Investors' Chronicle | Alpha

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Alpha shares analysis

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Dividend payers to ease tough times

Our secret institutional buy-side investor, with experience of UK, European and US equity and derivatives markets, runs the rule over three companies for income investing strategies

There's a difference between insider trading (which typically involves obtaining information unfairly ahead of the rest of the market from a contact inside a company, and is illegal) and knowing smart institutional investors who work within the system and can lend the benefits of their general experience. Our newest contributor to Investors' Chronicle Alpha has asked to remain anonymous as they still work in the industry, but they're helping us with some cogent analysis of companies that should be on income investors' radar – and some companies with tempting yields that ought to be side-stepped. - *JN*

Analyst: '**The Secret Buy-sider**'

The dividend investor

The dividend investor is someone who should be trying to identify companies that can maintain or grow their dividend through the economic cycle. They should focus their attention on finding businesses with some GDP type linked growth, pricing power and a generous capital return profile.

Those who follow dividend strategies should, in my view, do it for three primary reasons:

1. A belief it promotes a **strong capital allocation framework** within a business – if you commit to pay out a growing cash flow each year, you better make sure your internal investments are going to increase the cashflow pie; or to flip the sentiment, if I only have a limited amount of cash to invest each year, I better pick the highest returning projects. You also need to worry less about a rogue management team blowing all the cash on vanity growth projects that can destroy a significant amount of shareholder value.

2. A requirement for a **steadily growing income** – dividend-paying companies will provide the holder with a steady (and hopefully growing) income through tough economic times, preventing them from having to sell down their principle to fund their liabilities. In theory, there should be no corporate valuation difference between a company earning £100mn and using it to do buybacks, pay down debt, reinvest in the business or pay a dividend, but in practice there is. Investors value certainty. A strong dividend track record through

economic cycles is the closest to certainty an equity investor can get. The psychological separation of income and capital is powerful and although not strictly rational can help an investor stay the course when the going gets tough.

3. **It suits your world view –** a subject not talked about often in the financial theory books; but having a strategy that allows you to psychologically deal with the ups and downs of the market is more important than having the most optimal investment strategy. This is no less obvious when the famous money manager Peter Lynch who managed the Fidelity Magellan Fund from 1977-1990, compounded returns at 29 per cent but Fidelity reported that the average investor lost money in the fund. It was the right strategy for the wrong people. To make money, or at least not lose money in the markets you must be able to stay the course when your world view is challenged. Like dieting or exercising, the best investment strategy is the one that you're able to stick to.

Prevailing market conditions

It is becoming increasingly likely that we are in, or fast approaching, tough economic times where individual investor psychology and steel are tested. Whatever your political leanings, the recent UK 'mini' budget is causing significant price action in the sterling and gilt markets.

This price action has consequences and will feed into the real world through either: a continued devaluation of sterling and increased inflation or a rapid increase in interest rates to shore up sterling and pare back the inflationary pressures in the UK economy. History suggests rate hikes are the better course, but the UK has a recent habit of surprising markets (Brexit vote, Brexit day, this budget) negatively.

It is against this economic uncertainty and the above philosophy that I pick out British **American Tobacco (BATS)**, **Unilever (ULVR)** and **Tesco (TSCO)** as three attractive long-term UK dividend investments from the Investors' Chronicle dividend screen and discuss why you should avoid the UK domestic banks.

Continued below...

British American Tobacco (BATS)

Short summary: Cheap, high returning, incredible dividend track record, pricing power and growth dynamics through a recessionary period. Resilient to a falling pound, so has nice currency hedging dynamics for a UK portfolio.

Name	Div yield	EV/EBITDA	EV/EBIT	PE	EV/Sales	FCF yield	Net debt/EBITDA
British American Tobacco	7.20%	8.75	9.5	8.8	4	10.30 %	2.76

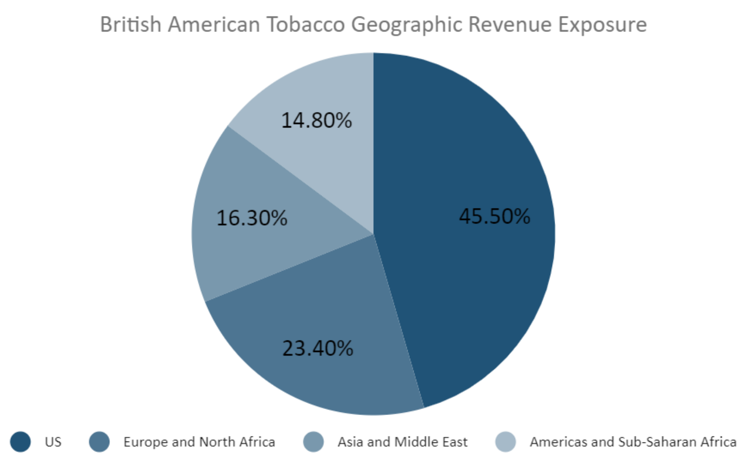
Source: Bloomberg

Longer summary: Tobacco is a very high return on capital sector with huge barriers to entry, a demonstrative ability to grow dividends and is unloved and unfavoured by the market.

In UK tobacco we can also consider Imperial Brands (IMB), they have reaffirmed commitment to returning cash to shareholders through a new £1bn buyback, but they have also cut their dividend in recent years (due to poor portfolio management). Arguably the British American Tobacco business model is best positioned for the long term – more emerging market and US market exposure; better brands and more cash to invest into the nascent 'heat-not-burn' category.

After spending the last five years paying down debt from a large deal in 2017, British American Tobacco is ready to return additional cash to shareholders through buybacks, underpinning its commitment to grow the dividend year-on-year.

BATS business model: British American Tobacco sells cigarettes, rolling tobacco and cigars globally. Post its 2017 take-over of Reynolds American the US is the biggest market.

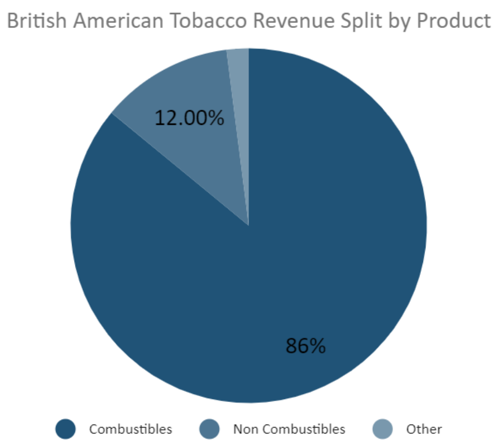


Source: Company report

In very simple terms, they sell an addictive product that has inelastic price demand. That means as prices go up, volumes don't go down by a commensurate amount creating a dynamic of increasing revenues and decreasing costs.

The barriers to entry are incredibly high: advertising is mostly banned, distribution is tightly controlled, and the market is now heavily consolidated: British American Tobacco, Altria, Philip Morris, Japan Tobacco and Imperial Brands dominate the global landscape.

Local market structure is oligopolistic with four-to-five major players in each market. In some markets British American Tobacco has the number four share, in others the number one. Price competition is muted as there is a 'bazooka-in-the-pocket' mechanism: participants have the attitude "if you get aggressive in my best markets and destroy pricing to take market share, I will do the same in your best markets." This generally creates a structure of steadily rising prices (and margins) globally.



Source: Company report

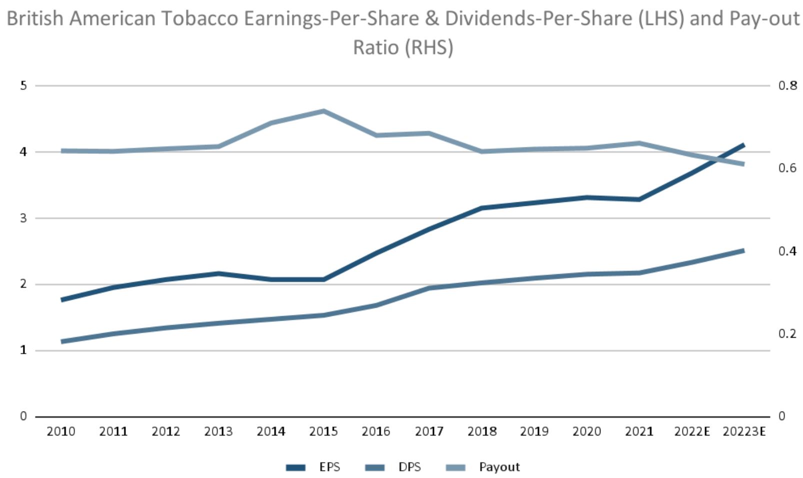
The market in more developed regions is slowly moving away from burning tobacco and this is evident from the growth of vaping and heat-not-burn companies and products. Today 'smoke-less' tobacco represents five-to-ten per cent of the market versus close to zero 10 years ago.

There is some uncertainty on a decades-long view whether tobacco companies can translate this growth into the profit pool generated by traditional tobacco products.

Although the outcome is uncertain, the big tobacco smokeless playbook is somewhat similar to that of traditional products – own all the big brands, influence regulation, dominate distribution, increase prices, and grow margins.

In recent years tobacco valuations in Europe have fallen as ESG (environment, social and governance) mandates have increased, and some believe a business model shift from traditional smoking tobacco to smokeless represents a long-term risk to the historical business model's ability to generate incredible returns, margins and cash. There is some merit to this second argument but at these valuations in this market environment that risk is more than priced in.

Dividends:

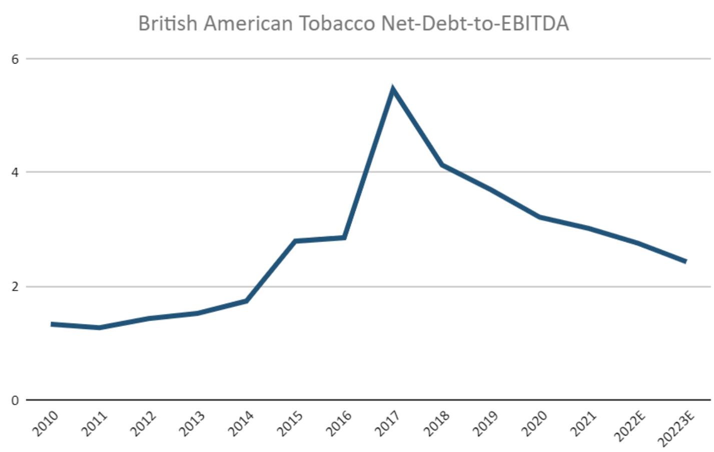


Source: Bloomberg

Policy: To progressively grow the dividend year on year.

Given the huge returns British American Tobacco generates, it has paid over half its market cap in the last 10 years. The dividend is sacrosanct and will only be cut in a catastrophic scenario. Of the three buys, this dividend is the most secure and most ingrained into the corporate culture. Earnings are forecast to grow, and a weak pound will provide a further near-term tail wind to earnings.

Valuation & balance sheet:



Source: Bloomberg

The European consumer staples sector trades at around twelve-and-a-half-times Enterprise value to earnings before interest tax depreciation and amortisation (EV/Ebitda). Tobacco as a sector and British American Tobacco are on sale. A large de-rating occurred as ESG mandates have grown and those that can invest worry about the viability of the model in 20 years.

Headlines around banning tobacco and restricting access have proven to be red herrings thus far and this stock is in deep value territory. It is not often you can buy a high returning, growing company on a 10 per cent free cash flow yield and 7 per cent dividend yield.

Unilever (ULVR)

Short summary: A great asset that has been poorly managed, now has a credible and effective activist investor, Nelson Peltz on the board creating a lot of upside optionality through corporate actions.

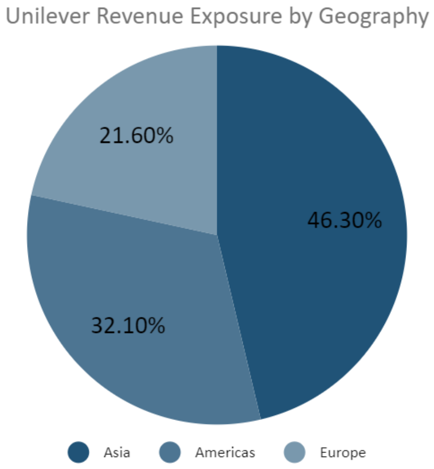
Div yield	EV/EBITDA	EV/EBIT	PE	EV/Sales	FCF yield	Net debt/EBITDA
4.40%	12.7	15	18	2.46	6.30%	2.04

Source: Bloomberg

Longer summary: A period of mismanagement has seen Unilever fall into the classic consumer staples trap: they need to grow earnings each year, so they tried to do that by raising prices, but this results in slower revenue growth. At some point prices rise so much that people stop buying the products (shifting to cheaper alternatives like supermarket own brands). Eventually, the stock underperforms.

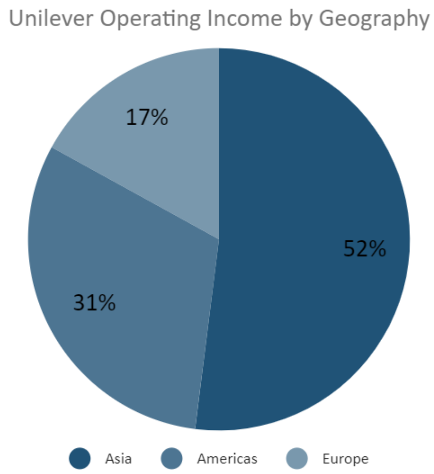
With CEO Alan Jope retiring at the end of 2023, activist Nelson Peltz on the board and plenty of value unlocking and growth initiatives on the table, Unilever can begin to remind the market what a good asset it is. It also helps that revenue and income is somewhat inflation protected and most of the income is earned overseas.

Business model: Unilever sells branded consumer goods; its margins are high because its prices are. These high prices feed into a high marketing spend which gets products in the hearts and minds of consumers. Consumers demand access to these products which allows Unilever to dictate pricing and merchandising terms to the distributors (supermarkets). This is the virtuous cycle of a consumer staples business model.



Source: Company report

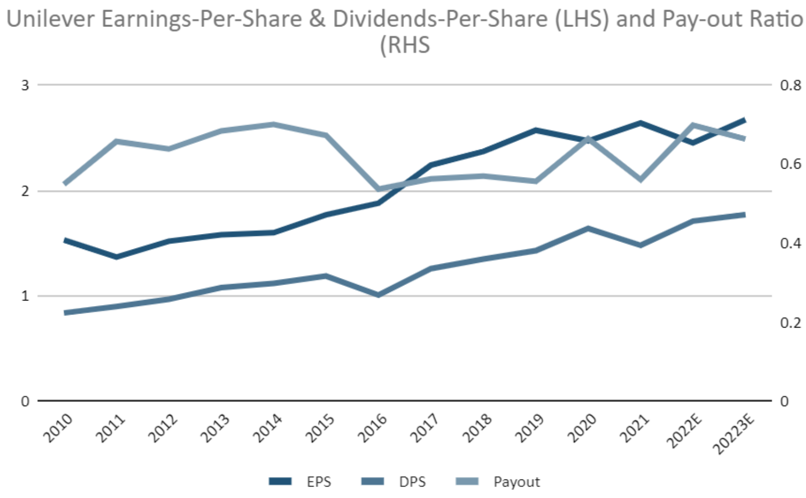
From time-to-time consumer staples companies can get the balance wrong and spend too little or too much on marketing, research and development, corporate structure and invest too little in pricing. This can cause the earnings algorithm (a term used by those who study these companies) to go a bit wonky. Normally the algorithm is GDP+ revenue growth, 50-100 basis points of margin expansion (one basis point is a hundredth of one per cent), resulting in earnings growing five to 10 per cent a year. With some dividend growth total shareholder return gets to a high-single-digit to low-teens percentage. Not bad.



Source: Company report

Unilever's revenue is almost the same as it was in 2010. In real terms, it is lower. Cue the arrival of Nelson Peltz who was appointed to the board in July 2022. There are many ideas on the table, invest back in the business, sell assets, split the business into different operating entities. All of which can result in significant outperformance if they can be well executed. In the meantime, you get a growing dividend and a business that has pricing power and should be able to stave off the worst of an inflationary environment.

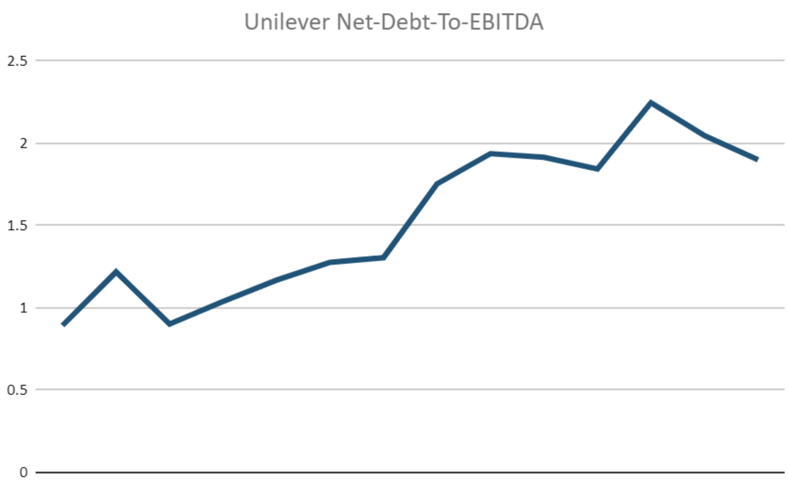
Dividend:



Source: Bloomberg

Policy: Pay-out around 60 per cent of earnings per share, but no fixed policy. The board is committed to returning excess cash flow to shareholders.

Valuation & balance sheet:



Source: Bloomberg

Management aims to keep net debt to Ebitda in the 2-2.5x range. Unilever has de-rated versus close peers as they have seen anaemic growth in recent years. This has led to the call for an activist investor. The board has several options at their disposal, sell assets and return cash, invest for growth, spin-off the emerging markets business, spin off either the HPC or Food business. All of which could lead to a re-rating and material share price performance. In the interim you get paid to wait with a growing dividend where revenues and income are somewhat inflation protected.

Tesco (TSCO)

Shorter summary: Cheap, upside if they can prove consistency in delivery, committed to a progressive dividend, income somewhat linked to inflation.

Div yield	EV/EBITDA	EV/EBIT	PE	EV/Sales	FCF yield	Net debt/EBITDA
5.20%	6	9.9	10	0.41	12%	2.55

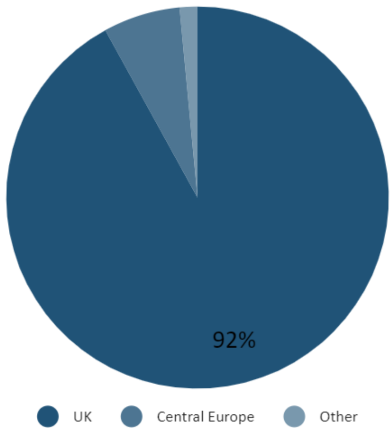
Source: Bloomberg

Longer summary: Tesco is coming out of a period of rationalisation and over earning. In 2014 it was rocked by a fraud where profits were overstated, and this began a period of introspection and back to basics. US, Asian and other international assets were divested, and the UK became the focus again. Margins were rebased as the business invested in price to fight the growth of the discount retailers. Now a track record is beginning to emerge and if they consistently deliver, a re-rating is in order along with GDP-linked revenue and income growth.

In its interim results on 5 October, Tesco maintained guidance (although at the lower end of the range) for its full-year adjusted operating profits. Although the nature of the business means it is somewhat protected against inflation, rising costs and investment in trying to hold down prices for customers in the inflationary environment contributed to lower first-half operating profit (down 11.5 per cent to £1.17bn) in the UK and Ireland year on year. This is part of a longer-term strategy to take market share so what may be lost in pricing is gained through volumes.

Business model: This is your classic retail model. Buy in from suppliers, apply a mark-up and then sell onto the consumer. The value add is in the scale Tesco can buy products from suppliers at, and the ability it has to distribute these products effectively. High density store networks create economies of scale for distribution hubs and as Tesco is the biggest supermarket in the UK, it can get the best buying terms. This gives Tesco structural advantages over its peers: in effect it can set the strategic direction for the sector and others generally follow.

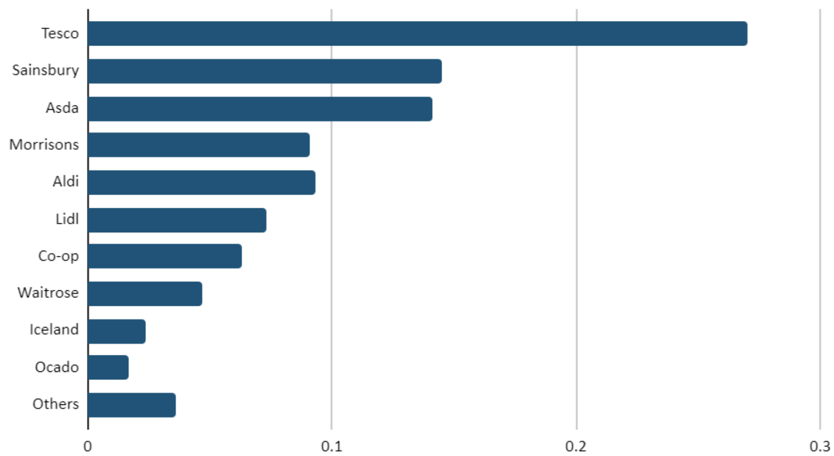
Tesco Revenue Split by Geography



Source: Company report

Historically there has been a 'big-four' in the UK; Sainsbury's, Tesco, Morrisons and Asda; with Waitrose, Lidl and Aldi operating at the fringes, occupying the premium and discount market segments.

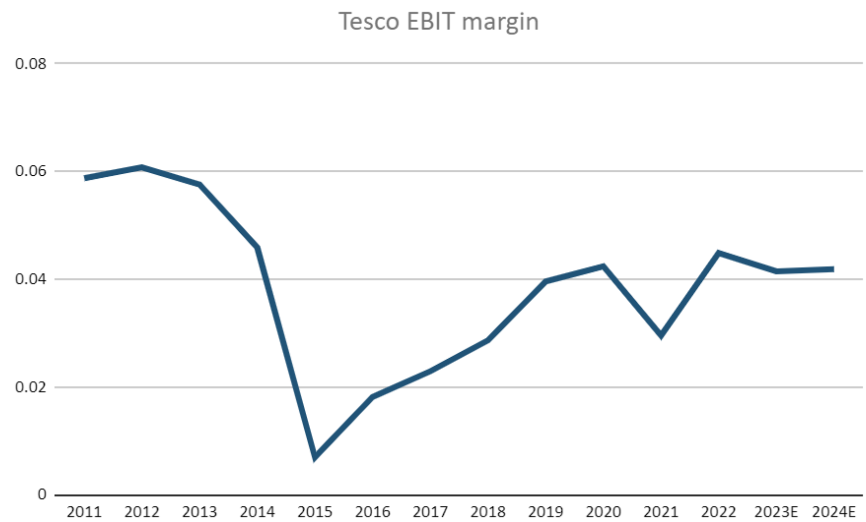
UK Food Retail Market Share



Source: Bloomberg

To understand investing in UK supermarkets it is key to know what can go wrong, as they are a defensive sector where revenues and income are both somewhat linked to inflation and to an extent are protected in a recessionary environment.

Number one – the UK supermarket sector has over-earned in recent years which has seen the rise of discount retailers Aldi and Lidl, this has caused the incumbents to invest in price, and falling margins. This process is mostly complete with Tesco margins settling around the four per cent level, much more in line with what we see when comparing to other European food retailers.



Source: Bloomberg

Number two – the UK supermarket complex has seen the rise of online grocery shopping. People buy groceries at a steady rate with growth linked to inflation. Tesco has an invested capital base (stores) which it has built to fill this demand. Consumer preferences change and they now wish to purchase online and have their groceries delivered, Tesco needs to increase its capital base to service this consumer. So, it has an over invested capital base relative to the market it serves. Some rationality has crept into this process at the market level, picking for online shoppers has gotten more efficient, and deliveries are for the most part no longer free. But this has weighed on returns and valuations in recent years.

Number three Tesco has been embroiled in their own controversy in 2014 where there was fraudulent behaviour carried out by management teams overstating profits. Since then, there has been a complete overhaul of management and governance processes. Tesco have also re-focused on the UK, selling off numerous international operations.

The sector growth dynamics have stabilised and Tesco as a business is now beginning to show consistency. The jury is still out, but herein lies the opportunity.

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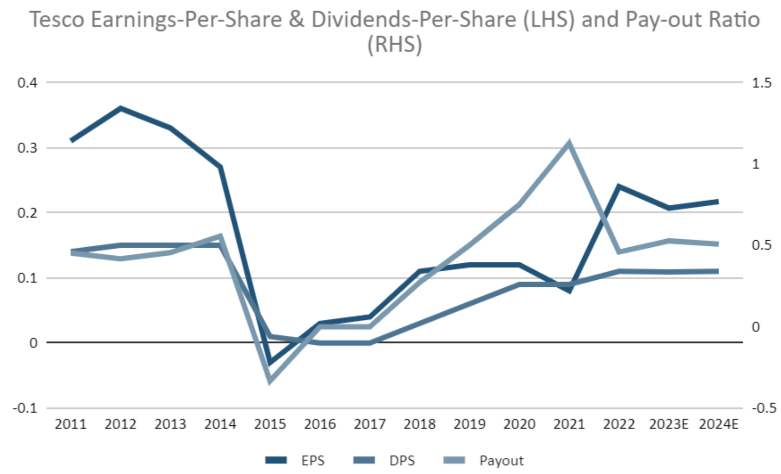
Dividend:

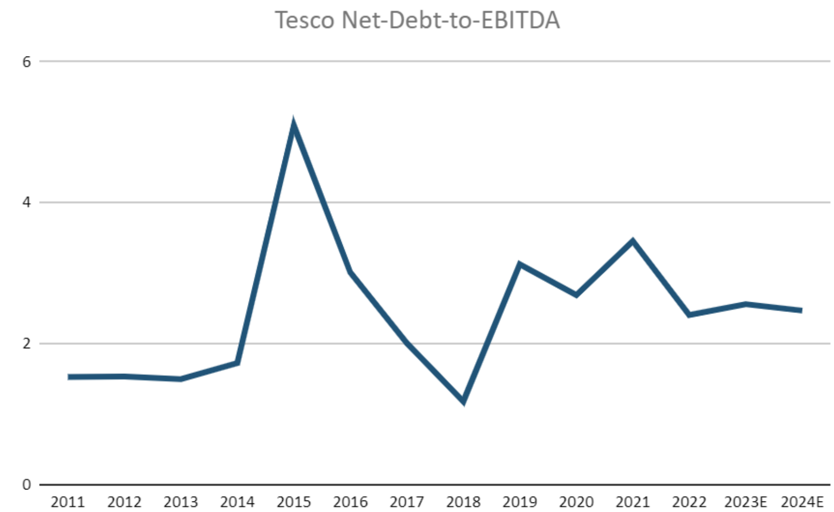


Source: Bloomberg

Policy: Pay-out of around 50 per cent and to progressively grow the dividend.

Of the three companies we've looked at this has the patchiest dividend track record. With the dividend rebased, a healthy pay-out ratio and a commitment to grow the dividend from here it still screens as an attractive name for a UK dividend portfolio.

Valuation & balance sheet:



Source: Bloomberg

Tesco screens as being cheap, in part because the shares have fallen thirty per cent this year over fears of the health of the UK consumer. Short-term events may be choppy, but long-term trends are good. Food retailers have historically had the ability and capacity to pass on inflation and maintain margins through economic cycles. Buying at these levels the holder is compensated for taking on the risk that a given year may see a mismatch in revenues and input costs.

Avoid UK banks: NatWest (NWG), Barclays (BARC) & Lloyds (LLOY)

Short summary: Conflicting pressures on the banks' business models make it hard to get excited about dividend growth and sustainability.

	PE	P/B	Div yield
Lloyds	6	0.63	5.70%
Barclays	6.5	0.65	11.90%
Natwest	4.6	0.4	4.70%

Source: Bloomberg

Longer summary: Rising rates are good for banks, but rates usually rise because growth is strong. We are in a peculiar macroeconomic situation where rates are rising but the economy is contracting. Analysis is, for the most part, driven by the macro situation and without confidence in an improving macro situation it is hard to push UK banks as a buy. You want to be investing in banks when there is a gentle increase in rates driven by a strong economy.

Business model: The model is banks take in deposits, lend out at a higher rate, charge fees and fines for access to products (overdrafts, mortgage arrangement fees, credit card late payments, access to corporate banking etc). Banks must hold enough capital to withstand drawdowns on bad loans through the tough times, leverage equity to get a high return. Rinse and repeat.

Higher rates are good because banks can make a bigger spread between what they pay on deposits and what they receive from lending out.

Typically, when rates start to increase there is a significant timing lag between increasing the rate the bank can lend at (its income) and the amount they borrow at from their depositor base (its costs). This creates an earnings tailwind.

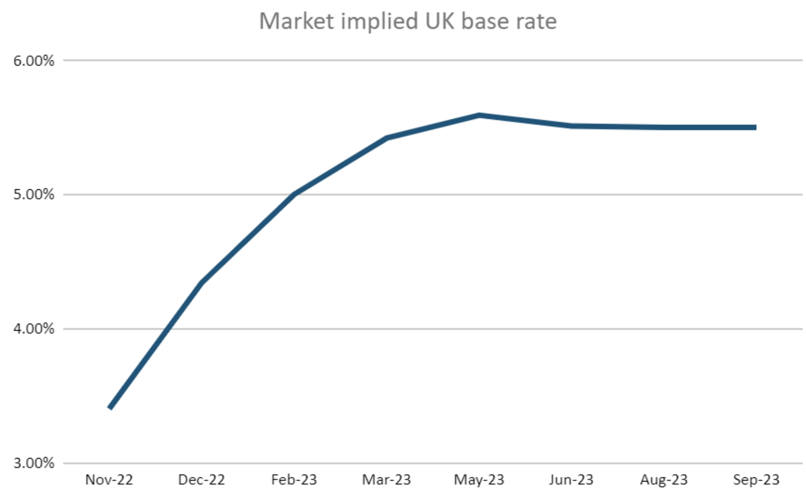
However, as rates rise faster, people and businesses will find it hard to service their debt and defaults (bad loans) will rise as rates rise, a dynamic that obviously isn't good for banks' earnings. It should be noted that in 2021 the UK had the highest household debt to GDP ratio in Europe at 86 per cent versus the European average of around 60 per cent. This is an economy that is very exposed to rising rates.

There is a technical calculation that compares the attractiveness of short-term bonds with long-term bonds based on their yield and duration (duration is the weighted average of times until fixed cash flows are received and therefore is also a measure of the sensitivity of a bond's price to changes in interest rates). It calculates the interest rate which would make the investor indifferent between investing in the short- or long-term bond. This calculation is used to indicate where the market predicts underlying interest rates to go. It is called the breakeven interest rate.

UK rates	Nov-22	Dec-22	Feb-23	Mar-23	May-23	Jun-23	Aug-23	Sep-23
expected baseline	3.40%	4.34%	5%	5.42%	5.59%	5.51%	5.50%	5.50%

Source: Bloomberg

Currently the market predicts a peak rate of five-point-nine per cent in 2023, banks have commented that depositors' rates will increase one-for-one when rates rise above three per cent. Taking UK interest rate expectations into account, any earnings tailwind from lending and borrowing spreads may be a mirage.



Source: Bloomberg

Dividends: Pay-outs have been very volatile across the sector in recent years, it is clear that the banks' income and ability to pay dividends is linked to the wider macro environment. I would expect a material dividend cut across the sector over the next three years. Pennies in front of a steamroller come to mind.

Continued below…

Valuation:

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Source: Bloomberg

Optically banks are cheap, focusing on price-to-tangible-book (P/B) and price-to-earnings (P/E). A P/B less than one suggests an acquirer could purchase the business and sell off all the assets at book value and book a profit.

Looking back over the past five years, the UK domestic banks' P/B ratios have traded in the 0.4x to 0.8x range. The market is telling us two things, either the banks are making returns below the cost-of-equity or that the banks inflate their book value of assets, or maybe a bit of both.

If I take the bank of England's (BOE) stress test downside the banking sector is trading on a P/B of 0.9-1.1x, which suggests scope for further downside in a tough macro-economic environment. In an absolute sense the banks appear cheap, but contextually they do not.

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