Dividend Dashboard

Q1 2018

AJ Bell Youinvest

Are FTSE 100 dividends sustainable?

This report shows:

- The FTSE 100 firms with the highest dividend yields
- The FTSE 100 firms with the best dividend growth records
- Earnings cover and why it is a concern
- The annual income that can be generated from the FTSE 100

Dividend dashboard explained

Each quarter, AJ Bell takes the forecasts for the FTSE 100 companies from all the leading city analysts and aggregates them to provide the dividend outlook for each company. The data below relates to the outlook for 2018.

Dividend yields are on the rise

The FTSE 100 is now forecast to pay out a total of £87.5 billion in dividends this year, equating to a yield of 4.4%. Given the meagre returns on cash and Government bonds, this dividend yield will be attractive to many investors and hence provides a potential source of support for UK stocks.

However, investors need to proceed with caution because this dividend yield has been boosted by the February and March swoon in the index which has seen share prices fall while dividend forecasts remained unchanged, pushing the forecast dividend yields higher.

In fact, the ten highest forecast dividend yields in the FTSE 100 this year are starting to look questionably high.

With the exception of Persimmon, all of those firms have seen share price weakness over the past year. Centrica, SSE, Imperial Brands, BT and M&S have all fared particularly badly and the recent 50% fall in the share price of Micro Focus has catapulted it into the list of top ten yielders.

The presence of three house builders in the top four highest yielders is testimony to the size of their capital return programmes, but it may also hint at investor scepticism that the industry can maintain its current lofty levels of profitability without the benefit of Government assistance, via the Help-to-Buy and Lifetime ISA schemes.

Table 1: The ten FTSE 100 companies forecast to have the highest dividend yield this year:

	Forecast dividend yield 2018	Forecast dividend cover 2018
Persimmon	9.3%	1.13x
Centrica	8.4%	1.19x
Barratt Developments	8.2%	1.50x
Taylor Wimpey	8.2%	1.40x
SSE	8.0%	1.27x
Imperial Brands	7.8%	1.40x
Direct Line	7.7%	1.08x
Micro Focus	7.5%	2.04x
BT	7.0%	1.76x
Marks & Spencer	6.8%	1.46x
Average	**7.9%**	**1.42 x**

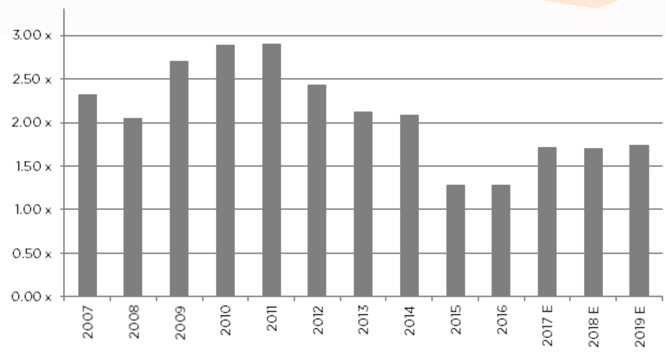
Source: Company accounts, Digital Look, analysts' consensus forecasts

Earnings cover is still a source of concern

The question now is whether these juicy looking yields are sustainable and the issue of skinny dividend cover refuses to go away.

Earnings cover for FTSE 100 dividends as a whole has improved slightly over the past quarter but it remains much thinner than ideal at 1.71 times for 2018 and has not reached the comfort zone of 2.0 times or more since 2014.

Ideally earnings cover needs to be around that 2.0 times mark to offer a margin of safety to dividend payments, should there be a sudden and unexpected downturn in trading at a specific company, or indeed the UK and global economies as a whole.



Source: Company accounts, Digital Look, analysts' consensus forecasts

The picture for the highest yielding shares is significantly worse, with the average cover across the 10 highest yielding stocks in the FTSE 100 reaching 1.42 times.

Investors therefore need to consider whether these juicy looking dividend yields are sustainable.

None of them appear to be in immediate jeopardy but this is at a time when the economy is strong, interest rates on borrowings are low and underlying trading generally favourable, with the possible exceptions of BT, Centrica and now Micro Focus. March's second profit warning of the year did not prompt analysts to revisit their dividend forecasts although investors will be looking for reassurance that the company has not bitten off more than it can chew with the acquisition of Hewlett Packard Enterprise's software division.

What level of dividend cover to look for

Divided cover of below 1.0 should ring alarm bells because it means the company is paying out more to shareholders than it makes in that year. This means it has to dip into cash reserves, sell assets or borrow money to maintain the payment. This is unlikely to be sustainable over the long term.

Dividend cover of around 1.5 is less than ideal because it means a company has less room for manoeuvre if profits fall in one year. It will then need to decide whether to reduce its dividend, stop reinvesting in the business or take on more debt.

Dividend cover of 2.0 or above is ideal because it means profit is double the amount the company is paying out to shareholders. This means it can continue to invest in the business and has scope to maintain its dividend payment in a bad year.

Dividend cover explained

Dividend cover is the amount of profit a firm makes divided by the dividend it pays out to shareholders.

The table below shows the dividend cover for a company making a profit of £100 and paying three different levels of dividend:

Dividend	Calculation	Dividend cover
£50	£100 divided by £50	2
£100	£100 divided by £100	1
£150	£100 divided by £150	0.67

Dividend growth champions

Regular readers of this report will know that consistent dividend growth is also a key trend to look out for as it can have a very positive effect on the total return delivered by a stock.

There are 26 firms in the FTSE 100 that have grown their dividend every year for at least the past 10 years and nine of these have grown their dividend every year for the past two decades.

The average total return, including dividends reinvested, from these 26 firms is 569% over the past decade, compared to the FTSE 100 average of 87% over the same period. In fact, only two companies – SSE and Imperial Brands – have failed to do better than the FTSE 100 on a total returns basis.

These calculations run from March 2008, so the Great Financial Crisis was just starting to rip around the world a decade ago, demolishing share prices in the process, so that makes the returns generated by this grouping of names all the more noteworthy.

25 of the 26 names are expected to increase their dividends in each of 2018 and 2019, to maintain their proud records, although in some cases the expected increments are pretty modest. The one exception is SSE where there are apparently some doubts over whether the dividend will rise in 2019.

However, the share price plunge at Micro Focus in March shows that buying dividend compounders is not an infallible strategy. But even after the latest collapse the IT services expert has still beaten the FTSE 100 hands down over the past decade, with a 684% total return over the past decade.

As a result, investors need to be on their guard that another firm does not join Tesco and Pearson as recent examples of 10-year growers who not only stopped increasing their payout but actually cut it, with subsequent damage to not only the yield but the share price. Diligent research on not just earnings cover but also balance sheets and cashflows is a must for anyone using an income-oriented investment strategy.

In addition, only 13 of the 26 were actually in the FTSE 100 a decade ago, so investors may need to burrow through the FTSE 250 if they are looking for the next generation of dividend growth champions.

Table 2: The FTSE 100 firms with the longest records of consecutive dividend increases:

Consecutive number of years of dividend increases	Company	Total return Mar 2008 – Mar 2018
38	Halma	718%
34	Scottish Mortgage	386%
31	Johnson Matthey	121%
29	Vodafone	129%
26	SSE	54%
24	Bunzl	285%
22	Sage	378%
21	Imperial Brands	80%
20	British American Tobacco	216%
19	Croda	834%
19	DCC	660%
19	Diageo	226%
18	Associated British Foods	246%
17	Compass	574%
17	Paddy Power Betfair	413%
15	Intertek	509%
14	BAE Systems	97%
14	InterContinental Hotels	700%
14	Whitbread	322%
13	Ashtead	4588%
13	Prudential	317%
13	Shire	212%
12	Micro Focus	684%
12	St James' Place	546%
10	Hargreaves Lansdown	1335%
10	Standard Life Aberdeen	163%
	Average of the 26 firms	**569%**
	FTSE 100 average	**87%**

Source: Thomson Reuters Datastream, Company Accounts

FTSE 100 income portfolios in retirement

The search for income is a perennial investment objective and the shift away from annuity purchase to income drawdown in retirement following the pension freedoms has only heightened the focus on income producing investments.

The ten stocks that are forecast to produce the highest dividend yield this year, if combined into an equally weighted portfolio would yield a total of 7.9%.

The average pension fund for people approaching or in retirement in the UK is £104,000*. The portfolio of the ten highest yielding FTSE 100 stocks would therefore generate an annual income of £8,216, without having to sell any investments. At the other extreme, someone with a pension fund worth the maximum £1,000,000, could take an income of £79,000 a year without selling any investments.

Investors concerned about the sustainability of these mouth-watering yields could look to the highest yielders that have dividend cover very close to or above the 2.0 times comfort level. There are plenty of firms here that still offer a very healthy looking yield. This portfolio would yield 4.4% (coincidentally the same as the FTSE 100 as a whole) and enable someone with the average pension fund of £104,000 to take an income of £4,576 without having to sell any investments. Someone with a £1m pension fund could take a very health £44,000 income.

Building a portfolio from the 26 firms that occupy the list of 10 year dividend growers would give a combined yield of 3.4%, so enough for an annual income of £3,536 on the average pension fund. (see table 4 for more examples)

Table 3: The ten highest yielding FTSE 100 firms with dividend cover at or above 2.0:

	Forecast dividend yield 2018	Forecast dividend cover 2018
Micro Focus	7.5%	2.04 x
WPP	5.1%	1.97 x
Sainsbury	4.6%	1.95 x
Anglo American	4.3%	2.39 x
G4S	4.1%	1.96 x
International Cons. Airlines	4.0%	4.39 x
Glencore	3.6%	2.41 x
Smith DS	3.6%	2.11 x
Kingfisher	3.5%	2.27 x
Schroders	3.5%	1.98 x
Average	4.4%	**2.33 x**

Source: Digital Look, analysts' consensus forecasts, Thomson Reuters Datastream

Table 4: The annual income that can be generated for different pension fund values based on the combined dividend yields from different FTSE 100 portfolios:

Pension fund value	£104,000	£250,000	£500,000	£1,000,000**
7.9% - Top 10 yielders (Table 1)	£8,216	£19,750	£39,500	£79,000
3.4% - 26 dividend growth champions (Table 2)	£3,536	£8,500	£17,000	£34,000
4.4% Top 10 yielders with healthy dividend cover (Table 3)	£4,576	£11,000	£22,000	£44,000

*FWD Research questioned 1,500 British adults aged 50 – 70 on behalf of AJ Bell. The survey took place from 28 February to 7 March 2018

**The maximum that can be held in a personal pension without exceeding the Lifetime Allowance as at March 2018