Income Investors: You Might Be Looking at Dividends All Wrong

Description

Many investors love dividends. It's easy to see why.

Stock prices can fluctuate wildly. Even stable blue-chip stocks can see their share price vary by 20% or 30% during the course of a given year. And these are supposed to be boring companies suitable for long-term investing.

Dividends are much more stable. Sure, a payout can always be cut, but that's generally a last resort from a company that has struggled for years. Dividends tend to go up slowly over time, as a company improves profitability. These dependable payouts give investors a solid return no matter what the underlying stock price does.

But we must remember dividends aren't the only way a company can give back to its shareholders. Share buybacks can be incredibly powerful too, especially if a management team makes the decision to gobble up undervalued stock.

Investors who ignore share buybacks while just focusing on dividends are missing out on a significant opportunity. Let's take a closer look at one company crushing it on this metric: **Magna International** (TSX:MG)(NYSE:MGA).

A tale of two yields

Magna is one of the world's largest makers of auto parts, with plants and research centres located around the world. Big investments being made today by the company include working on ways to get vehicles lighter and more fuel efficient, and maximizing the efficiency of electric engines.

Shares trade at an incredibly cheap valuation — at less than eight times forward earnings expectations — for a few notable reasons. Investors aren't in love with the car parts business. Organic growth expectations look a little weak, but the company has a history of making acquisitions. And investors are worried a recession will send Magna earnings sharply downwards as car sales plunge.

While the market worries, Magna continues to generate significant amounts of free cash flow. The company's projections for 2019 see it posting close to US$2 billion in free cash flow. To put that into perspective, the stock has a current market cap of US$15 billion. That gives the stock a price-to-free cash flow ratio of approximately seven times. You won't find many cheaper valuations.

Magna has been serious about growing its dividend over the last few years, increasing the payout from US$0.50 per share in 2010 to US$1.46 per share currently. That represents growth of more than 10% annually. Shares currently yield a hair under 3%.

3% is a solid dividend — especially when it's paired with 10% growth potential — but investors should be much more excited about its share buyback. From 2011 to 2018, Magna returned US$7.7 billion back to shareholders in the form of share buybacks. That compares to less than US$3 billion worth of dividends during the same period.

Let's take a look at a little more recent history to demonstrate just how powerful the share buyback has been. In 2018, Magna repurchased 32.6 million shares for approximately US$1.8 billion. Compare that to the dividend, which equaled US$448 million in 2018.

Combine the two together, and Magna's shareholder yield was 14.6% in 2018.

This number is simply amazing. If Magna keeps up its current pace on share buybacks, it'll eliminate approximately 50% of total shares outstanding in the next five years. That would double earnings per share, even if the bottom line stayed exactly the same.

It's not all about the dividend

Simply put, Magna's 3% dividend isn't very exciting. But its total shareholder yield sure is. There are few stocks on the TSX that are buying back shares in a serious way and none that get close to what Magna is doing.

Dividend investors need to look past the current yield and factor in share buybacks. This offers a far more accurate picture of total yield.

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