Motilal Oswal

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Back to Basics

STOCK INFO.
BSE Sensex: 8,262

S&P CNX: 2,484

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Sensex trading at 14.5x FY06E EPS; dividend yield of 1.6%.

The Indian stock market Bull Run is backed by huge capex and new projects which may reverse the demand supply situation across sectors going forward. However, a clearer picture will be evident only after a time lag of 1-2 years as most of these projects have a gestation period of 1-2 years.

In light of this, capital preservation and wealth creation are better indicators of corporate and market behaviour in the long term than any technical factors that try to time the markets. Thus, punting on companies which may or may not be successful in execution of new projects is nothing short of a gamble.

This could be the best time to zero in on stocks by taking a 'Back to Basics' approach. Keep expectations realistic and recognize the important role that dividend yield plays in a moderate return environment. Moreover, over the next few years, companies cannot afford to ignore dividend as investors are looking at higher payouts on an anticipated improvement in profits. All this makes dividend yield an important tool for selecting a stock.

What is dividend yield?

There are two ways to earn returns from a share. The first one is dividend income and the second is capital appreciation. Dividend is an important source of income for several investors. However, lately its importance with respect to stock picking has reduced.

As dividend is tax free in the hands of the investor it becomes very attractive. Also, Indian companies have paid dividends to their shareholders on a regular basis. The total dividend paid in FY05 stood at Rs341b a 20.6% YoY growth and a CAGR of 23.7% over the last four years. Dividend yield is the return an investor gets as dividend on a current purchase price. It is calculated as a ratio of DPS/Price * 100.

TOP 5

COMPANY NAME	DIVIDEND YIELD (%)
Jetking Infotrain	6.4
Chambal Fertiliser	5.0
Banco Products	4.9
Samkrg Pistons	4.8
GE Shipping Co	4.5

Comparing markets on dividend yield

India currently has a very low dividend yield. It doesn't feature among the ten highest dividend yielding markets where the Asean markets fare well. The current dividend yield of Indian markets stands at c.1.6% is justified as India is a growing economy which requires huge capex, thereby resulting in low dividend payouts. However, similar growth rate may not be sustainable going forward

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Top 10 markets for dividend yield (%)

Countries	Dividend yield in 2005
Venezuela	14.4
Singapore	5.9
New Zealand	5.6
Pakistan	5.5
Brazil	4.4
Thailand	4.3
Malaysia	4.3
Australia	4.1
Portugal	3.9
Italy	3.9
World Avg	**2.3**

Why look at dividend yield?

Going forward, the importance of looking at dividend yield is expected to increase as the markets get mature providing moderate returns and the majority of companies which have been reinvesting in their businesses would prefer to increase the dividend payout as limited growth opportunities will be available.

Statistics indicate that companies included in the Sensex which had high dividend yield during 2003 performed better than those with lower dividend yield. We have reproduced the list of companies which had a dividend yield of more than 5% in FY03 and their returns over a two year period below. Sensex yield during FY03 stood at c.3%. The compounded average growth rate for the top six stocks on the basis of dividend yield stood at 67.8% as against 50% for the remaining stocks. It may be noted that we have not included new stock listings that took place during FY03-05.

Companies	Yield FY03	Yield FY05	2-year return
Tata Steel	9.1	3.9	96.6
Hero Honda Motor	8.9	3.9	57.4
O N G C	8.5	4.9	51.3
Guj. Ambuja Cem	6.3	3.2	59.1
ICICI Bank	6.2	2.4	72.3
Tata Power Co.	5.4	2.2	70.2
Average return			**67.8**

*Prices as on 29th/30th April *Source: Motilal Oswal Securities*

This shows that by just investing in the high dividend yield stocks included in the Sensex, an investor could gain better returns than the Sensex CAGR of c.47%.

How to use dividend yield?

Michael Higgis in his book "Beating the Dow" focused on an investment strategy called "Dogs of the Dow". It is a simple strategy which doesn't require detailed analysis. The Dogs of the Dow are 10 of the 30 companies in the Dow Jones Industrial Average (DJIA) with the highest dividend yield. According to this strategy, the investor shuffles around his portfolio, adjusting it so that it is always equally allocated in each of these 10 stocks. On an average, 3-4 stocks will be shuffled every year. The replacement is because of a fall in the dividend yields or because they have been removed from the DJIA.

The premise of this investment strategy is that stocks which have fallen out-of-favor now are still good companies and holding on to them could give better returns in future. Once these companies become favorites again and are revalued, the stocks of such companies can be sold and shares of new companies that are out of favor temporarily can be bought. This strategy has an implied benefit of selling the stock when they are dearer and buying them when they are cheap. Moreover, the lower volatility in such stocks also lowers the downward correction in them in a falling market.

From 1957 to 2003, the Dogs have outperformed the Dow by about 3%, averaging a return rate of 14.3% annually whereas the Dow averaged a return of 11%.

Dividend yield: not the sole criterion

Though this method looks simple to use, it has some inherent pitfalls. Dividend yield cannot be taken as a sole indicator for buying a stock. The dividend yield of a stock could be higher because of some specific fundamental reason which has resulted in a decline in stock price. A company's dividend yield could suddenly increase as its price falls on the back of lower expected earnings or such other fundamental reasons.

The difficult task is to select a stock from the list of companies with high dividend yield. Also, while selecting a stock, we are banking on the consistency in dividend payout. The company may declare a special dividend during the year which may result in a higher dividend yield for that period only (eg. Ador Welding)

Further, picking and replacing stocks in an ongoing bull market as per the "Dogs of the Dow" theory could result in selling stocks too early, when you would have been better off holding on or adding to your position.

Some ratios to look at in order to avoid such a pitfall:

1) Dividend coverage ratio(x) or dividend payout ratio: Like the interest coverage ratio, this ratio will give an understanding of the number of times the company can pay dividends from its profit for the year. Any fall in this ratio would indicate a fundamental change in the company's profitability. Also, this would indicate if the company is borrowing to pay off dividends in order to attract investors.

2) Profit growth (%): There has to be a growth in earnings as lower earnings may result in a decline in share price, thereby resulting in higher dividend yield.

3) Reasonable RoE: RoE greater than opportunity cost of capital indicates that there is an incentive for plowing back some profits rather than distributing it as dividends. A company would continue to expand as long as the RoE is more than its opportunity cost of capital as that would mean an optimum utilization of resources and increase in earnings. RoE should be reasonable as companies with higher dividend yield normally will not have growth opportunities for expansion or are not willing to enter into new businesses unlike 'growth companies'.

It may also be noted that the dividend yield strategy will neglect companies wherein there is a huge growth potential. The companies that have huge growth potential would retain earnings to grow further. For example, Microsoft demonstrates the relationship between dividend and growth. The company didn't pay dividend but reinvested all earnings to fuel further growth. Eventually, 18 years after its IPO, the company thought of rewarding its shareholders through dividend and share buybacks as it could no longer grow at the unprecedented rate it had maintained for so long. Microsoft, later planned to distribute nearly $75b worth of value through $0.08 quarterly dividends, a special $3 one-time dividend, and a $30b share buy back program spanning four years. Along similar lines, Bharti has not declared any dividends till date.

Companies/sectors with high yields

As mentioned earlier, a company declares a higher dividend when it belongs to a mature industry where the growth is stable thereby leaving no incentive for plowing back the profits. These companies attract investors via dividend/buyback. Godrej Consumer and Nestle etc. where the dividend payout is more than 75%, belong to this category. Also, it would include companies whose topline growth is dependent on its holding company. However, it must be noted that a positive change in the business prospects or earnings prospects of such companies could make these companies attractive as they have a high dividend yield with limited downside.

Criteria for stock selection

After taking into consideration the traps of dividend yield, we have selected some companies based on the following criteria:

- **Stock with 2.5% dividend yield:** The dividend yield on the Sensex stands at c.1.6%. We have selected the companies with a dividend yield of more than or equal to 2.5%
- **Consistent growth in profit:** The profit growth for the last three years should be consistent. This would eliminate companies which had one-time profit growth in FY05.
- **RoE of more than 15%:** We have selected companies with a RoE of more than 15% which is higher than average opportunity cost of capital estimated at c.12-13%. However, companies in which we see a growth potential and have an RoE equal to the opportunity cost of capital have been taken.
- **No one time dividend:** Companies which had paid dividend only in FY05 or a higher one time dividend would show a better dividend yield. We have filtered out such companies and have selected companies that have consistently paid dividends for the last three years

The following is the list of companies that satisfy the criteria mentioned above. Investing in these companies could reduce the downside risk and produce reasonable returns. However, it may be noted that a detailed research on these companies has not been undertaken and hence we would suggest one does a detailed analysis before investing in these companies.

Companies that meet our criteria

Company Name	Dividend Yield	Payout ratio FY05	Profit CAGR FY03-FY05	RoE	P/E Ratio
Jetking Infotrain	6.4	35.9	25.0	41.2	11.0
Chambal Fertiliser	5.0	35.7	13.7	22.3	10.1
Banco Products	4.9	51.6	15.1	16.2	9.9
Samkrg Pistons	4.8	67.5	24.6	24.1	13.3
GE Shipping Co	4.5	21.7	80.6	36.7	4.3
Swaraj Engines*	4.4	65.0	30.6	27.9	13.4
Ador Fontech	4.4	47.0	33.0	27.0	11.8
Sambandam Spg.	4.4	41.1	32.2	29.8	11.7
Rajshree Sugars	4.3	38.5	80.2	28.3	9.6
Indian Card Clothing	4.2	54.6	102.0	11.6	9.4
Andhra Sugars	4.1	39.3	35.8	23.7	9.0
G N F C	3.9	25.4	62.8	25.6	5.5
City Union Bank	3.9	21.3	17.8	20.9	5.2
Ashok Leyland	3.6	46.7	42.2	25.0	11.6
Deepak Fertilizers	3.6	34.8	13.4	19.8	8.6
Tata Chemicals	3.5	43.6	25.2	17.0	11.8
GIC Housing Finance	3.4	23.5	64.0	16.2	5.4
NRB Bearings	3.2	37.4	45.9	25.1	10.9
Coromandel Fert.	3.0	28.6	61.5	19.5	10.4
Hero Honda Motor	2.9	53.0	18.0	61.6	16.9
Cummins India	2.8	62.7	19.6	20.3	19.4
Tata Invest.Corp	2.7	25.4	56.6	25.3	9.1

**Adjusted for bonus*

Source: Capitaline / Motilal Oswal Securities Ltd

NOTES

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The MOSt group and its Directors own shares in the following companies covered in this report: Indian Card Clothing, Hero Honda Motor

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