

AlphaScreens: finding dividend diamonds

19 August 2024

Shares for a well-diversified income portfolio

Our screens suggest shares that could be worth a place in a UK investor's income portfolio. They each have risks - and a sensible portfolio should be multi-asset anyway - but for the equities allocation, these companies aren't too similar in their idiosyncratic risks.

The opportunity cost of a high dividend payment is the money that could be reinvested in the business to help generate even greater returns for investors in the future when they need to cash them in. For those of a shorter time horizon, for example in the drawdown phase of managing a self-invested personal pension (Sipp), then high cash payouts today are extremely welcome.

If you have no moral objection, then tobacco stocks fit the bill nicely. **Imperial Brands (IMB)**, which faces the secular decline of demand for the wicked leaf, has nevertheless seen signs of promise in its new generation products division. Arguably, tighter regulation of products like vapes could be around the corner, but in the meantime uncertainty is rewarded. The failure of our cash conversion test hints at future challenges and a time when the dividend could come under pressure but for those with a shorter term focus, the forward yield for the next twelve months still supports the case for holding.

Also ranking highly on our list are two companies with a vital role in energy. The future of oil & gas major **BP (BP.)** has excited debate amongst environmentalists and investors alike in recent years. The comparison with last year has been a tough one but there has been a firm commitment to returning cash to shareholders. Oil & gas prices will decide how sustainable the payout remains (alongside the competing force of capital expenditure), but for now any undulations may continue to be more cyclical than secular, so BP is worth its place in a well-diversified income portfolio.

SSE (SSE) has recently been prioritising investment over its dividend, which was slashed this year. Many would fairly see that as an automatic disqualifier for an income screen but it is worth holding some stocks that could grow their payout again in the future. The need for power is going nowhere and the policy is to increase dividend growth in line with earnings growth at 5-10 per cent p.a., going forward.

Intermediate Capital Group (ICG) the flexible capital solutions business with a focus on private equity, private debt and real assets investment has seen assets under management (AUM) and fee earning (invested) AUM increase in the past year and a pivot to a more dovish interest rate environment would be bullish for the company.

Throw in supermarket **Tesco (TSCO)** and the leading lights on this month's screen offer

quite a well diversified basis for an income portfolio. Over differing timeframes, cycles and scenarios, these five stocks are plenty different. Although income investors ought to spread risk across multiple assets (and try to lock in some safe gilt income before yields fall).

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	2162	18411	6.6	6.9%	7.3%	6.5%	11.9%	8%	-12593	8
Tesco	TSCO	341	23401	12.6	3.5%	3.9%	10.3%	9.9%	11%	-15798	7
Intermediate Capital	ICG	2118	6156	12.4	3.7%	4.2%	4.2%	6.7%	-7%	-	7
SSE	SSE	1888	20645	11.4	3.2%	3.5%	2.6%	4.0%	1%	-3816	7
BP	BP	441	72560	7.1	5.3%	5.7%	-14.0%	23.2%	-10%	-36215	7
Severn Trent	SVT	2550	7653	19.8	4.6%	4.8%	28.2%	70.8%	-3%	106	6
United Utilities	UU	998	6804	15.5	5.0%	5.2%	52.7%	70.5%	-9%	292	6
Admiral	ADM	2960	9067	17.1	4.2%	5.3%	43.2%	13.6%	11%	-	6
Reckitt Benckiser	RKT	4272	29764	12.9	4.6%	4.9%	-2.2%	7.1%	-7%	-6056	6
Shell	SHEL	2790	175027	8.5	2.9%	4.0%	-2.4%	2.8%	-1%	-42202	6
Aviva	AV	500	13396	9.9	6.7%	7.5%	16.7%	12.6%	1%	-	6
GSK	GSK	1591	65948	9.3	3.8%	3.9%	2.8%	10.8%	-11%	-17362	6
HSBC	HSBA	657	121192	6.7	7.4%	8.4%	6.8%	1.3%	-6%	-	6
Barclays	BARC	228	33533	6.1	3.6%	3.9%	23.2%	21.7%	6%	-	6
Centrica	CNA	128	6663	7.8	3.3%	4.1%	-45.2%	-17.5%	-13%	-1083	6
Legal & General	LGEN	229	13611	10.1	9.0%	9.4%	50.0%	13.1%	-10%	-	4
Lloyds Banking	LLOY	59	36470	8.3	4.9%	5.4%	-13.1%	14.6%	7%	-	4

*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/
Tesco	TSCO	/Div cover/Interest cover/
Intermediate Capital	ICG	/Beta < 0.9/
SSE	SSE	/Div Cut/Beta < 0.9/
BP	BP	/EPS growth/ROE > 12.5%/
Severn Trent	SVT	/Div cover/Interest cover/ROE > 12.5%/
United Utilities	UU	/Div cover/Interest cover/ROE > 12.5%/
Admiral	ADM	/Div Cut/Div cover/
Reckitt Benckiser	RKT	/Div cover/EPS growth/Cash conv/
Shell	SHEL	/DY < 3/EPS growth/ROE > 12.5%/
Aviva	AV	/Div cover/
GSK	GSK	/Div Cut/Cash conv/ROE > 12.5%/
HSBC	HSBA	/ROE > 12.5%/Beta < 0.9/
Barclays	BARC	/ROE > 12.5%/Beta < 0.9/
Centrica	CNA	/Div Cut/EPS growth/Cash conv/
Legal & General	LGEN	/Div cover/ROE > 12.5%/Beta < 0.9/
Lloyds Banking	LLOY	/EPS growth/ROE > 12.5%/Beta < 0.9/

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

Mid-Cap 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
ME Group	MEGP	195	734	12.8	4.0%	4.3%	6.2%	9.3%	-	15%	-8	9	n/a
Mears Group	MER	369	355	10.4	3.8%	4.0%	33.0%	-23.5%	-	-3%	-169	8	/EPS growth/
XPS Pensions	XPS	319	664	17.6	3.1%	3.6%	16.9%	7.1%	81.5%	26%	-	8	/Cash conv/
IG Group	IGG	965	3547	9.1	4.8%	4.9%	32.1%	8.8%	-7.6%	22%	-	8	/EPS growth/
Drax	DRX	666	2568	5.8	3.6%	4.1%	2.3%	-11.0%	-	18%	-1675	7	/EPS growth/Beta< 0.9/
Petershill Partners	PHLL	224	2423	12.1	5.4%	5.7%	12.4%	29.1%	-	11%	-	7	/Cash conv/ROE > 12.5%/
Morgan Sindall	MGNS	2995	1434	12.1	4.0%	4.1%	-2.4%	4.3%	36.6%	24%	-956	7	/EPS growth/Beta< 0.9/
Lancashire Holdings	LRE	650	1586	5.8	2.4%	12.5%	5.8%	2.6%	320.2%	4%	-	7	/EPS growth/Interest cover/
Breedon	BREE	406	1395	11.6	3.4%	3.6%	-3.6%	11.5%	46.1%	4%	-319	7	/EPS growth/ROE > 12.5%/
MITIE Group	MTO	123	1612	10.7	3.2%	3.5%	-2.0%	9.3%	-	2%	-882	7	/fc DY < 3.5/EPS growth/
Bodycote	BOY	644	1200	11.8	3.6%	3.9%	6.0%	11.8%	498.8%	-15%	-251	7	/ROE > 12.5%/Beta< 0.9/
Mony Group	MONY	221	1187	12.2	5.5%	5.8%	7.9%	8.3%	1.6%	-6%	-124	7	/Div cover/Cash conv/
DCC	DCC	5275	5216	10.5	3.7%	4.0%	8.0%	6.3%	3.6%	-13%	-2630	7	/ROE > 12.5%/Beta< 0.9/

Source: FactSet and Investors' Chronicle

UK small-cap income 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	140	124	9.3	5.3%	5.4%	5.4%	20.7%	-	-4%	-39	10	n/a
Castings	CGS	340	148	12.7	5.4%	5.5%	-35.7%	22.5%	59.4%	-13%	-2	8	/EPS growth/Interest cover/

Source: FactSet and Investors' Chronicle

Aim-listed income 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
Alumasc	ALU	253	91	9.1	4.1%	4.3%	6.0%	5.6%	-	39%	-16	9	/Cash conv/
Kitwave	KITW	311	218	9.9	3.6%	4.3%	14.9%	7.1%	-	-18%	-127	9	/Cash conv/
FRP Advisory	FRP	152	386	14.2	3.3%	3.5%	5.7%	5.4%	14.9%	18%	-	9	/Cash conv/
Nichols	NICL	1165	426	18.5	2.6%	4.4%	7.1%	6.9%	56.5%	8%	37	9	/Cash conv/
Nexseq	NXQ	91	60	10.4	3.6%	3.3%	-38.5%	0.6%	-	-38%	8	8	/fc DY < 3.5/EPS growth/
Sanderson Design	SDG	86	61	9.4	4.1%	4.1%	-36.0%	8.0%	28.6%	-20%	-1	8	/EPS growth/ROE > 12.5%/
Ramsdens	RFX	213	68	8.3	5.0%	5.4%	6.6%	0.6%	2.0%	5%	-	8	/EPS growth/Cash conv/
Helios Underwriting	HUW	173	125	6.0	3.5%	9.3%	5.5%	50.5%	139.0%	3%	-	8	/Cash conv/Interest cover/
NWF Group	NWF	170	84	9.4	4.8%	5.0%	-8.9%	18.3%	4.9%	-22%	-91	8	/EPS growth/ROE > 12.5%/
M.P. Evans	MPE	868	459	10.0	5.2%	4.8%	9.9%	5.9%	39.1%	3%	-12	8	/EPS growth/ROE > 12.5%/
Wynnstay	WYN	350	81	12.0	5.0%	5.3%	-5.1%	1.8%	3.5%	-8%	-61	8	/EPS growth/ROE > 12.5%/
Midwich	MIDW	330	344	9.3	5.0%	5.1%	-10.5%	9.7%	-	-16%	-258	8	/EPS growth/Interest cover/
Knights Group	KGH	130	111	5.3	3.4%	3.8%	12.2%	11.8%	40.4%	-10%	-25	8	/Interest cover/ROE > 12.5%/
Gateley	GTLY	141	188	10.1	6.7%	6.8%	-3.2%	3.8%	-11.5%	25%	-35	8	/Div cover/EPS growth/
Fonix	FNX	238	235	22.4	3.2%	3.6%	15.7%	2.9%	-	-1%	-35	8	/Div cover/EPS growth/
Eckoh	ECK	46	132	19.1	1.8%	2.0%	9.0%	10.9%	12.4%	23%	-8	8	/fc DY < 3.5/ROE > 12.5%/

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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