

## AlphaScreens: finding dividend diamonds

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### Watch out for valuation risk in income portfolios

*Building a portfolio for income is a balance between selecting reliable dividend payers, diversifying the risk of cyclical cuts to dividends per share, spotting value traps and including some companies that are maturing and committing to growing their dividend.*

We have a more relaxed way of screening for income among large-cap shares compared with the rest of the UK equities universe. At the upper end of the size scale, there are just two compulsory tests: the trailing 12-month dividend yield must be above 3 per cent; and the current year forecast dividend per share must imply a yield of above 3.5 per cent on the price.

All the other tests give guidance on where risks might materialise. Of these, the test that year-on-year dividend growth rate shouldn't have fallen in the past five years ought to have been compulsory, too. Covid-19 and the extraordinary dividend cuts that occurred mean that enforcing this rule would result in throwing a few babies out with the bath water, so the requirement is relaxed.

Still, the no cuts to dividend test is one of the first to look at – if companies do fail it, investors should be asking themselves whether the instability in the payout was exceptional and due to Covid, or if there is some underlying cyclical frailty. In answering that question it is useful to pay attention to the other tests that a company fails.

For example, pharmaceutical company **GSK (GSK)** has consistently had detractors when it comes to strategy. The spin-off of consumer goods division **Haleon (HLN)** allows GSK to focus more on core activities but the low forecast dividend per share growth is testament to investment in a new growth strategy being a competing call on the company's free cash flow. However, the strong dividend cover (12-month trailing earnings per share is 5.9 times 12-month trailing dividend per share), suggests this will continue to be a safe dividend payer.

Since we last ran this screen, private equity (PE) and infrastructure-focused investment company **3i Group (III)** no longer makes the cut, due to its forecast DPS now being below the threshold. Its portfolio is arguably more resilient than many PE businesses in the face of less liquid financial markets, but the scope for dividend growth is constrained in the tighter environment. A 29 per cent rise in the share price over the past three months now makes the company less attractively valued relative to the outlook for the payout.

Other companies such as advertising group **WPP (WPP)** are especially vulnerable to economic cycles, so would never be the most intuitive choice for a buy-and-hold income investor. In general, though, the tests commonly failed on the large-cap screen relate to the outlook for earnings and dividend growth. Some businesses may be able to protect (if not grow) their dividend, so the decision on whether to buy or top up on their shares will also come down to valuation. However, if the payouts aren't going to grow, then the strong rally in UK share prices is making those valuations less attractive – especially when considered relative to a 10-year gilt yield of around 3.5 per cent.

Screen results tables are below

### Alpha UK large-cap dividends

Name	Ticker	Share price (p)	Mkt cap (£mn)	Fwd 12-mth PE	Trailing 12-mth DY	Median NTM Fwd DY	Fwd EPS grwth cur.FY	Fwd EPS grwth next FY	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 11)
GSK	GSK	1457	59651	9.9	4.2%	3.9%	34.3%	6.5%	8%	-14933.0	8
Smurfit Kappa	SKG	3269	8468	10.9	3.8%	3.9%	-23.1%	-1.1%	3%	-1955.5	8
Shell	SHEL	2579	179233	6.7	3.3%	3.8%	-11.6%	-7.0%	9%	-66231.6	7
Rio Tinto	RIO	6037	75448	9.9	8.8%	6.3%	-25.7%	-15.7%	11%	1964.6	7
Imperial Brands	IMB	2053	19080	6.8	6.9%	7.3%	11.2%	8.6%	1%	-9289.0	7
National Grid	NG	1058	38877	14.3	4.9%	5.5%	-2.1%	7.9%	5%	-21421.0	7
Unilever	ULVR	4268	108057	18.3	3.5%	3.7%	1.5%	7.8%	6%	-17448.3	7
Tesco	TSCO	250	18307	11.9	4.6%	4.3%	-2.9%	-1.0%	10%	-11478.0	7
WPP	WPP	1004	10752	9.8	3.4%	4.0%	21.1%	6.4%	15%	-12602.5	7
Mondi	MNDI	1487	7218	11.0	3.8%	4.3%	33.7%	-20.3%	-5%	-1060.4	6
Legal & General	LGEN	258	15429	7.3	7.2%	7.9%	-0.7%	2.3%	5%	-	6
HSBC	HSBA	612	122266	7.3	3.5%	6.8%	23.4%	27.6%	28%	-	6
United Utilities	UU	1052	7170	42.2	4.2%	4.7%	-	-	4%	-447.7	6
Schroders	SDR	500	8060	14.3	4.1%	4.4%	-17.9%	3.4%	7%	-	6
Kazatomprom JSC Sponsored GDR	KAP	2543	6595	12.8	5.2%	7.7%	70.7%	26.5%	3%	-	6

Sources: FactSet, Investors' Chronicle

### UK large-cap shares, steady income tests failed summary

Company	Test failed 1	Test failed 2	Test failed 3	Test failed 4	Test failed 5
GSK	No cut to dividend	Past dps growth rate below 5%	Forecast dps growth rate		
Smurfit Kappa	No cut to dividend	Forecast eps growth rate below 5%	Forecast dps growth rate		
Shell	No cut to dividend	Forecast eps growth rate below 5%	Past dps growth rate below 5%	Forecast dps growth rate	
Rio Tinto	Forecast eps growth rate below 5%	Past dps growth rate below 5%	Past eps growth rate below 5%	Forecast dps growth rate	
Imperial Brands	No cut to dividend	Past dps growth rate below 5%	Dividend cover	Forecast dps growth rate	
National Grid	Forecast eps growth rate below 5%	Past dps growth rate below 5%	Interest cover	Forecast dps growth rate	
Unilever	No cut to dividend	Forecast eps growth rate below 5%	Past dps growth rate below 5%	Forecast dps growth rate	
Tesco	No cut to dividend	Forecast eps growth rate below 5%	Dividend cover	Interest cover	
WPP	No cut to dividend	Past dps growth rate below 5%	Past eps growth rate below 5%	Forecast dps growth rate	
Mondi	No cut to dividend	Forecast eps growth rate below 5%	Past dps growth rate below 5%	Past eps growth rate below 5%	Forecast dps growth rate
Legal & General	Forecast eps growth rate below 5%	Past dps growth rate below 5%	Past eps growth rate below 5%	Interest cover	Forecast dps growth rate
HSBC	No cut to dividend	Past dps growth rate below 5%	Past eps growth rate below 5%	Interest cover	Positive FCF
United Utilities	Forecast eps growth rate below 5%	Past dps growth rate below 5%	Past eps growth rate below 5%	Interest cover	Forecast dps growth rate
Schroders	Forecast eps growth rate below 5%	Past dps growth rate below 5%	Past eps growth rate below 5%	Interest cover	Forecast dps growth rate
Kazatomprom JSC Sponsored GDR	Past dps growth rate below 5%	Past eps growth rate below 5%	Dividend cover	Interest cover	Positive FCF

Sources: Investors' Chronicle

Continued below

All investments have idiosyncratic risks, but some are especially worth noting. The **National Atomic Company Kazatomprom (KAP)** is a global depositary receipt (GDR) (listed price is in US dollars but the price is converted to pence in our table). GDRs are issued by banks, which purchase the shares of an underlying foreign-listed business, giving GDR holders exposure to the performance of the underlying security. KAP is a play on uranium production – a commodity in high demand to meet low-carbon energy targets. However, any investor buying that big-picture narrative should also consider other geopolitical issues: Kazakhstan being sandwiched between Russia and China is a risk even before you consider underlying volatility in uranium prices and forex risk.

## Mid Cap, small cap and Aim income screen results

### Alpha UK mid-cap dividends

Name	Share Ticker	Share price (p)	Mkt cap (£mn)	Fwd 12-mth PE	Trailing 12-mth DY	Median NTM Fwd DY	Fwd EPS grwth cur. FY	Fwd EPS grwth next FY	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 11)	Tests failed
Big Yellow	BYG	1275	2349	22.6	3.4%	3.6%	7.6%	-0.4%	8%	-43.7	9	/Fwd EPS grwth/FC DPS grwth/
Intermediate Capital	ICP	1450	4212	11.7	5.7%	5.7%	-72.9%	174.5%	19%	-	9	/Fwd EPS grwth/Div Cov/
Dr. Martens	DOCS	155	1552	9.6	3.8%	3.5%	-12.1%	2.3%	-46%	73.0	8	/Trail DPS Grwth/Fwd EPS grwth/FC DPS grwth/
IG Group	IGG	810	3361	8.6	5.5%	5.7%	0.8%	1.5%	-1%	-	8	/Trail DPS Grwth/Fwd EPS grwth/FC DPS grwth/
DCC	DCC	4642	4584	9.9	3.9%	4.2%	6.3%	3.3%	3%	-2368.1	8	/Trail EPS grwth/Fwd EPS grwth/FC DPS grwth/

Sources: FactSet, Investors' Chronicle

### Alpha UK small-cap dividends

Name	Share Ticker	Share price (p)	Mkt cap (£mn)	Fwd 12-mth PE	Trailing 12-mth DY	Median NTM Fwd DY	Fwd EPS grwth cur. FY	Fwd EPS grwth next FY	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 11)	Tests failed
DWF	DWF	73	250	5.9	6.6%	8.8%	5.7%	10.6%	-5%	-101.0	11	na
Foresight Group	FSG	468	544	12.8	3.1%	4.8%	43.6%	11.9%	32%	-	9	/Trail DPS grwth/Trail EPS grwth/

Sources: FactSet, Investors' Chronicle

### Alpha UK Aim company dividends

Name	Share Ticker	Share price (p)	Mkt cap (£mn)	Fwd 12-mth PE	Trailing 12-mth DY	Median NTM Fwd DY	Fwd EPS grwth cur. FY	Fwd EPS grwth next FY	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 11)	Tests failed
iEnergizer	IBPO	412	783	11.0	6.0%	6.2%	2.4%	17.3%	-12%	13.4	10	/Div Cov/
Serica Energy	SQZ	258	703	2.2	6.6%	6.6%	291.2%	13.5%	-1.7%	-123.7	8	/Trail DPS grwth/Trail EPS grwth/FC DPS grwth/
LendInvest	LINV	84	116	8.6	6.8%	5.9%	8.6%	12.9%	2%	-	8	/Trail DPS grwth/Interest cov/FC DPS grwth/

Sources: FactSet, Investors' Chronicle

## Investors' Chronicle Alpha dividend screen methodology (11 tests)

### Compulsory

- Trailing 12-month dividend yield at least 3 per cent
- Dividend yield on forecast current year dividends per share of at least 3.5 per cent

### Other tests

- No decrease in year-on-year dividend per share growth rate in last five years
- Forecast DPS to be less than 0.8 times forecast EPS for next three years

- Forecast compound annual growth rate (CAGR) for EPS to be above 5 per cent over current unreported and next financial years, with positive growth expected in both years.
- Last three years' EPS CAGR above 5 per cent
- Last three years' DPS CAGR above 5 per cent
- Dividend cover (trailing one year EPS divided by trailing one year DPS) of at least 1.5 times.
- Interest cover (trailing one year operating profit divided by trailing one year interest expense) of at least 5 times.
- Positive free cash flow on a trailing 12-month basis.
- Forecast DPS growth between forecast for current unreported year and forecast for the next two financial years after that, above median.

## Mid-cap, small-cap and Aim companies

For mid-cap companies we exclude any companies that fail the dividend cut test. For smaller and Aim-listed companies we do the same and also make the forecast EPS growth test compulsory.

The results are more likely to be cyclical value stocks further down the market capitalisation scale.

## Screened indices

We screen an equities universe inspired by the Numis family of UK indices (although we do not copy their methodology exactly).

### Investors' Chronicle UK screening cut-offs:

Large Cap: The top 80 per cent of the UK main market's market capitalisation.

Mid cap: The next 15 per cent of UK main market capitalisation (80th to 95th percentile)

Small Cap: The bottom five per cent of the main market by capitalisation with a £35mn lower cut-off.

Aim: We cut off the Alternative market by excluding all companies below £35mn market cap.

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