BY JOHN KINGHAM

THE DIVIDEND HUNTER

HOW I FIND LONG-TERM DIVIDEND GROWTH STOCKS

One major difference between investors who focus primarily on dividends and investors who focus primarily on capital gains is their time horizon. Companies that pay dividends usually do so every six months, so a dividend investor who buys into a company will often have to wait several months before their first dividend appears. Capital gains, on the other hand, occur almost every second of the trading day (as do capital losses). So the time horizon for dividend investors should almost always be measured in months and years rather than days or weeks.

This fact should have a profound impact on the way dividend investors select which companies to buy. From a personal point of view, when I buy shares it is very likely that I'll be holding onto those shares for several years, and potentially as much as ten years or longer. So I am of course very interested in whether that company is likely to sustain and grow its dividend over that sort of time frame. For me the best way to build up a picture of what a company might achieve over the next ten years is to look back at what it has achieved over the past ten years.

Looking back over the last ten years

Thanks to the internet it is very easy these days to get hold of a company's annual reports and financial results for the past ten years. Here are a few of my favourite sources:

ShareScope/SharePad (www.sharescope.co.uk): This is where I get most of my data from as it's very easy to export the numbers to a spreadsheet for further analysis. It's a paid service, but for portfolios north of £30,000 or so I think the benefits can outweigh the costs.

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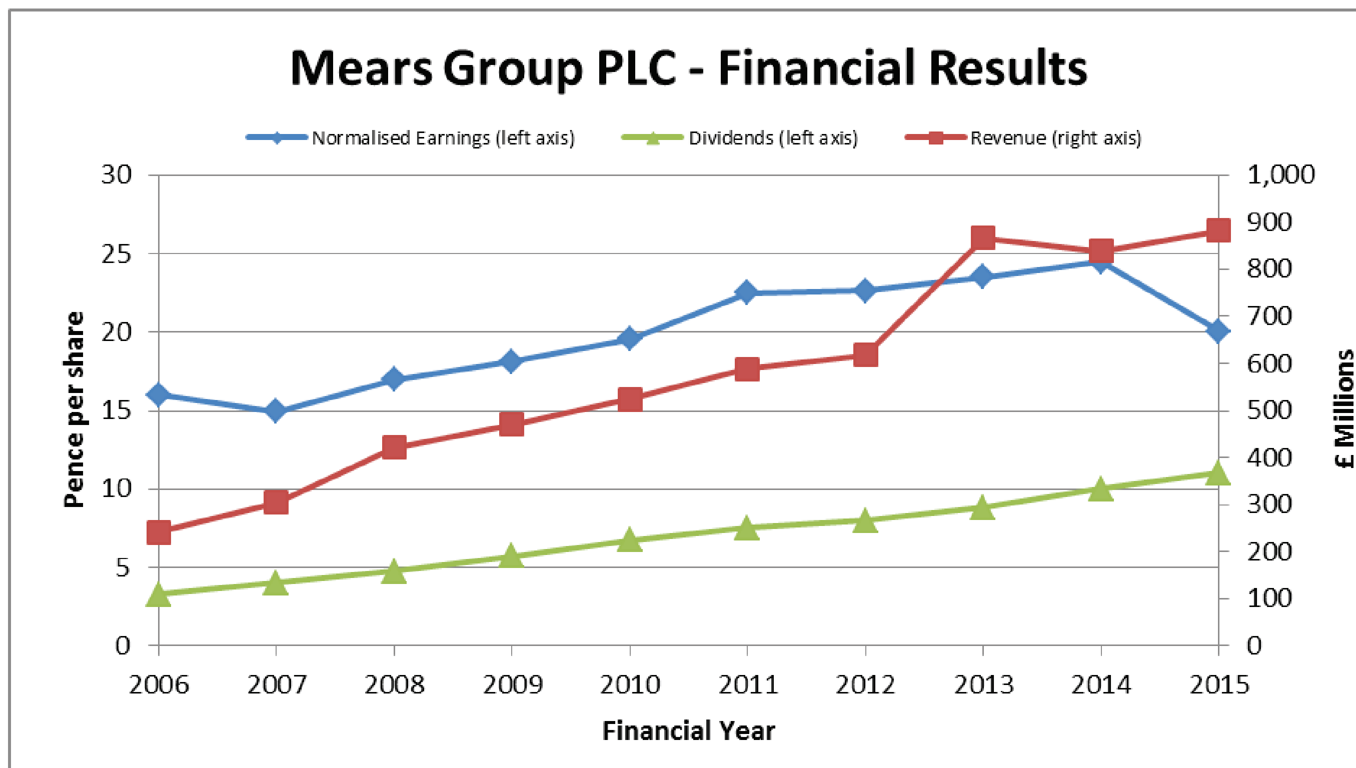
Morningstar Premium (www.morningstar.co.uk): Although I don't use this paid service anymore, I did for a couple of years and it's another easy way to access data going back ten years. You can also read company reviews by Morningstar analysts, which I found helpful in terms of seeing someone else's point of view.

Sharelockholmes (www.sharelockholmes.com): This is a great low-cost way to get ten years of financial data. It's cheap and looks basic, but it does the job nicely.

FE Investegate (www.investegate.co.uk): With this free website you can search through all regulatory announcements (including annual and interim results) from a company going back ten years or more. It's a labour-intensive way to get the data, but it's a great way to find out what a company's been up to over the last decade or more.

Company investor websites: Most companies today have fairly comprehensive investor websites with links to annual and interim reports going back many years, as well as other documents and presentations. This is where I typically go to build up a picture of what a company does today and how it got there.



> **"I'M WILLING TO INVEST IN A COMPANY THAT HAS CUT ITS DIVIDEND IN THE PAST, BUT ONLY IF THE REST OF THE INVESTMENT CASE STACKS UP."**

This desire to look back over ten years means that any company I invest in must actually have a ten-year track record as a listed company. This immediately rules out IPOs, even of large and supposedly defensive companies like **Royal Mail (LON:RMG)**. However, if a company has the required ten-year track record then it's time to get serious and start kicking the tyres.

This month I'll be kicking the tyres of **Mears Group (LON:MER)**, a leading provider of repair and maintenance services for housing associations and other groups in the UK. You can see Mears' financial results over the last decade in the attached chart. It has the sort of consistent record of growth that most dividend investors are looking for, but we can be much more specific than that.

Dividend growth begins with dividends and profits

A company cannot grow its dividend if it isn't paying a dividend, so I want to invest in companies that will, at the very least, continue to pay a dividend over many, many years. I think the best way to find those companies is to look for those that have already achieved it in the past. So my first investment rule is this:

Rule #1: Only invest in a company if it paid a dividend in every one of the last ten years.

Note that I'm looking to avoid companies that failed to pay a dividend for a whole financial year, i.e. the dividend for a given year is zero. So this rule would not exclude BP for example, which suspended its dividend for a short period in 2010 but still managed to pay a final dividend for that year.

Some investors would go a step further and exclude any company that cut its dividend in the last ten years, but that isn't something I do. That's partly because I wouldn't want to exclude companies that report dividends in foreign currencies, which can cause the dividend to decline in Sterling terms even though it was held or even raised in the reporting currency. I also think it's a bit too restrictive, so generally I'm willing to invest in a company that has cut its dividend in the past, but only if the rest of the investment case stacks up.

In the case of Mears, it has indeed paid a dividend in every one of the last ten years and so it sails through this test with ease. But of course, dividends don't exist in isolation. They are paid out of profits and so profits are the next thing on my checklist.

From an accounting point of view, a company's total cumulative dividend payments should not be more than total cumulative profits, so it's important for dividend sustainability that profits are greater than dividend payments. This may or may not be the case in any one year, but over the longer term it definitely should be true.

However, unlike dividends I don't insist on an unbroken record of profits over the last ten years. Even very good companies can make the occasional loss and so I'm willing to invest even if there

were perhaps one or two loss-making years out of the last ten.

My second investment rule is:

Rule #2: Only invest in a company if its ten-year dividend cover is greater than one.

Ten-year dividend cover is simply the ratio of total profits to total dividends over ten years, or more specifically the ratio of total earnings per share to total dividends per share. Also, in order to get a better picture of how the core business is doing, I use normalised or adjusted earnings which remove any "exceptional" income or expense items.

Looking again at Mears, it generated total earnings of 199p per share over the past ten years and paid out 70p in dividends. That gives it a ten-year dividend cover of 2.8, which is obviously well above one.

With those two basic checks in the bag we can now begin to look at measuring long-term dividend growth.

Looking for inflation-beating dividend growth

At a minimum, I want a company to be growing at least as fast as inflation; not just this year but over the long term. So my third investment rule is:

Rule #3: Only invest in a company if its growth rate is above 2%

I use 2% as the cut-off as that's the Bank of England's inflation target. If inflation over the period was markedly different to 2% then I might use CPI inflation as the benchmark instead.

There are lots of different ways to measure long-term growth, but the method I've settled on is one borrowed from Benjamin Graham, the father of value investing. Graham suggested measuring growth between one three-year period (e.g. 2006-2008) and another (e.g. 2014-2016), because this reduces the importance of any one year.

Turning back to Mears again, in the 2006-2008 period it paid annual dividends of 3.3p, 4.0p and 4.75p, giving that period an average dividend of just over 4.0p. In the 2013-2015 period it paid dividends of 8.8p, 10p and 11p, giving that period an average dividend of 9.9p. Growth in the dividend between those two periods was therefore 147%. Since there are seven years between those two three-year periods you can get the annual growth rate by raising 147% to the power 1/7, which gives an annual dividend growth rate of 13.8%. With a long-term dividend growth rate of 13.8%, Mears definitely has a faster dividend growth rate than my 2% target.

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As I've already mentioned though, dividends don't exist in isolation. If a company's dividend increases are not accompanied by increases in profits, then at some point the dividend will not be affordable. In the same way, if dividends and profits are increasing but revenues are not, then profit margins must be increasing. But profit margins can only go so high which means that revenue growth is necessary if dividend growth is to be sustainable over the longer-term. As a result I like to measure growth across revenues and earnings per share in addition to dividends per share, using the approach I've just outlined.

For Mears, we have 2006-2008 average revenues of £322m versus 2013-2015 average revenues of £862m. That gives a total for revenue growth of 168% and a revenue growth rate of 15.1%. In terms of normalised earnings we have 2006-2008 average EPS of 16.0p and 2013-2015 average EPS of 22.7p. That gives total EPS growth of 42% and an EPS growth rate of 5.1%. I calculate a company's "overall" growth as the average of its revenue, earnings and dividend growth. In this case that's the average of 147%, 168% and 42%, which is 119%, and the annual growth rate associated with that overall growth is 11.8%.

So Mears has an overall ten-year growth rate of 11.8%, and that's well above my 2% target and also well above the average for FTSE 350 companies.

Looking for consistent dividend growth
Ideally I'd like to see a company's divi-

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dend going up every year rather than one which stays flat year after year and is only occasionally bumped upwards. Put another way, I like to see consistent or high-quality growth.

My measure for dividend growth quality is simple: I just count how often a company's dividend went up over the last ten years. In ten years there are nine opportunities to raise the dividend, so a score of nine out of ten (or 100% in other words) is what I'm after. However, I realise that raising the dividend every year is not always possible, so I'm willing to settle for less, but only to a degree. I would also like to see revenues and profits going up every year. Of course, very few companies can actually manage this over a ten-year period, so again I'm willing to be flexible. My rule for this is:

Rule #4: Only invest in a company if its growth quality score is above 50%

In the case of Mears we have dividends per share which increased nine times out of nine, earnings per share seven times and revenues eight times. That's a total of 24 out of a possible 27 increases, or 89% of the maximum. A growth quality score of 89% marks Mears out as a company with highly consistent results over many years, which you can get a good feel for by looking at its results chart.

So there we have four rules, each of which is designed to be an easy way to exclude companies that can't easily be described as generating "consistent, long-term, profitable dividend growth". Of course calculating these metrics by hand would be somewhat boring, but they're very easy to automate with a spreadsheet. Personally I just dump the financial data from SharePad into my spreadsheet (which is available on my website) and it immediately tells me whether a particular company passes each of these rules, or not.

There are still lots of other factors to take into consideration, but next to profitability and debt levels I think a long track record of relatively consistent profits, dividends and growth is more important than anything else.

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*.

His website can be found at: www.ukvalueinvestor.com.