Passive Income: How to Predict Dividend Growth

Description

I'm a firm believer that dividend growth is more important than dividend yield. A high-yield dividend stock could be a value trap that is likely to destroy value for shareholders over time. However, a company that can consistently boost dividends is probably facing robust demand and steady pricing power for its goods.

Research indicates that dividend growth accounts for a substantial portion of total shareholder returns over time, with some estimates as high as 42%. In some cases, the dividends from a stock could grow so large that the return on investment could be as high as 100% on an initial cost-basis.

With that in mind, every investor looking for passive income needs to keep an eye out for potential dividend growth stocks. Here are three ways to spot these wealth creators.

Low payout

Some managers are very conservative with the company's cash flows. When a management team pays out only a fraction of net income in dividends every year, it leaves plenty of room for payout expansion when sales or net income grow faster than expected.

Companies with a low payout ratio can also boost dividends suddenly when the management struggles to find any other use for the company's excess cash. When potential investment opportunities and internal improvement projects are exhausted, the management team is usually compelled to hand over more cash to shareholders.

iA Financial is a good example of this. The company currently pays less than a third of its annual income in dividends. Meanwhile, sales and net income are expected to grow sharply as the company captures more market share in its lucrative industry. That makes it an ideal candidate for a dividend growth portfolio.

High sales growth

A rapidly expanding top line is my second-favourite indicator of a dividend growth stock. Companies with double-digit growth in sales, coupled with a robust dividend policy, eventually boost shareholder rewards.

Dividends are also likely to expand when the management team is feeling optimistic about forecasted sales, which is yet another green flag for investors.

Grocery chain **Alimentation Couche-Tard** expects to double its net income within five years through acquisitions and store expansion. It seems clear to me that the company's dividend payouts will expand alongside the company's bottom line over the next half decade.

Cash reserves and low debt

Some companies simply have too much cash. A company's net cash reserve (cash and cash equivalents less long-term debt) should act as a buffer against market downturns or be kept as dry powder for future acquisitions. However, when this cash reserve becomes unreasonably large, shareholders deserve a large payout.

Companies with strong balance sheets tend to steadily increase their dividend payouts.

Bottom line

Dividend growth is the holy grail of long-term investing. A company that can expand shareholder rewards over time deserves a spot on your watch list. Rapidly accelerating sales, better profits, and a low payout ratio tend to indicate capacity for dividend growth.

Investors should keep an eye out for these factors and add potential dividend growth stocks to their portfolio.

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vraisinghani