Barratt & Cooke

INVESTING SINCE 1880

# Dividend growth stemming from corporate success

# Introduction

A core principle of Barratt & Cooke's investment philosophy is investment into high quality businesses. Those with strong profitability, sensible balance sheets and highly competent management teams. Often this can manifest itself with investments in companies which we anticipate will be in a position to pay a rising stream of dividends long into the future, stemming from the strength of the underlying company fundamentals. With this in mind, we produce a report to analyse the dividend progress for the companies in which our clients are invested.

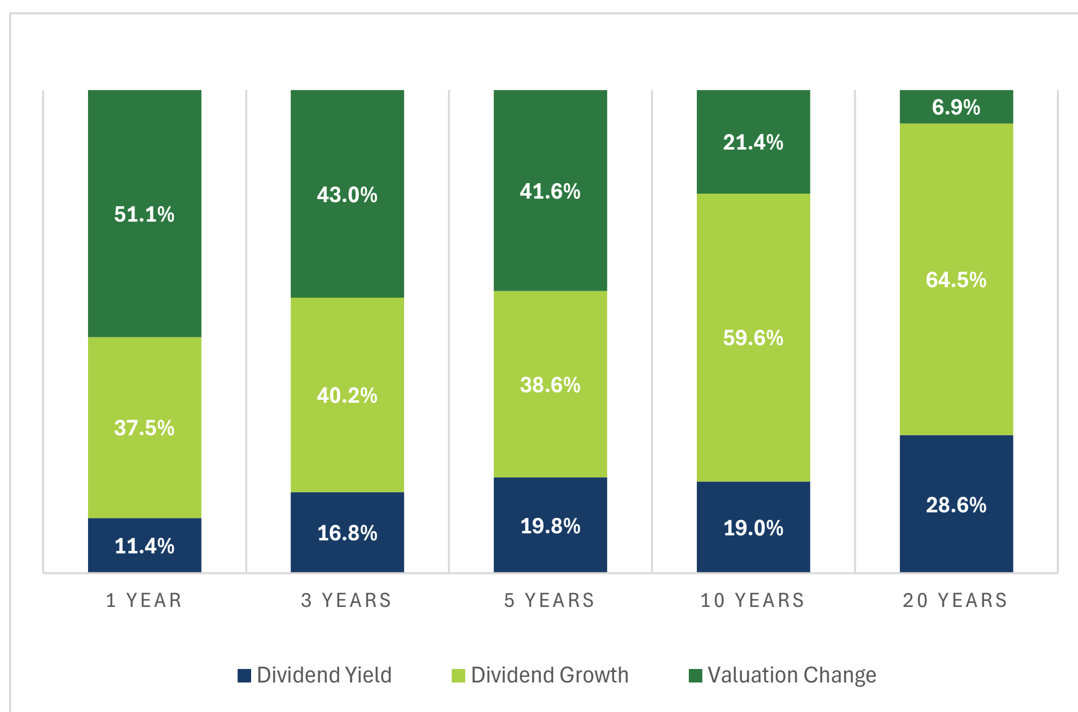
Dividends represent the distribution of a proportion of a company's profits to shareholders, one of the key means by which an equity investor stands to make a return on their investment (the other being capital gain associated with a rising share price).

With dividend returns typically being less volatile than share price returns, a focus on dividend paying stocks can help mitigate some of the volatility associated with investing. Indeed, dividends have formed a key component of investors' returns over the long term, not least when this cash flow is reinvested, compounding portfolio returns and benefitting from what Einstein dubbed the 'eighth wonder of the world'.

# Because where dividends lead, share prices often follow

Companies with growth ambitions typically pay out only a proportion of their profits by way of dividends (known as the 'payout ratio'), with the balance typically reinvested back into the business. By retaining earnings, the company helps to support future growth in profits and, with it, the potential for a higher dividend in the future, helping to drive what can be a virtuous cycle of dividend growth.

To put the importance of dividend growth into greater context, consider the results of a study conducted by MSCI looking at global equity returns between 1994 and 2015. This 'deconstructed' shareholder returns into dividend yield, dividend growth and valuation changes. As can be seen, over the long term, it is the growth in a company's dividend that is the predominant driver of shareholder returns (accounting for roughly 60% of returns over a 10-year period in the case of MSCI's study).




*Source: MSCI*

# Dividend yield vs. dividend growth – the hare and the tortoise

It is important to differentiate between a company for which the dividend yield is high, to that of a company that pays a steadily and consistently increasing dividend over time. The dividend yield on an investment is the dividend per share divided by the share price. A high yield can therefore reflect a high dividend and/or a low share price, the latter which perhaps reflects modest (or worse) future growth prospects.

When looking at overall company prosects, we focus on companies likely to engage in dividend growth over the medium term; this does not necessarily mean a high dividend yield at the outset.

Consider the classic analogy of the hare and the tortoise. Hare Plc is a company with a high dividend yield, paying out all of its profits to shareholders. Tortoise Plc is a company with a lower dividend yield, reinvesting part of its profits back into the business to help drive future growth. As the data below demonstrates, the steady compounding progress in dividend delivered by Tortoise Plc can result in a race-winning performance.

Say that Hare Plc pays a flat dividend of 5p each year (i.e. yielding 5% on a 100p starting share price), whilst Tortoise Plc pays a lower dividend of 2p (i.e. yielding 2% on a 100p starting share price) but with the dividend growing at 10% year.

After 10 years, Hare Plc will have paid 50p of dividends, whilst Tortoise Plc will have paid 31.8p of dividends. Hare Plc looks to be winning the race, but this is just one side of the story.

If one assumes that the shares remain on dividend yields of 5% and 2% respectively, then after 10 years the share price of Hare plc would still be 100p i.e. unchanged after 10 years, whilst Tortoise plc share price would have risen to 235p.

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After 10 years, investors in Hare Plc will therefore have earned total returns of 50p on their 100p investment, whilst investors in Tortoise Plc will have earned total returns of 166.8p on their 100p investment (31.8p from dividends, 135p from capital growth).

Tortoise Plc is undoubtedly the victor in this example and, as can be seen, it can make good sense to invest into lower yielding equities with stronger dividend growth prospects.

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# Recent dividend progress

In order to demonstrate the progress of the companies in which our clients are invested, we have analysed, and document below, the recent growth in dividends that they have reported in their most recent full year results.

We have included dividend data on all companies within our research coverage which we have a 'buy' or 'hold' rating on, which pay a dividend, and for which our clients (in aggregate) have material shareholdings.

Of the 57 companies that fall into the aforementioned universe, we list below the number of companies which:

- Grew their dividend by over 20% 5
- Grew their dividend by 10-20% 19
- Grew their dividend by 5-10% 10
- Grew their dividend by 0-5% 16
- Held their dividend 2
- Reduced their dividend 5

At a time of elevated inflation, a very reassuring 50 (or 88%) out of the 57 companies reported an increase in their dividend in the period.

Furthermore, of the 50 companies that reported an increase in their dividend in the period, the average increase was a very encouraging 10.9%.

We provide high level comments on the six cohorts of companies below:

## Those companies which grew their dividend by over 20%

These were Atlas Copco, Fastenal, L'Oreal, Novo Nordisk and Shell.

Of particular note in this cohort is *Novo Nordisk* (which increased its dividend by 52%). A long-standing industry leader in the treatment of diabetes, Novo Nordisk is now also benefitting from the seemingly inexorable demand for their newer anti-obesity treatment, Wegovy. This step-change in operational performance has driven extraordinary dividend and share price returns. Alongside a sharply rising dividend, the company continues to reinvest in the business to help meet the significant demand for its products (which currently outstrips supply).

## Those companies which grew their dividend by 10-20%

These were ASML, Automatic Data Processing, BP, Bytes, CME, Intercontinental Hotels, Lonza, Mastercard, Microsoft, MSCI, National Grid, Nike, Otis, PepsiCo, Rentokil Initial, Spirax-Sarco, Verisk Analytics, Visa and Wolters Kluwer.

Of particular note in this cohort are *Mastercard* & *Visa* (which increased their dividends by 16% and 18% respectively). These payment processing companies have continued their excellent track records. As the two industry leaders, with modest external competition, these companies enjoy high profit margins and strong cash generation. As businesses which do not need to invest significantly in capital (e.g. machinery, property etc.), they are able to pay rising dividends whilst also buying back their own shares (a popular approach in the US in particular). Their dividends have increased by more than 15% a year for the last five years, approximately doubling since the onset of the pandemic.

## Those companies which grew their dividend by 5-10%

These were Bunzl, Coloplast, Diploma, Halma, London Stock Exchange, Nestle, Reckitt Benckiser, RELX, Schneider Electric and Xylem.

Of particular note in this cohort is *RELX* (which increased its dividend by 9%). With a research database that is only accessible to those professionals and businesses that pay to access it, RELX enables its subscribers to make more informed decisions. This data set is becoming an increasingly valuable resource, not least with the ability to gain greater insights aided by Artificial Intelligence (AI), which ensures excellent customer loyalty and provides the company with strong pricing power. Since 2014, RELX has grown its dividend by more than 9% a year, meaning the dividend has more than doubled in the period.

## Those companies which grew their dividend by 0-5%

These were Becton Dickinson, Church & Dwight, Colgate Palmolive, Croda, Diageo, Estee Lauder, Experian, Intertek, LondonMetric Property, LVMH, Novartis, Phoenix Group, Procter & Gamble, Roche, Softcat and Unilever.

Of particular note in this cohort is *Croda* (which increased its dividend by 4%). Whilst Croda is not a household name, its specialty ingredients form an important component of skin and health care products, with customers including the likes of L'Oreal and Unilever. The company has grown its dividend every year since listing in 1990. Whilst we subscribe to the view that share prices typically follow dividends over the long term, the outcome can of course differ in the short term (e.g. a company's share price rising as its dividend is cut or, in Croda's case in the recent period, a company's share price falling whilst its dividend is increased). Croda's sales and profits have been impacted as their customers run down inventories of Croda's ingredients. However, the Board remain confident in the longer-term prospects of the company (as we do), hence furthering the impressive dividend growth record, demonstrating the importance of retaining previous years' cash flows and ballast for tougher times (as outlined above in the case of Hare plc and Tortoise plc).

## Those companies which held their dividend

These were AstraZeneca and Liontrust Asset Management.

Of particular note in this cohort is *AstraZeneca* (which held its dividend in the period). AstraZeneca is currently one of the fastest growing global pharmaceutical companies with both revenue and operating profit increasing by 15% in 2023. Alongside an attractive dividend, the company has significantly increased Research and Development in recent years, with a particular focus on their portfolio of Oncology drugs, whilst also making tactical acquisitions of smaller pharmaceutical and biotechnology companies. As a result, AstraZeneca now enjoys a strong pipeline of innovative medicines, which we are confident will position the company well to deliver attractive dividend growth over the longer term.

## Those companies which reduced their dividend

These were Admiral, Anglo American, Persimmon, Rio Tinto and SSE.

Of particular note in this cohort are the mining companies, *Anglo American* and *Rio Tinto*. Mining companies typically adopt a policy of paying out a fixed percentage of profits from year to year, as opposed to seeking to deliver a progressive dividend from year to year. Given the volatility in commodity prices (and therefore mining company profitability), we endorse this approach, albeit acknowledging that this will lead to volatility in dividends from year to year. As commodity prices have fallen over the last 18 months, so have the profits and therefore dividends of Anglo American and Rio Tinto. As and when

economic momentum reaccelerates, we would anticipate commodity prices increasing and thus the dividends paid by the mining shares to increase accordingly.

# Dividend heroes

We detail below those companies in our research coverage which enjoy a dividend track record of more than 20 consecutive years of dividend growth, demonstrating their high-quality nature and resilience throughout economic cycles.

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|---|---|---|
| Becton Dickinson | Diploma | Novo-Nordisk |
| Church & Dwight | Halma | PepsiCo |
| Colgate-Palmolive | Intertek | Procter & Gamble |
| Coloplast | Nestle | RELX |
| Croda | Nike | Roche |
| Diageo | Novartis | Spirax-Sarco |

The dividend growth that many of these companies have delivered over the past 10 years has been excellent, but when putting into the context of the difference between the yield on value (i.e. the current dividend as a function of the current share price) and the yield on cost (i.e. the current dividend as a function of the 'starting' share price, had you invested 10 years ago) the 'yields' become rather exceptional.

For example, if you had purchased RELX (Reed Elsevier) 10 years ago:

- Price (31/03/2014): 916p
- Dividend (for the year ending 31/03/2014): 23.65p
- Yield on purchase: 2.6%

Over the subsequent 10 years, RELX has delivered fantastic operational, share price and dividend performance:

- Price (31/03/2024): 3424p
- Dividend (for the year ending 31/03/2024): 55.9p
- Current yield: 1.6%

The current yield is unexciting, reflecting the fact that the share price has risen by 270% vs the dividend growth of 136% over the period.

However, if we consider the dividend 'today' (of 55.9p) against the original acquisition price (of 916p), the dividend yield on cost is an impressive 6.1% (55.9p/916p).

# High yielders – jam today

Whilst we have set out a justification for placing a focus on dividend growth as opposed to dividend yield, not all investors are in the position to take a long-term view with income, instead requiring 'jam today'. Where appropriate, we will therefore incorporate higher yielding shareholdings within our clients' portfolios, for which growth prospects are typically lower (both in terms of dividend and capital), but satisfying an important requirement for income 'now'.

One such example is the Phoenix Group, for which the dividend yield is a lofty 11%. Phoenix is the UK's largest long-term savings and retirement business, with c.13 million customers and over £300 billion of assets under administration. We have regular dialogue with the company management team and share their confidence in the company's ability to continue to generate significant cash flow and, with it, to continue to pay a very attractive dividend.

# Dividend traps

As we have noted earlier in this report, with the dividend yield being a function of the share price, a high dividend yield can simply reflect a depressed share price, perhaps implying poor prospects for dividend or capital growth, or worse perhaps a dividend at risk of being cut. A dividend 'trap' therefore explains the situation where an investor makes an investment into a high yielding share, only to find that the dividend is subsequently cut or cancelled (and the yield therefore falls, perhaps the share price too).

Ensuring that you have good confidence in the likely sustainability of the dividend is therefore key when investing into a high yielding share. This is why, in the aforementioned example of the Phoenix Group, we place a particularly high premium on analysing the business and engaging with management, putting ourselves in as strong a position as possible to mitigate the risk of dividend cuts.

There are plenty of examples of high-profile companies, in the UK and overseas, where high dividend yields have been a precursor to slashed dividends. One such example is Vodafone Group, the UK-listed telecommunications company. Intense competition and costly debt has undermined Vodafone's financial resilience in recent years and, with it, it's ability to maintain dividend payments. Indeed, in 2013, a point at which Vodafone was the second largest company listed in the UK (by market capitalisation), and one of the highest dividend paying companies, Vodafone paid a dividend totalling €0.2269 per share (adjusting for subsequent capital changes), whereas in 2023 this was €0.09 per share, a cut of 60%. Over the past 10 years (to 31st March 2024), the Vodafone share price has fallen by 68%.

# Non-dividend payers – the elephant in the room?

Given our typical preference for investing into companies which stand to deliver growth in their dividends long into the future, why do we make investments into companies not paying dividends at all?

Typically, younger, less mature companies will decide to retain profits and cash to reinvest into the business. This might be because the markets they are operating in are developing quickly and the benefit of first mover advantage can be significant, hence the opportunity cost of paying a dividend is higher. Once these businesses become more established, in what are typically increasingly mature markets, the management teams may then look to reward shareholders via dividends.

As an example, Microsoft listed on the stock exchange in 1986, but only started paying a dividend in 2003 (of 32 cents per share). During this period, Microsoft shareholders enjoyed extraordinary growth in their capital, but no dividend. Quite incredibly, since first paying a dividend in 2003, the dividend has increased by almost 10 times (to 300 cents per share), with the share price rising even more sharply.

We will therefore invest into companies before they have embarked on paying dividends. However, typically this is into companies for which dividends could be payable in the future due to strong company fundamentals and underlying cashflow generation.

# Conclusion

We are encouraged to report that over 85% of the dividend-paying companies in which our clients are materially invested (in aggregate) have delivered dividend growth in the period in question. Furthermore, of those companies increasing their dividends, the average rise was an impressive 10.9%. This outcome reflects the strength (in aggregate) of the underlying growth in revenues, profits and cashflows of the companies in question.

It is noteworthy that this growth has been achieved during a period of significant uncertainty, with historically high levels of inflation, rising interest rates, ongoing conflicts and broader geo-political volatility.

Of course, in the short term, growth in dividends does not necessarily lead to higher share prices. Indeed, there are plenty of examples of companies listed above whose shares in fact fell during the period, despite impressive dividend growth. However, if a company can grow its dividend in a sustainable manner over the long term, it is likely that the share price will follow, where it is company fundamentals that determine how shareholders are rewarded.

If you have any questions regarding the information contained in this report, please contact your Investment Manager at Barratt & Cooke.

Authored by Edward Sidgwick & Harry Dodds

## Important information

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- Has been prepared for use by Retail Clients (as defined by the FCA).
- When considered in isolation, has no regard for the specific investment objectives, financial situation or needs of any specific investor.
- Is for information only and does not constitute an offer to provide services or to purchase or sell investments or related financial instruments.

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