What Makes a Solid Income Share?

Description

Deciding which dividend shares to purchase is never a straightforward task. Certainly, a company may have a high yield or be forecast to raise dividends at a rapid rate. But there is no guarantee that dividends will prove to be sustainable, or that they will cause investor sentiment in the company to improve. In fact, analysing a company from an income perspective requires a focus on their finances, maturity and business model.

Financial strength

Whether a company’s current level of dividend is affordable or not is likely to have a major impact upon its future payouts. Put simply, a business which can easily afford its dividend today is much more likely to offer at least some dividend growth in future. In contrast, a company which has been overly generous with shareholder payouts in the past may need to reduce dividends in future. This is in order to generate sufficient capital through which to invest in its asset base for future earnings growth.

One means of measuring whether a company is being overly generous with its dividend payments is the dividend payout ratio. This is calculated by dividend total dividends by total earnings and produces a percentage figure. If this figure is above 100%, it means a company is paying out an amount greater than its profit in dividends. This situation is unsustainable in the long run, and a dividend cut may be necessary.

Conversely a company which pays out less than 100% of profit as a dividend could increase shareholder payouts at a faster rate than profit over the long run. As such, a stock with a low payout ratio is likely to make a superior income stock.

Business model

As well as a low payout ratio, assessing a company’s business model is crucial when seeking solid income stocks. A company which operates within a relatively stable and resilient sector such as utilities or tobacco is likely to offer a consistent dividend. Similarly, a more cyclical stock which has earnings that are more positively correlated to the performance of the economy could see its dividends fluctuate to a greater extent.

As such, a company's dividends tend to mirror its business model. Investors seeking a stock which is able to rapidly grow dividends per share may be better off buying cyclical companies, while investors looking for reliable dividend growth may wish to focus on more defensive sectors.

Maturity

The maturity of a business also impacts on dividend payments. Younger companies tend to require greater investment in which to grow, which means there may be less capital available for dividend payments. In contrast, mature businesses which are not seeking to rapidly expand, or that are unable to offer a high return on capital, may prefer to pay out the majority of their net profit as a dividend. Investors seeking dividend growth may therefore wish to focus on more established stocks, rather than their younger counterparts.

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