Investors' Chronicle | Alpha

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AlphaScreens: finding dividend diamonds

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Dividend payers to fight stagflation

Dividends are an important source of returns and also a useful valuation measure that can be used to identify shares with the potential for capital growth. But it's important to screen out potential value traps when using yield as a guide.

- Strip out Russian-linked precious metals miner **Polymetal (POLY),** which has a trailing dividend yield of 27 per cent, and this month's UK large-cap dividend screen gives an interesting mix of companies. Some are beneficiaries of the last stage in the cycle and should be thought about cautiously now, others look apt for the current set of challenges facing investors. In a time of slowing growth and rising inflation – in the UK year-on-year CPI was recorded at 7 per cent – the risks of stagflation are serious. In such a scenario, the income component of total returns becomes even more important.

- No large-cap company passes 8/8 tests, but topping our screen, **BAE Systems (BA.)** only fails the newly introduced forecast dividend growth test. With the geo-political instability wrought by Vladimir Putin's aggressive foreign policy and Sino-American rivalry, there is a narrative around defence stocks but investors shouldn't expect dividend growth to be ramped-up. As Robin Hardy pointed out in his recent Alpha analysis piece, European governments will probably look within the EU when farming out contracts. Therefore, while there may be growth for BAE, it is unlikely to be spectacular. The dividend will be safe, but there are competing priorities for cash generated such as capex and research and development that may be given greater importance than increasing the pay-out.

- The other company that only fails one test is advertising group **WPP (WPP)**, which comes up short on trailing three-year earnings per share growth. Although eps rebounded strongly in the 2021 financial year after a loss-making 2020, the company hasn't recovered its pre-pandemic levels of profitability. With huge macro-economic uncertainties, this isn't a good defensive holding given the cyclicality of advertising.

- Other results in the screen are closer to fitting the bill for the current macro-environment. Tobacco stocks do carry a moral dilemma but both **Imperial Brands (IMB)** and **British American Tobacco (BATS)** are the sort of steady consumer staples stocks with sizable pay-outs that could be a very useful source of return in a difficult period. The tests failed by IMB relate to its below average forecast growth for dividend per share (albeit from a high base) and the fairly

stunted eps growth trends. The eps growth test is also failed by BATS, which also fails our dividend cover test, although the threshold should probably be less conservative for this type of company and the figure of 1.4 isn't too great a concern.

- It is unsurprising to see mining giant **Rio Tinto (RIO)** scoring well. It's another company that has always been committed to returning cash to shareholders and although mining is highly cyclical, the current narrative of rising commodity prices as a hedge against inflation suits the company. Mining operations aren't immune to inflation themselves, however, and Rio's profitability could yet face headwinds from rising costs in the iron ore and copper businesses. Furthermore, the risks of global recession are real and that would hurt demand for materials. Still, some exposure to metals and income-committed stocks is arguably sensible for part of a portfolio.

New approach to UK income shares

We've had a rethink about our Alpha dividend yield screens. Previously we were screening the FTSE All-Share index for large-cap companies and the FTSE All-Small Companies index and the FTSE Aim All-Share index for small-cap stocks.

This created a problem, however. The FTSE All-Share is a big index and includes many companies that aren't large cap. There is actually an overlap in some constituents of the All-Share and All-Small indices. This means the results we were getting from our All-Share screen, although the criteria were designed for larger companies, often showed-up small ones.

For income investors, the challenge is to build a portfolio of companies with reliable cash flows and resilient quality, a track record of sustaining and growing dividends; and reasonable growth prospects to keep that up. To that end, while there are some gems further down the market cap scale, the core holdings should be large cap.

With that in mind we have re-jigged our UK equity income screens and made the split between genuine large-cap, mid-cap and small-cap (including Aim) stocks, to focus on each group separately. We're now splitting the universe for our screens according to the methodology of the Numis index family.

As ever, all screens are meant as a source of ideas and not off-the-shelf portfolios (certainly some of this month's results warrant scrutiny). With that important caveat, these suggestions for further research should give investors a better idea of what the UK market has to offer in terms of core and satellite holdings that could help construct an income portfolio.

UK dividend screens criteria

Given the disruption to UK dividends caused by the coronavirus pandemic, we have taken a much more forward-looking approach to dividends in our new screen. We've changed the compulsory test from having a 12-month trailing dividend yield above the median (many shares that could legitimately be classed as income plays would have failed that after coronavirus), to having a 12-month average forecast dividend yield above the median. We keep the trailing test as a flag, but companies that fail it can be included in the results.

We've also added a test for companies to have a three-year forecast dividend per share growth rate above the median. Finally, although we're maintaining the criteria for small companies to have a market cap above £10mn to be considered, we're now keeping most tests for small and large companies the same. This is because we're copying some of the income growth focus previously given to smaller companies to the large-cap screens and because the new large cap only screen already acts to give a more appropriate selection of bigger companies.

- Next 12 months' forecast dividend yield above the median average.
- Forecast dividend per share growth above the median.
- Forecast average earnings per share growth above 5 per cent for the next two years and earnings per share growth in both years.
- Trailing 12-month dividend yield above the median.
- Dividend per share smoothed-out average growth rate for the past three years above 5 per cent.
- Earnings per share smoothed-out average growth rate for the past three years above 5 per cent.
- Trailing dividends per share covered at least one-and-a-half times by trailing earnings per share.
- Operating profit/earnings before interest and taxation (EBIT) covers interest expense at least five times.
- Trailing 12-month free cash flow after lease obligations is positive.

· Companies that pass the forward dividend yield test are ordered by the number of tests passed and then how they rank based on a combination of trailing dividend yield and dividend cover (keeping the nod to their historic income reliability as well as expectations).

UK large-cap income (passing at least 6 out of 8 tests)

Name	Ticker	Share price (last close)	Mkt cap (£mn)	Fwd 12-mth PE	Trailing 12-mth DY	NTM Fwd DY (median est.)	Fwd EPS gwth cur FY	Fwd EPS gwth next FY	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 8)	Tests failed	Special div paid?	Trailing DY (inc specials)
BAE Systems	BA	771.6	24318	15.0	3.3%	3.4%	6.4%	6.6%	34%	-5585.0	7	/FC DPS grwth/	-	3.3%
WPP	WPP	971.8	10793	10.5	3.2%	3.8%	14.3%	12.9%	-18%	-12602.5	7	/Trail EPS grwth/	-	3.2%
Royal Mail	RMG	329.8	3154	6.1	5.1%	7.3%	12.0%	-7.1%	-36%	-1150.0	6	/Fwd EPS grwth/Trail EPS grwth/	YES	11.1%
Kingfisher	KGF	260.7	5304	9.1	4.8%	4.8%	-18.7%	4.2%	-24%	-2293.0	6	/Fwd EPS grwth/FC DPS grwth/	-	4.8%
Polymetal Int'l	POLY	265.5	1257	1.8	27.3%	19.6%	-13.2%	-6.2%	-78%	-368.4	6	/Fwd EPS grwth/FC DPS grwth/	-	27.3%
Imperial Brands	IMB	1678	15948	6.6	8.3%	8.6%	0.0%	5.8%	1%	-9521.0	6	/Fwd EPS grwth/FC DPS grwth/	-	8.3%
Barratt Devp.	BDEV	512.8	5244	6.4	6.5%	7.8%	10.4%	-0.3%	-25%	32.6	6	/Fwd EPS grwth/Trail EPS grwth/	-	6.5%
Taylor Wimpey	TW	132.4	4768	6.9	6.5%	7.0%	5.0%	8.0%	-18%	-114.1	6	/Trail EPS grwth/FC DPS grwth/	-	6.5%
Intermediate Capital	ICP	1664	4835	13.1	3.5%	4.5%	-9.9%	-10.7%	-18%	-	6	/Fwd EPS grwth/Trail EPS grwth/	-	3.5%
Rio Tinto	RIO	6154	76877	7.3	9.4%	9.6%	-6.7%	-27.8%	13%	1964.6	6	/Fwd EPS grwth/FC DPS grwth/	YES	12.3%
Schroders Non Voting	SDRC	1928	8272	8.0	6.3%	6.5%	-2.7%	8.8%	-17%	-	6	/Fwd EPS grwth/FC DPS grwth/	-	6.3%
Mondi	MNDI	1427	6929	10.1	3.8%	4.1%	10.9%	1.2%	-25%	-1060.4	6	/Trail EPS grwth/FC DPS grwth/	-	3.8%
Smurfit Kappa	SKG	3091	8043	11.1	4.2%	3.7%	19.7%	4.2%	-24%	-1643.9	6	/Trail EPS grwth/FC DPS grwth/	-	4.2%
British American Tobacco	BATS	3270	74583	9.0	6.7%	7.1%	7.4%	9.2%	12%	-11879.0	6	/Trail EPS grwth/Div Cov/	-	6.7%
Schroders	SDR	3178	8272	13.3	3.8%	3.9%	-3.1%	9.0%	-10%	-	6	/Fwd EPS grwth/FC DPS grwth/	-	3.8%
DS Smith	SMDS	313	4300	9.0	4.1%	5.0%	25.5%	15.6%	-21%	-1643.0	6	/Trail EPS grwth/Div Cov/	-	4.1%
St. James's Place	STJ	1391	7547	16.8	3.7%	4.4%	8.7%	12.7%	-16%	-	6	/Div Cov/Interest cov/	-	3.7%

Sources: FactSet, Numis Large-Cap index, Investors' Chronicle

UK mid-cap income (passing at least 6 out of 8 tests)

Name	Ticker	Share price (last close)	Mkt cap (£mn)	12-mth Fwd PE	Trailing 12-mth DY	NTM Fwd DY (median est.)	Fwd EPS gwth cur FY	Fwd EPS gwth next FY	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 8)	Tests failed
Bellway	BWY	2550	3149	6.2	5.0%	5.5%	15.9%	1.5%	-15.6%	-611.8	7	/Trail EPS grwth/
Vistry	VTY	918.5	2042	6.5	6.5%	7.8%	11.7%	2.4%	-17.7%	-590.2	7	/FC DPS grwth/
Man	EMG	237.8	3209	10.6	4.4%	4.9%	-24.5%	9.0%	9.7%	-	7	/Fwd EPS grwth/
IG Group	IGG	837.5	3614	9.4	5.2%	6.0%	-9.5%	-1.6%	2.4%	-	7	/Fwd EPS grwth/
Crest Nicholson	CRST	271.6	698	6.7	5.0%	6.0%	16.5%	7.1%	-19.9%	-114.3	7	/Trail EPS grwth/
Morgan Adv Materials	MGAM	293	836	9.9	3.1%	3.3%	8.3%	5.1%	-15.6%	-100.5	7	/FC DPS grwth/
Inchcape	INCH	655.5	2485	11.3	3.4%	3.6%	1.6%	10.0%	-27.0%	-1145.6	7	/Div Cov/
RHI Magnesita NV	RHIM	2386	1121	5.7	5.3%	6.0%	7.8%	9.5%	-32.7%	-525.6	6	/FCF +ve/FC DPS grwth/
OSB	OSB	581	2601	6.8	4.5%	4.7%	-5.0%	10.8%	4.6%	-	6	/Fwd EPS grwth/Interest cov/
Paragon Banking	PAG	497.2	1217	7.8	5.2%	5.2%	1.9%	9.3%	-14.6%	-	6	/Interest cov/FCF +ve/
CLS	CLI	206	839	16.3	3.7%	4.3%	10.2%	5.7%	-5.5%	-	6	/Trail EPS grwth/Interest cov/
Ashmore	ASHM	233	1661	11.6	7.3%	7.3%	-37.7%	-7.1%	-21.6%	-	6	/Fwd EPS grwth/FC DPS grwth/
Synthomer	SYNT	286.2	1338	7.2	10.5%	5.4%	-48.4%	8.8%	-27.5%	-58.2	6	/Fwd EPS grwth/FC DPS grwth/
Vesuvius	VSVS	343	930	8.0	6.2%	5.9%	17.2%	14.5%	-27.4%	-353.9	6	/Trail EPS grwth/FC DPS grwth/
Morgan Sindall	MGNS	2330	1081	10.5	3.9%	4.2%	0.2%	5.1%	0.9%	-658.3	6	/Fwd EPS grwth/FC DPS grwth/
Beazley	BEZ	409	2494	8.3	3.2%	3.4%	23.5%	30.9%	-13.5%	-	6	/Interest cov/FC DPS grwth/
Sirius Real Estate	SRE	120.4	1411	16.3	2.9%	3.5%	49.0%	4.3%	-12.4%	-	6	/Trail DY/Trail EPS grwth/
Pets At Home	PETS	328.4	1642	13.9	3.0%	3.6%	62.8%	5.4%	-26.2%	-195.2	6	/Trail DY/Trail EPS grwth/
Rathbones	RAT	2150	1339	13.0	3.8%	3.9%	-1.3%	2.9%	7.5%	-	6	/Fwd EPS grwth/FC DPS grwth/
Liontrust Asset Mgmt	LIO	1284	834	11.0	4.5%	5.3%	4.1%	8.6%	-34.2%	-	6	/Trail EPS grwth/Div Cov/
ContourGlobal	GLO	190.4	1249	25.1	6.8%	8.1%	14.7%	5.9%	1.9%	-626.2	6	/Div Cov/Interest cov/
Bodycote	BOY	622.5	1192	13.6	3.2%	3.4%	23.1%	15.0%	-27.7%	-223.7	6	/Trail EPS grwth/FC DPS grwth/
Telecom Plus	TEP	1524	1204	22.3	3.7%	4.0%	4.9%	13.5%	-0.7%	-127.6	6	/Trail EPS grwth/Div Cov/
FDM Group	FDM	1042	1138	28.6	3.2%	3.4%	6.8%	10.5%	-14.3%	14.3	6	/Trail EPS grwth/Div Cov/
Centamin	CEY	97.5	1128	12.8	3.9%	4.1%	11.3%	13.5%	6.8%	93.9	6	/Div Cov/FC DPS grwth/

Sources: FactSet, Numis Mid-Cap index, Investors' Chronicle

Small-cap UK income shares below

UK small-cap and Aim income (passing at least 7 out of 8 tests)

Name	Ticker	Share price (last close)	Mkt cap (£mn)	Fwd 12-mth PE	Trailing 12-mth DY	NTM Fwd DY (median est.)	Fwd EPS gwth cur FY	Fwd EPS gwth next FY	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 8)	Tests failed
LSL Property Services	LSL	375	394	9.5	3.0%	3.2%	2.5%	11.2%	-7.4%	-	8	na
SThree	STEM	389	520	11.2	2.8%	3.1%	8.4%	10.5%	-10.8%	-160.9	8	na
Duke Royalty	DUKE	42	150	12.0	5.1%	7.2%	10.3%	28.6%	1.8%	-	7	/Trail EPS grwth/
S&U	SUS	2445	297	9.1	5.2%	5.5%	-15.1%	7.4%	-9.8%	-	7	/Fwd EPS grwth/
Forterra	FORT	231	518	10.1	4.3%	5.4%	25.2%	14.5%	-13.2%	-49.3	7	/Trail EPS grwth/
Mission	TMG	66	60	8.9	3.7%	4.0%	9.2%	14.1%	-5.1%	-32.3	7	/Trail EPS grwth/
Argentex	AGFX	73	83	7.8	3.7%	3.8%	25.4%	25.7%	-16.8%	-	7	/Trail EPS grwth/
Morgan Adv. Materials	MGAM	293	836	9.9	3.1%	3.3%	8.3%	5.1%	-15.6%	-100.5	7	/FC DPS grwth/
Springfield Properties	SPR	150	178	8.0	4.0%	4.8%	14.6%	18.6%	1.7%	-71.5	7	/FCF +ve/
RBG Holdings	RBGP	107	102	9.9	4.7%	6.1%	24.3%	8.1%	-15.8%	-11.5	7	/FC DPS grwth/
Watkin Jones	WJG	254	649	12.6	3.2%	4.0%	5.1%	32.1%	-1.6%	26.8	7	/Trail EPS grwth/
Up Global Sourcing	UPGS	146	130	10.0	3.4%	5.0%	31.6%	6.8%	-22.7%	-39.3	7	/FC DPS grwth/
Cake Box	CBOX	198	79	12.2	3.1%	4.0%	48.5%	12.9%	-43.4%	0.2	7	/Trail EPS grwth/
Brooks Macdonald	BRK	2490	403	14.3	2.7%	3.1%	5.4%	8.7%	-6.0%	-	7	/Trail DY/

Sources: FactSet, NSCI plus Aim, Investors' Chronicle

New indices, a tighter set of ideas

Going forward, we're switching to screening in an equities universe inspired by the Numis family of UK indices. The aim is to give investors a true overview of genuine large-cap, mid-cap and small-cap quality shares.

We will also be excluding investment trusts from results. The purpose of these screens is to highlight individual companies that are worth investigating further. Including closed-end funds in the universe skews the results and distracts from that objective. Investment trusts are given their own, far more detailed, analysis in the regular Alpha Investment Trust report.

Breakdown of the Numis indices we have been inspired by:

Numis Large-Cap index (excluding investment companies/trusts): This includes the top 80 per cent of companies by market capitalisation that are listed on the UK main market. The lower size cut-off for 2022 is **£4.12bn** market cap.

Numis Mid-Cap index (excluding investment companies/trusts): This includes the 15 per cent of UK main market listed companies below the top 80 per cent, but above the bottom 5 per cent by market capitalisation. The upper size cut-off is **£4.12bn** and the lower cut-off is **£880mn** market cap.

NSCI plus Aim, version excluding investment trusts: This adds all Aim companies below the **£1.64bn** market cap cut-off to the NSCI (Numis Small Companies Index), which is the bottom 10 per cent of main market companies by market cap.

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