This Ratio Could Predict a Stock's Future Dividend Growth

Description

With the prospect of higher inflation across the globe, investors are likely to turn increasingly to higher-yielding shares. While this may help them to overcome inflation in the short run, over a longer timeframe it is the dividend growth offered by a company which could make the biggest impact on their real-terms return. In other words, stocks which can grow their dividends at a faster pace than inflation may offer the highest total returns in the long run.

Under-appreciated

Clearly, it is never easy to forecast how quickly a company will increase dividends per share. However, one way of doing so is focusing on the payout ratio or dividend coverage ratio of a particular business. The payout ratio represents the percentage of net profit which was paid as a dividend, while the coverage ratio is the inverse of this ratio.

A company which has a low payout ratio or high coverage ratio has more scope to raise dividends than a business which has a high payout ratio or low coverage ratio. Therefore, other things being equal, a company with a low payout ratio would be expected to increase dividends per share at a relatively fast pace over the long run. This is especially the case within a specific industry or sector, where the companies in question will face similar challenges and catalysts to push their earnings growth rate higher.

Multi-faceted

Of course, a low payout ratio is not the only factor in determining the rate of growth in a company's dividends. Its stage in the life cycle also has an important bearing on its propensity to pay higher dividends.

For example, a relatively young company which is still able to offer a high rate of return on reinvested capital would be unlikely to raise dividends significantly. The capital funding them would be more effectively used in developing investment opportunities within the business. In contrast, a more mature business is more likely to increase dividends at a fast pace as internal rates of return naturally decline in the mature phase of a company's life cycle.

Furthermore, management strategy has a large bearing on the rate of dividend growth. Some management teams may wish to pay down debt using additional capital, or engage in M&A activity. Others may prefer to pay higher dividends or engage in share buybacks so as to more directly reward the company's shareholders.

Takeaway

There are a number of factors which impact on the rate of dividend growth. However, the payout ratio can provide a useful means of assessing the likelihood of dividend growth – especially when it is compared to a company in the same industry and at a similar stage in its life cycle. With inflation edging higher, consideration of the payout ratio could lead to improved income returns and better overall portfolio performance in the medium term.

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