

AlphaScreens: finding dividend diamonds

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Dividend yields and the Aim re-rate scenario

Dividend yields can be a sign of value or a warning when it comes to small caps, but there could be plenty of re-rate potential amongst stocks on London's junior market.

Income portfolios should be a combination of steady dividend-paying large-cap stocks and quality companies with growing earnings profiles which are likely to expand their payout in the future. For many smaller companies, however, a high dividend yield can be a red flag.

Sometimes smaller companies can over-extend themselves with too generous a pay-out, or the dividend could be the result of a one-off special payment (perhaps returning proceeds of an asset sale), so isn't sustainable. It's also possible, the company is rewarding investors at the peak of a cycle and it is due for a less lucrative time in the immediate future.

There is, however, the possibility that high dividend yields simply reflect the fact the UK's Aim market is undervalued. Certainly, the Aim All Share was a dire underperformer amongst UK indices in 2024. There is a bit of a checklist investors should run through when deciding whether an enticing dividend yield is a positive sign for a small-cap stock.

Firstly, you should look at how well the prospective dividend yield is covered by prospective earnings. Then you should look into the quality of those earnings – are they repeatable, driven by organic growth in customer numbers and sale? Digging deeper, it's important to understand how revenue is recognised – how much of sales growth is seen in rising receivables. Growth in cash from operations is a good sign and a healthy cash conversion ratio – cash from operations being more than 1:1 versus earnings before interest, taxes, depreciation and amortisation (Ebitda) – are reassurances.

Then there are the competing calls on cash other than dividends. It's important that profits easily cover the cost of interest payments on debt (as debt is senior to equity in capital structures). Then there is investment in the company's growth. Capital expenditure can mean cash will be invested back in the business rather than returned as dividends. This is actually tremendously positive if good projects are found to invest in. Some of the companies on our Aim list may be in a situation where they choose to pay out less cash in the future, the important point to consider is will that be a good long-term decision?

UK large-cap income shares (passing at least 6 out of 9* tests)

Name	Ticker	Share price (p)	Mkt cap (£mn)	Fwd PE	LTM DY	NTM DY	Fwd EPS grwth FY	Fwd EPS grwth next FY	3-mth share price mom.	LTM net cash (£mn)	Tests passed (out of 9*)
Imperial Brands	IMB	2785	23052	8.3	5.5%	5.9%	6.4%	10.7%	6%	-10384	8
Reckitt Benckiser	RKT	5134	35090	14.4	3.9%	4.2%	0.2%	8.2%	6%	-7063	8
Associated British Foods	ABF	1853	13454	9.6	3.4%	3.7%	-6.1%	10.9%	-13%	-2011	7
SSE	SSE	1524	16860	9.4	4.0%	4.5%	0.6%	1.8%	-9%	-4185	7
Shell	SHEL	2634	158807	9.2	4.1%	4.3%	-6.6%	8.9%	5%	-44653	7
Intertek	ITRK	4886	7886	18.1	3.2%	3.6%	10.0%	9.7%	2%	-707	7
Severn Trent	SVT	2462	7391	15.7	4.8%	5.1%	27.2%	58.3%	-6%	238	7
Centrica	CNA	145	7270	9.4	3.1%	3.9%	-17.1%	1.9%	10%	-2564	6
Rio Tinto	RIO	4818	60416	9.4	6.4%	6.3%	-2.3%	-2.6%	-2%	-2259	6
Intermediate Capital	ICG	2068	6010	11.9	3.8%	4.5%	-14.3%	27.8%	-4%	-	6
Diageo	DGE	2066	45961	15.8	3.9%	3.9%	-10.5%	6.1%	-21%	-6767	6
Tesco	TSCO	339	22851	11.6	3.7%	4.4%	13.9%	9.5%	-9%	-16631	6
Unilever	ULVR	4540	114150	16.9	3.3%	3.5%	6.8%	6.4%	-3%	-14691	6
United Utilities	UU	992	6766	11.2	5.1%	5.4%	49.3%	82.1%	-8%	544	6
NatWest	NWG	441	35539	7.7	4.9%	6.5%	5.4%	11.9%	9%	-	5
HSBC Holdings	HSBA	870	154565	8.5	5.9%	6.1%	-2.9%	6.1%	14%	-	5
Lloyds	LLOY	70	42144	8.9	4.6%	5.2%	17.5%	28.8%	26%	-	5
Admiral	ADM	3022	9257	13.5	6.4%	6.7%	2.5%	5.4%	14%	-	5
Aviva	AV	548	14663	10.1	6.5%	7.0%	10.5%	12.2%	15%	-	5

*Banks and insurers must pass 4 out of 7 tests on the large-cap screen
Source: FactSet and Investors' Chronicle

UK large-cap tests failed

Name	Ticker	Tests failed
Imperial Brands	IMB	/Cash conv/
Reckitt Benckiser	RKT	/Div cover/
Associated British Foods	ABF	/EPS growth/Beta< 0.9/
SSE	SSE	/Div Cut/Beta< 0.9/
Shell	SHEL	/EPS growth/ROE >12.5%/
Intertek	ITRK	/Div cover/Beta< 0.9/
Severn Trent	SVT	/Div cover/Interest cover/
Centrica	CNA	/EPS growth/Cash conv/Beta< 0.9/
Rio Tinto	RIO	/Div Cut/EPS growth/Beta< 0.9/
Intermediate Capital	ICG	/EPS growth/Cash conv/Beta< 0.9/
Diageo	DGE	/Div Cut/EPS growth/Cash conv/
Tesco	TSCO	/Div cover/Interest cover/ROE >12.5%/
Unilever	ULVR	/Div Cut/Div cover/Cash conv/
United Utilities	UU	/Div cover/Interest cover/ROE >12.5%/
NatWest	NWG	/Div Cut/ROE >12.5%/Beta< 0.9/
HSBC Holdings	HSBA	/EPS growth/ROE >12.5%/Beta< 0.9/
Lloyds	LLOY	/ROE >12.5%/Beta< 0.9/
Admiral	ADM	/Div Cut/Div cover/Beta< 0.9/
Aviva	AV	/Div cover/ROE >12.5%/Beta< 0.9/

*Banks and insurers must pass 4 out of 7 tests on the large-cap screen

Mid and small-cap high dividend yield shares below

UK mid-cap income shares (passing at least 7 out of 9 tests)

Name	Ticker	Share price (p)	Mkt cap (£mn)	Fwd PE	LTM DY	NTM DY	Fwd EPS grwth FY	Fwd EPS grwth next FY	3-yr EPS CAGR	3-mth share price mom.	LTM net cash (£mn)	Tests passed (out of 9)	Tests failed
Galliford Try	GFRD	346	352	11.3	4.9%	4.8%	10.2%	6.0%	72.9%	-6%	-387	8	/Beta< 0.9/
Mears Group	MER	384	338	10.1	3.7%	4.2%	54.0%	-18.8%	-	6%	-169	8	/EPS growth/
MITIE Group	MTO	114	1434	9.3	3.8%	3.9%	-2.7%	12.2%	-	2%	-1080	8	/EPS growth/
Morgan Sindall	MGNS	2985	1433	10.9	4.4%	4.5%	-2.8%	3.3%	9.8%	-22%	-856	8	/EPS growth/
ME Group Int.	MEGP	193	728	12.1	4.1%	4.6%	8.0%	9.3%	35.8%	-10%	1	8	/Beta< 0.9/
Drax	DRX	567	2059	5.6	4.6%	5.1%	-14.7%	-38.5%	90.1%	-12%	-1179	7	/EPS growth/Beta< 0.9/
Keller	KLR	1408	1028	6.9	3.5%	3.7%	0.9%	4.6%	36.2%	-7%	-547	7	/EPS growth/Beta< 0.9/
Plus500	PLUS	2710	1980	9.3	6.4%	3.0%	4.8%	8.1%	7.9%	3%	-	7	/fc DY< 3.5/EPS growth/
Wilmington	WIL	353	318	15.0	3.2%	3.4%	-2.1%	10.0%	-	-11%	-21	7	/fc DY< 3.5/EPS growth/
IG Group	IGG	951	3340	8.7	4.9%	5.1%	32.7%	6.0%	-7.6%	-2%	-	7	/EPS growth/Beta< 0.9/
Greggs	GRG	1850	1892	13.4	3.7%	3.7%	-0.5%	3.0%	9.2%	-35%	-185	7	/EPS growth/Beta< 0.9/
XPS Pensions	XPS	366	763	17.7	2.9%	3.3%	28.5%	7.2%	81.5%	4%	-	7	/fc DY< 3.5/Beta< 0.9/
Clarkson	CKN	3635	1119	13.7	3.0%	3.1%	-7.5%	4.4%	18.8%	-10%	135	7	/fc DY< 3.5/EPS growth/

Source: FactSet and Investors' Chronicle

UK small-cap DY shares (passing at least 8 out of 10 tests)

Name	Ticker	Share price (p)	Mkt cap (£mn)	Fwd PE	DY	NTM DY	Fwd EPS grwth FY	Fwd EPS grwth next FY	3-yr EPS CAGR	3-mth share price mom.	LTM net cash (£mn)	Tests passed (out of 10)	Tests failed
Ultimate Products	ULTP	78	68	6.9	9.5%	7.2%	-23.0%	29.4%	9.3%	-35%	-51	8	/EPS growth/Cash conv/
Castings	CGS	263	114	15.6	7.0%	7.1%	-74.3%	74.9%	59.4%	2%	-11	8	/EPS growth/ROE >12.5%/
Stelrad	SRAD	133	169	9.0	5.9%	5.9%	11.3%	10.4%	4.1%	-5%	-54	8	/Cash conv/Interest cover/

Source: FactSet and Investors' Chronicle

Aim-listed DY shares (passing at least 8 out of 10 tests)

Name	Ticker	Share price (p)	Mkt cap (£mn)	Fwd PE	DY	NTM DY	Fwd EPS grwth FY	Fwd EPS grwth next FY	3-yr EPS CAGR	3-mth share price mom.	LTM net cash (£mn)	Tests passed (out of 10)	Tests failed
Nexteq	NXQ	68	41	17.4	4.9%	5.3%	-59.2%	-33.6%	-	4%	15	9	/EPS growth/
M.P. Evans	MPE	980	511	8.7	4.8%	5.2%	45.6%	0.6%	-	2%	-13	9	/EPS growth/
Johnson Service	JSG	136	565	11.1	2.9%	3.6%	17.8%	14.3%	79.7%	-5%	-102	9	/ROE >12.5%/
Tristel	TSTL	325	155	18.3	4.3%	4.7%	6.6%	12.7%	20.3%	-17%	6	9	/Div cover/
Billington Holdings	BILN	460	61	8.3	4.3%	4.6%	-21.6%	-16.2%	-	-1%	-6	8	/EPS growth/Interest cover/
Next 15	NFG	294	297	5.3	5.2%	5.3%	-14.0%	-21.3%	-	-31%	-190	8	/EPS growth/Cash conv/
Midwich	MIDW	231	241	8.2	7.1%	7.6%	-28.2%	2.2%	-	-17%	-286	8	/EPS growth/Interest cover/
Ramsdens	RFX	215	69	7.9	5.2%	5.5%	5.0%	0.8%	180.7%	-4%	-	8	/EPS growth/Cash conv/
NWF Group	NWF	174	86	8.2	4.7%	5.0%	-9.0%	27.1%	4.9%	12%	-100	8	/EPS growth/ROE >12.5%/
Character	CCT	264	49	9.0	7.2%	7.2%	-1.2%	-	-23.0%	-1%	-20	8	/Div cover/EPS growth/
Helios Underwriting	HUW	209	151	5.7	2.9%	13.8%	30.7%	40.6%	-	-12%	-	8	/Cash conv/Interest cover/
Kitwave	KITW	257	215	7.8	4.4%	4.8%	42.8%	6.9%	146.6%	-19%	-137	8	/Cash conv/Interest cover/
Personal Group	PGH	203	63	10.2	6.1%	7.9%	5.8%	30.1%	-	3%	-	8	/Div cover/Interest cover/
Knights Group	KGH	138	118	5.2	3.3%	3.8%	12.1%	12.8%	40.4%	29%	-25	8	/Interest cover/ROE >12.5%/
FRP Advisory	FRP	139	357	11.8	3.7%	4.0%	13.7%	4.7%	14.9%	-7%	-	8	/EPS growth/Cash conv/
Fonix	FNX	193	191	17.3	4.3%	5.2%	0.9%	3.7%	20.7%	-14%	-27	8	/Div cover/EPS growth/
Warpaint London	WTL	367	296	13.5	2.6%	3.6%	0.6%	13.1%	-	-32%	-11	8	/EPS growth/Cash conv/
Brooks Macdonald	BRK	1415	233	9.9	5.6%	5.9%	-16.3%	8.2%	-31.6%	-12%	-	8	/Div cover/EPS growth/
Keystone Law	KEYS	540	171	18.1	3.5%	3.7%	9.0%	0.7%	-	-6%	-14	8	/Div cover/EPS growth/
Tatton Asset Mgmt	TAM	610	369	19.6	2.9%	3.6%	18.3%	15.5%	25.4%	-13%	-	8	/Div cover/Cash conv/

Source: FactSet and Investors' Chronicle

Investors' Chronicle Alpha dividend screen methodology

Large cap

Shares are ranked first on the number of tests passed and then on a composite of their rank amongst large caps for trailing dividend yield and dividend coverage. We tabulate companies that pass at least seven of the nine tests below.

- **Compulsory test** – the NTM dividend yield above 3.5 per cent. This is the yield of current share price to the next twelve months of dividends per share (DPS) forecast by analysts (we take the median of forecasts from FactSet).
- No DPS cut in either of the last two complete fiscal years. This shows consistency and commitment to the dividend.

- Trailing 12-month dividend yield above 3 per cent. Again, a slightly arbitrary figure and deliberately modest to not prejudice the screen towards cyclical value traps.
- Dividend cover above 1.6x. This is earning per share divided by dividend per share. This figure is chosen because it's the inverse of DPS/EPS not being more than 80 per cent.
- Earnings per share growth forecast in the current (unreported) and next financial years. This is to reassure us of growing profits from which to maintain the pay-out ratio.
- Operating cash conversion above 100 per cent. This is cash from operations divided by operating profit (both figures for last full FY) and shows how much hard cash the business operations are generating from which to support making payments to shareholders.
- Interest coverage ratio of more than 5x. This is how many times EBIT (Earnings before interest and tax) covers interest expense. A high figure demonstrates a company isn't over-leveraged and can support its debt.
- Return on equity (ROE) above 12.5 per cent. This is net income divided by ordinary shareholders' equity. It is a measure of quality. ROE can be inflated by leverage, so it is important to assess this with an eye on the previous interest cover test.
- Beta below 0.9 – this is a stability test. We don't want super volatile stocks amongst our large cap income shares.

Mid cap

Ranked first on number of tests passed, then on a composite of their rank amongst mid-caps for trailing dividend yield and dividend coverage. We tabulate companies that pass at least seven of the nine tests below. For mid-caps it is also **compulsory that they are in the top 100 mid-cap companies based on the div yield and div cover ranking.**

Compulsory test. No cut in dividend per share in either of the last two financial years.

- **Compulsory test.** Must have a trailing DY over 2 per cent.
- Forecast DY above 3.5 per cent. This isn't compulsory for mid-caps because we don't want to exclude companies that may grow into being good dividend payers.
- Dividend cover above 1.6x.
- EPS growth forecast for current (unreported) and next financial years PLUS last full year EPS is higher than two years previously.
- Operating cash conversion above 100 per cent.
- Interest cover above 5x.
- ROE above 12.5 per cent.
- Beta below 0.9.

Small cap and Aim:

Ranked first on the number of tests passed, then on a composite of their rank amongst small caps/Aim stocks for trailing dividend yield and dividend coverage. We tabulate companies that pass at least eight of the ten tests below. For small caps or Aim companies it is also compulsory that they are in the top 100 small-cap or Aim companies based on the div yield and div cover ranking.

- **Compulsory test.** No cut in dividend per share in either of the last two financial years.
- **Compulsory test.** Trailing dividend yield must be in the top 2/3 of companies that pay dividends. There is an argument for screening out the very highest dividend yields as a safety measure, but we leave this up to judgement interpreting the screen.
- **Compulsory test.** Trailing dividend yield must not be in the top five per cent of companies that pay dividends. This is to guard against value traps.
- Forecast DY above 3.5 per cent. This isn't compulsory for small caps because we don't want to exclude companies that may grow into being good dividend payers.
- Dividend cover above 1.6x.
- EPS growth forecast for current (unreported) and next financial years PLUS last full year EPS is higher than two years previously.
- Operating cash conversion above 100 per cent.
- Interest cover above 5x.
- ROE above 12.5 per cent.
- Free cash flow is positive.

Universe rules:

UK main market – we start with all companies with a market cap above £35mn, of these:

- Biggest 85 per cent go into the 'large cap' bucket.
- Those below the fifteenth percentile but bigger than £250mn go into 'mid cap'.
- Those between £35mn and £250mn go into small caps.

Aim market is run separately but we ignore companies below £35mn.

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