



BY JOHN KINGHAM

## DIVIDEND HUNTER

# HUNTING FOR DIVIDENDS IN THE 'GOLDILOCKS' ZONE

**John Kingham examines a couple of FTSE All-Share companies, both of which have more than 10 consecutive years of dividend payments and a starting dividend yield of more than of 4%.**

It goes without saying that dividend investors want a reasonable yield, but what is reasonable?

Some investors are happy with yields of 2% or less because they believe that high growth tomorrow will more than compensate for a low yield today. But for investors who want a decent income today, 2% is unlikely to be enough for all but the wealthiest.

At the other end of the scale, some investors will only invest in high-yield opportunities, aiming for something close to and preferably above a double-digit yield. At first glance this seems like a no-brainer, but don't forget that dividends are not guaranteed

and promises of double-digit yields are often followed by the reality of dividend cuts and suspensions.

For most dividend investors then, looking for shares where the dividend yield is in the 'Goldilocks' zone (just the right amount) is sensible. Of course, what is neither too high nor too low an amount is subjective, but I think something in the range of 4% to 8% is a good starting point.

So, this month I have decided to focus on a couple of FTSE All-Share companies, both of which have more than 10 unbroken years of dividend payments and a starting dividend yield above 4%.









## Elementis PLC

- **Index:** FTSE 250
- **Share price:** 129p
- **Dividend yield:** 4.9%

Elementis develops and manufactures chemical additives which improve the performance of its customers' products.

These additives are applied in a range of industries, including personal care; coatings; energy; chromium (Elementis is the world's largest producer of chromic acid, used for chrome plating) and talc (for use in plastics, ceramics, paper and even food).

The company can trace its roots as a chemical manufacturer back to 1947 and is a global business, with only 4% of revenues generated in the UK.

### Dividend growth but shrinking dividend cover

The first thing I do when analysing a company is to find its financial data for the last 10 years, on SharePad and enter it into my spreadsheet. This gives me an overview of the company's performance over the last few years.

For Elementis, this highlights a couple of concerns straightaway. First, the company made a loss in 2009, although that's not exactly shocking as it was the year of the financial crisis, so perhaps a small loss is forgivable. Second, over the last two years, Elementis has spent around



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\$850 million on acquisitions, which is a lot for a company earning around \$100 million per year (I'm quoting US-dollar figures as that's the reporting currency).

Turning to the headline results, revenues per share have failed to grow at all over the last 10 years, while earnings have been volatile and also show no underlying growth trend. Dividends have grown consistently, and the annualised dividend growth rate is just over 6% per year over 10 years.

The company also paid a string of special dividends during the 2012-2015 period, when earnings were at their peak and the company was largely debt free. However, following those large acquisitions the company is no longer debt free and so the special dividends have come to an end.

As I said in last month's Dividend Hunter article, sustainable dividend growth requires earnings growth, and the lack of earnings growth at Elementis, combined with consistent dividend growth, has seen its dividend cover shrink from around three times in the early 2010s to about two times today. If earnings continue to lack growth in the years ahead, then at some point dividend growth will have to grind to a halt as well.

Capital employed (equity capital, debt capital and leased capital), which is the engine of corporate results, grew by about 30% during the early part of the last decade. In the last two years it leapt upwards by another 30%, driven by an additional \$590 million of debt which was used to fund the recent acquisitions (with the remainder funded by shareholders through a rights issue).

### Profitability is high but also declining

My preference is for companies to self-fund their capital employed



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growth (which should increase their earnings potential) with retained earnings. This forces management to focus on producing high rates of return on capital, because measly returns on capital will produce measly retained earnings which will produce measly growth and measly management bonuses.

In the years leading up to the recent acquisitions, Elementis produced net returns on lease-adjusted capital employed (net ROLACE) of 18%. That's very good and far above the average return which is in the region of 7% to 10%. This may suggest that Elementis has some kind of competitive advantage, such as low cost of production or the ability to develop better additives.

After dividends, the company retained earnings equivalent to about 13% of its capital base each year, so that represents the company's self-fundable growth rate. However, we know that Elementis didn't grow its revenues or earnings at all during this period, so although those retained earnings did lead to capital employed growth, that bigger corporate engine didn't produce any better results. This shows up in the net ROLACE figures, which declined from around 20% a few years ago to little more than 11% today.

Without knowing all the details, this looks like a company that has been reinvesting earnings into capital assets, but those assets have not been able to generate returns that are comparable to the company's existing assets. This is not a good sign and perhaps Elementis has lost its competitive edge.

#### **Reigniting growth but uncertainty is high**

To fix this zero-growth situation, a new chief executive was brought in with the inevitable business review and subsequent new strategy, code-named Reignite Growth. The findings



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of this review were that the company had many leading positions in a variety of additives and markets, but that it was underperforming relative to its potential.

One area of focus was additives for personal-care products, which is both a defensive and high-growth market. This led to the acquisition of SummitReheis, the global leader in active ingredients for anti-perspirants, for around \$360 million in 2017. In 2018 Elementis purchased Advent Mondo, a leading global supplier of talc-based additives, for around \$500 million.

In summary then, Elementis is a company with historically high levels of profitability which has produced progressively weaker returns for

much of the last decade. To fix this, the new chief executive is carrying out a turnaround strategy involving very large acquisitions.

As a potential investment, I quite like the look of Elementis, especially its global reach and leading positions in multiple markets. However, I'm not keen on investing in turnarounds and I don't like investing in highly acquisitive companies, as large acquisitions have a nasty habit of not working out very well. The company also has a substantial post-acquisition debt pile, which will probably take a few years to pay down.

At the moment Elementis isn't quite what I'm looking for, but it isn't a 'basket case' either, so I'm going to reserve judgement for the moment.



## Chesnara PLC

- **Index: FTSE Small-Cap**
- **Share price: 325p**
- **Dividend yield: 6.2%**

Chesnara is a life insurance and pensions closed-book consolidator. In plain English that means it buys 'books' of existing insurance policies (sometimes tens-of thousands of policies) from companies that no longer want to manage those policies.

This typically happens when a company has sold life insurance or pensions as an add-on to some other service, such as estate agency or funeral services. The management of these insurance policies then becomes a distracting burden, so the company looks for some way to offload them, preferably onto a company where managing closed books of insurance is the core business.

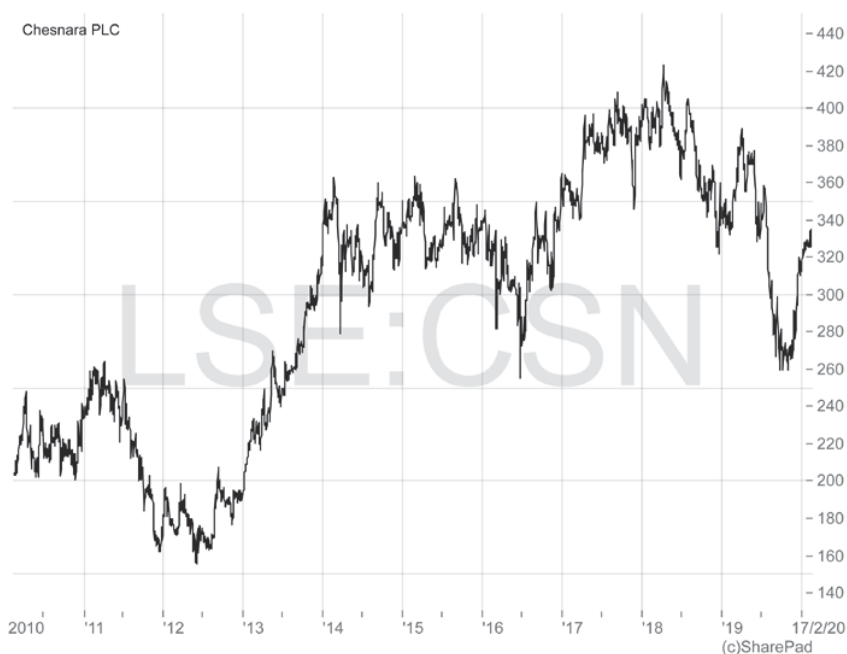
Chesnara's whole existence has revolved around acquiring closed books of business. In fact, the company was born following the spin-out of Countrywide PLC's life-insurance book (Countrywide is a leading UK estate agency). The newly spun-out company, Countrywide Assurance, became Chesnara's first subsidiary and since then Chesnara has followed a path to growth driven primarily by the prudent acquisition of unwanted closed books of business.

The basic idea is simple. For each acquisition to work out, Chesnara has to be able to run the policies efficiently, manage the investment assets successfully and pay out any claim expenses promptly in order to satisfy the demands of customers and regulators.

Of course, Chesnara has to be able to buy these policies at a price which makes sense, where the discounted value of the book's future cash flows are likely to provide an attractive rate of return and sufficient cash to grow the dividend.

Chesnara is an interesting company because management describes it as "a reliable income stock". This is unusual, but the description is backed up by 14 years of consistent dividend growth, which is every year since the company was formed in 2004.

One final point I'll make before diving into the numbers is that Chesnara has acquired some 'open books' over the years, and



does write new policies in Sweden through its Movestic business and in the Netherlands through Scildon, which it acquired from Legal & General. Both of these 'new business' operations provide additional cash for acquisitions or dividends.

So, having entered 10 years of data into my spreadsheet, I can see a couple of things right away.

### **Volatile earnings but steady growth of book value and dividends**

First, Chesnara's earnings are volatile and don't show any sort of upward

growth trend. On the other hand, its assets (mostly insurance-premium reserves and pension assets held in collective investment funds) have increased reasonably steadily at about 5% per year, and its capital employed (equity capital, debt capital and leased capital) has grown by about 7% per year. The dividend has increased every year, by an average of 3% per year.

The lack of earnings growth is a concern, but at least the company's assets and capital employed are increasing. This is good, as an insurer's dividend can only grow sustainably if



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the company is also increasing its pool of premium assets, as they are the fundamental source of dividends.

So why are earnings volatile with no underlying growth trend? The main reason is that earnings for life insurers can be significantly impacted by investment market returns. In Chesnara's case, it has more than £7 billion of financial assets, at least £5 billion of which are equities or collective-investment schemes. When markets went up in 2017, Chesnara's investment return was recorded as an income of £532 million, and when markets went down in 2018 the decline was recorded as an expense of £335 million. Most of those investment gains and losses are negated by related changes in insurance and pension liabilities, but these are still huge swings for a company earning an average of about £40 million a year.

In my opinion, what matters here is not so much that earnings are going up smoothly and steadily, but that they cover the dividend consistently over time. And that has been the case almost every year over the last decade, with dividend cover averaging 1.7. The only uncovered dividend came in 2018, largely thanks to terrible market returns that year which depressed earnings. Last year was a much better year for markets, so I would expect the dividend to be re-covered sooner rather than later.

### Profitability is okay but growth is only partially self-funded

Turning back to growth, the most sustainable form of growth is self-funded growth driven by retained earnings. This requires both sufficient profits to be generated from capital employed and for a dividend policy that allows some earnings to be retained to support and drive growth.

In Chesnara's case, it has produced average net returns on lease-adjusted capital employed of just over 10% over the last decade. This is reasonably good and just exceeds my preferred hurdle rate of return of 10%. About six percentage points of those earnings have been paid out as dividends, leaving average retained earnings equivalent to about 4% of capital employed.

So, 4% is approximately the company's self-fundable growth rate, ie growth funded purely from retained earnings. However, Chesnara's capital employed has grown by about 7% per year, so additional capital must have come from rights issues, debts or leases.

In fact, most of this additional capital has come from rights issues, which have increased the number of shares from about 100 million a decade ago to 150 million today. I'm not a massive fan of using rights issues to fund acquisitions, but in this case, acquisitions are central to Chesnara's DNA and their size and frequency has

not been excessive. In other words, Chesnara spent the equivalent of 50% of earnings on acquisitions over the last decade, and my definition of excessive acquisitions is anything over 100% of earnings over 10 years.

### A medium to high yield dividend plodder

What are the results of this initial analysis? We have an insurance consolidator which has a reasonably long history of successfully acquiring and squeezing value and cash out of closed insurance and pension books. We have a dividend which has grown every year since the company floated 14 years ago, at an annual rate of about 3% over the last decade. We also have a self-fundable growth rate of 4%, total asset growth of about 5% per year and capital employed growth of about 7%, fuelled partly by additional funds from rights issues.

Chesnara's dividend yield is currently just over 6%. If the company can continue to find attractive acquisitions and continue to write profitable new insurance and pension business, it may be able to sustain its historic levels of profitability and its mid-single digit growth rate. If it can do that, then a dividend yield of 6% plus dividend growth of 4% means that expected returns could be in the region of 10% per year, using the yield plus growth method of estimating potential returns.

Of course, there are no guarantees and the future is a very uncertain place, but I like Chesnara, and I like its valuation and yield. That's why I'm a shareholder. This certainly isn't a very exciting investment, but if you're looking for a decent yield today and the potential for steady dividend growth tomorrow, Chesnara could be worth a closer look.

### About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

John is also the author of *The Defensive Value Investor: A Complete Step-By-Step Guide to Building a High Yield, Low Risk Share Portfolio*.

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