Adding These 2 Dividend-Growth Giants Will Help Your TFSA

Description

In 2009, Warren Buffet and **Berkshire Hathaway** started going all-in on railroad stocks, citing improved fundamentals and a once-in-a-generation opportunity to make a bet on the direction of the American economy.

That bet has proved remarkably profitable as railroad stocks have roared ahead during the current bull market, many of them reaching all-time highs.

While the opportunity to invest in railroads today isn't quite as rich as it was nearly 10 years ago when Buffett made his move, companies like **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) and **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) are widely regarded in the market as blue-chip stocks offering defensive qualities that are becoming more desirable as we enter the ninth year of the current market cycle.

Their dividends today

CP Rail raised its dividend in May from $0.50 per quarter to $0.5625 per quarter, marking a 12.5% increase. Against Friday's closing price of $193.40 on the Toronto Stock Exchange, that works out to a 1.16% payout annually.

CNR, meanwhile, raised its quarterly payout from $0.375 per quarter to $0.4125 in January of this year — a 10% increase — giving the company a 1.65% yield against Friday's closing price of $99.57.

For retirees or those living off the income from their portfolios, neither CP's nor CNR's current yield is going to be very appetizing at less than 2%.

But maybe there's more to the story if we look at the potential of these two companies to sustainably grow their payouts over time.

The potential to grow their dividends

While both major Canadian railroads may come up short in terms of offering adequate income streams today, both are attractive candidates to grow those payouts significantly over time.

CNR generated returns on equity (ROE) of 25% in 2016 and paid out 30% of earnings in the form of dividends. This means the company retained the other 70% of earnings, which can be used to reinvest in future growth.

Essentially, a lower payout ratio today is traded for more growth tomorrow.

Taking into consideration the company's ROE and retention ratio, its estimated that CNR should be able to increase its dividend payout by 17.5% into perpetuity — a very impressive feat.

Meanwhile, with CP Rail the prospects are even more encouraging. Management at CP has done an exemplary job over the past few years of improving returns on invested capital. The result is that ROE has improved from 10% in 2012 all the way to 34% in 2016.

If the company can maintain those returns, in combination with a retention rate of 81%, it suggests that CP should be able to sustainably grow its dividend by 26% annually.

Conclusion

For income investors and retirees, there may be better options to obtain a current yield through the likes of utilities such as **Altagas Ltd.** (TSX:ALA), which pays a yield of 7.58%, or even an income trust like **Dream Global REIT** (TSX:DRG.UN), which pays out a 7.21% yield.

Yet for those investors who don't require income today, the growth potential of both CNR and CP, supported by strong underlying fundamentals, suggests the boon in railroad stocks may be far from over.

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jphillips