THE CASE FOR A CONSISTENTLY GROWING, PRUDENTLY PAID, LONG-TERM DIVIDEND

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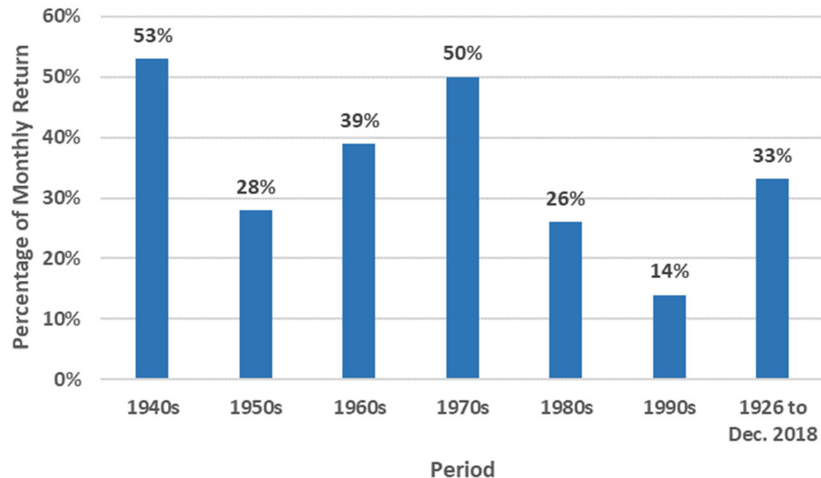
Version 1

"Since 1926, dividends have contributed approximately one-third of the total return of the S&P 500, while capital appreciations have contributed two-thirds." The compounding effect of these dividends is even more powerful (almost doubly powerful).[1]

DIVIDEND INCOME AS A PERCENT OF MONTHLY TOTAL RETURN OF THE S&P 500



Source: *A Fundamental Look at the S&P 500 Dividend Aristocrats*, Smita Chirputkar, February 2019

While companies like Amazon and Berkshire Hathaway have never issued dividends, they have created immense value for shareholders through their abilities to compound capital.

However, not every company has access to high growth investment opportunities like these outlier firms, so paying a dividend may be the most appropriate way to create value for shareholders.[2] **To reap the greatest benefit of paying a dividend, firms should abide by the following tenets: consistently grow the dividend over time, prudently pay it according to cash flows, and continue to pay it over the long term.**

Consistently Growing

Earnings can bounce around over a 5-, 10-, or 20-year period, but the dividend must be the constant – the backbone of the total return. And each year, the dividend should grow.

Investors want certainty and stability. Having an inconsistent dividend is equivalent to providing unreliable guidance to your shareholders. It is difficult to justify investing in a stock that, in good times pays a consistent dividend, but in bad times, shuts it off. And having a dividend that either does not increase at any regular rate or is largely variable with no upward trajectory, does not have the reliability shareholders are looking for.

[1] *A Fundamental Look at the S&P 500 Dividend Aristocrats*, Smita Chirputkar, February 2019.

[2] The decision on whether to issue dividends is a capital allocation decision. Management teams have essentially five areas to which they can allocate capital: (1) pay dividends, (2) pay down debt, (3) buy back shares, (4) build the cash balance and, last, but not least, (5) reinvest in the business.

For instance, if you were considering investing in a company or partnership that was going to buy a piece of real estate,[3] you would only need to know the following: *how much money am I going to get and when am I going to get it?*

If the sponsors of this real estate deal told you they would pay about a 5-7% dividend on cost in the first year, and they plan to grow that dividend at about 3-5% each year, you would know what to expect (an 8-12% Total Return). If, however, the sponsors of the deal did not follow through with this guidance, you would not be satisfied. The trust you had for the sponsors would erode and you would likely sell your investment – maybe even for less than you had originally paid. This happens in stocks every day.

In addition to providing reliability, consistently growing dividends becomes a powerful force within the company and gets embedded in the culture. **Consistently growing dividends will motivate the company to properly invest its discretionary cash flow, and challenge employees to do more with fewer resources, fueling innovation and reducing waste.** All of this will help generate excess cash flow that will support increases in dividends per share over time. Once the growing dividend is embedded in the company and the culture, it is very difficult to stop the forward momentum of growth and innovation.

Because everyone in the company is acting resourcefully to ensure that the business generates a profit, employees will be more excited about their equity-based compensation, since they know the company will be more valuable in the future.

The companies in the *S&P 500 Dividend Aristocrats* index provide great examples of the positive impacts realized from consistent dividend growth. To qualify for the index, a company must have followed a policy of growing dividends annually for at least 25 consecutive years. With both capital growth and dividend income qualities, the index has produced higher returns and lower volatility when compared to the S&P 500.[4]

In short, not only your firm's employees, but also your partners, and the public will witness the momentum generated by the growing annual dividend and will be excited to take part in that growth.

Prudently Paid

Dividends should be prudently paid. That is, the company should **pay a dividend as a percentage of Discretionary Cash Flow that is not too high. The percentage should be set so that in both good times and bad, leadership feels confident they will be able to cover a growing dividend.** And as the Discretionary Cash Flow grows, so too will the dividend.

Every company, whether publicly traded or private, should have an internal model defining Discretionary Cash Flow ("DCF"). For our purposes, we will define it as:

$$\begin{aligned} &Discretionary\ Cash\ Flow\ = \\ &EBITDA - Maintenance\ Capex - Interest\ Expense \\ &- Taxes - Working\ Capital\ Adjustments \end{aligned}$$

DCF is the money that the owners, management, and/or board, collectively, need to decide how to allocate each year. They have essentially five areas from which to choose: (1) pay dividends, (2) pay down debt, (3) buy back shares, (4) build the cash balance, and last, but not least, (5) reinvest in the business. Generally, leadership should have a pretty good plan of how to allocate the DCF over the next 3 – 5 years.

Every time the board and management team increase the dividend, they will be making the difficult capital allocation decision for not only

[3] This concept applies to any investment, including shares of stock in a publicly traded company.

[4] *A Fundamental Look at the S&P 500 Dividend Aristocrats*, Smita Chirputkar, February 2019.

the current year, but also for future years, when the economic environment is largely unknown. If the board and management believe that earnings growth will be stagnant over the near term, they should temporarily slow the growth rate of the dividend. For instance, if they usually increase the dividend by 3%, maybe instead they increase it by 1%. Assuming their long-term vision for the business has not changed, they will get back to 3% relatively soon.

Choosing how to allocate discretionary cash flow can be especially difficult in times of economic stress like the present.[5] But committing to prudently paying dividends will enable the company to provide stability to shareholders, in both good times and bad.

Long Term

Dividends should be paid consistently over multiple decades. For those who think that the implementation of a long-term, **multi-decade**, consistently growing dividend will not produce good stock value, please look at a relatively unknown company called Casey's (NYSE: CASY) or look at a better-known company like Coca-Cola (NYSE: KO). The dividend compounded annual growth rate has largely matched the increase in stock price.[6]

Companies that pay a long-term dividend enable shareholders to create their own value through reinvestment. While the company may not be able to explicitly account for this type of benefit, the board and management team should consider it indirectly.

Maintaining a long-term payout ratio of 30% can produce a solid total return over the course of 20 years.[7]

When deciding by how much to increase a dividend, leadership should seriously consider if Discretionary Cash Flows are being used to generate consistently increased earnings over time.

Since cash today is worth more than cash tomorrow, any expected increase in earnings tomorrow should be worth ***substantially more*** than the amount of the dividend increase today. If the expected increase in earnings tomorrow cannot meet the "substantially more" criteria, then companies should increase the dividend accordingly, and provide investors the opportunity to reinvest on their own terms. This will create significant value for shareholders over many decades.

Conclusion

All companies, whether private or public, should aim for one end result: good revenue growth that generates Discretionary Cash Flows that can be used to do good things for the company, its employees, and shareholders.[8] Companies that abide by these tenets when paying dividends will be greatly rewarded by shareholders.

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[5] "The current pandemic is certainly one of the worst crises this country has faced in many years. But our consistent long-term focus has gotten us through other crises before and we are confident that we'll get through this one as well. An important driver of the long-term value creation by National Retail Properties is our history of raising the dividend every year for the past 30 years." (May 4, 2020 Earnings Transcript, National Retail Properties)

[6] Casey's dividends have grown from 1990 – 2020 at 14.0% compounded annually, while the stock has grown at 14.9%. Coca-Cola's dividends have grown from 1990 – 2020 at 9.8% per year, while the stock has grown at 7.8%. Both without dividends included. Unsurprisingly, the stock has closely followed the dividends in both cases.

[7] Payout Ratio = Dividends Paid / DCF. Some firms like REITS may be required to pay out 90% of earnings.

[8] This can be implemented on a private company with one shareholder or a public company with millions of shareholders.

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