividends for decades.

**In conclusion**

Here’s how to decide when to buy your favourite dividend stock: check if the business has a trend of growing earnings. If it does, check if its payout ratio is in line or lower than competitors’. If it passes both tests, compare the dividend yield to historical yields to decide if it’s a good time to buy.

**CATEGORY**

1. Dividend Stocks
2. Investing

**POST TAG**

1. Editor's Choice

**TICKERS GLOBAL**

1. TSX:CU (Canadian Utilities Limited)

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