Safest Dividend Yields

Cash is king, especially in a severe economic decline. Only firms with strong core earnings will be able to sustain their dividends. We do the diligence on core earnings to measure the reliability of dividend yields. Earlier this week, we featured the Riskiest Dividend Yields. Safer dividend stocks are this week's Long Idea.

Get the best fundamental research

Our Robo-Analyst[1] identifies firms with attractive dividend yields and the cash flows to sustain them. These firms are in a better position to maintain dividends in the future, even as economic conditions deteriorate.

Not All Dividend Yields Are Created Equal

High yielding dividend stocks hold great appeal for some investors. But, that appeal is only realized if the firm generates the free cash flow needed to pay its promised dividend.

Here are the criteria we used to identify the safest dividend yields:

- Dividend yield greater than 3.5%
- Positive free cash flow (FCF) yield over the trailing twelve month (TTM) period
- Cumulative five-year FCF greater than cumulative five-year dividend payments
- Net debt less than 25% of market cap
- A Neutral-or-better Risk/Reward rating

We then ranked these firms based on the surplus between FCF and dividend payments over the last five years.

Figure 1 includes the firms with a FCF-minus-dividends surplus greater than $5 billion.

Figure 1: Safe Dividend Yields – FCF vs. Dividend Surplus Greater Than $5 Billion

Company Name	Ticker	Sector	Rating	FCF Minus Dividends ($B)	Dividend Yield	FCF Yield
Citigroup Inc.	C	Financials	Attractive	$128.8	4.8%	20.5%
Discover Financial	DFS	Financials	Very Attractive	$8.7	4.9%	19.2%
Novartis AG	NVS	Healthcare	Very Attractive	$11.5	3.7%	16.3%
Omnicom Group	OMC	Consumer Cyclicals	Very Attractive	$5.3	4.7%	12.9%
JPMorgan Chase	JPM	Financials	Very Attractive	$61.3	4.0%	10.6%
PNC Financial	PNC	Financials	Very Attractive	$13.6	4.8%	10.0%
Philip Morris	PM	Consumer Non-cyclicals	Very Attractive	$9.7	6.4%	8.5%
Caterpillar Inc.	CAT	Industrials	Very Attractive	$20.7	3.6%	7.7%
Ameriprise Financial	AMP	Financials	Very Attractive	$9.6	3.8%	7.0%
Eaton Corporation	ETN	Industrials	Attractive	$7.4	3.8%	5.6%

Excludes Real Estate Investment Trusts (REITs)
Sources: New Constructs, LLC and company filings.

The firms in Figure 1 vary by industry, but each has generated significantly more in free cash flow than they have paid out in dividends over the past five years. In a slowing or even contracting economy, ample cash provides a life raft to ride out tough times while maintaining returns to shareholders.

[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

As a byproduct of ample cash flows, some firms, such as Eaton Corporation (ETN), actually raised its dividend payment when it announced the most recent quarterly dividend in mid-February.

Figure 2 includes the firms with a FCF-minus-dividends surplus of greater than $2 billion but less than $5 billion.

Figure 2: Safe Dividend Yields – FCF vs. Dividend Surplus Between $2-$5 Billion

Company Name	Ticker	Sector	Rating	FCF Minus Dividends ($B)	Dividend Yield	FCF Yield
Comerica Inc.	CMA	Financials	Very Attractive	$3.8	9.3%	44.4%
Zions Bancorp	ZION	Financials	Attractive	$2.2	5.1%	23.2%
Seagate Technology	STX	Technology	Neutral	$3.6	5.3%	16.2%
State Street Corp	STT	Financials	Attractive	$4.3	3.9%	13.4%
M&T Bank Corp	MTB	Financials	Very Attractive	$2.1	4.3%	13.3%
Western Union	WU	Industrials	Neutral	$4.3	5.0%	13.1%
Harley-Davidson	HOG	Consumer Cyclicals	Attractive	$2.1	8.0%	12.2%
Ralph Lauren Corp	RL	Consumer Cyclicals	Very Attractive	$2.9	4.1%	11.8%
Cummins Inc.	CMI	Consumer Cyclicals	Neutral	$2.2	3.9%	6.8%
Emerson Electric	EMR	Industrials	Very Attractive	$4.8	4.2%	5.2%

* Excludes Real Estate Investment Trusts (REITs)
Sources: New Constructs, LLC and company filings.

Figure 2 contains many Consumer Cyclicals firms that may see diminished demand as stores shutter amidst stay-at-home orders across the country. However, their high FCF yields and history of generating free cash flow above dividend payments provide an important margin of safety not found in many firms. For instance, Harley-Davidson (HOG) actually increased its dividend in mid-February, as other consumer goods firms with less cash were forced to cut.

Figure 3 includes the firms with a FCF-minus-dividends surplus of less than $2 billion.

Figure 3: Safe Dividend Yields – FCF vs. Dividend Surplus Less than $2 Billion

Company Name	Ticker	Sector	Rating	FCF Minus Dividends ($B)	Dividend Yield	FCF Yield
Lazard, Ltd.	LAZ	Financials	Very Attractive	$1.7	8.0%	34.8%
Foot Locker, Inc.	FL	Consumer Cyclicals	Very Attractive	$1.8	6.9%	17.9%
Evercore, Inc.	EVR	Financials	Very Attractive	$0.5	5.0%	15.8%
Ally Financial Inc	ALLY	Financials	Very Attractive	$0.8	5.3%	15.3%
Williams-Sonoma	WSM	Consumer Cyclicals	Very Attractive	$0.9	4.5%	11.2%
NetApp Inc.	NTAP	Technology	Very Attractive	$1.4	4.6%	9.4%
ManpowerGroup	MAN	Industrials	Attractive	$1.2	4.1%	8.2%
Axis Capital.	AXS	Financials	Attractive	$0.8	4.2%	8.0%
MSC Industrial	MSM	Industrials	Attractive	$0.5	5.5%	6.5%
Snap-On Inc.	SNA	Industrials	Attractive	$0.8	4.0%	5.7%

* Excludes Real Estate Investment Trusts (REITs)
Sources: New Constructs, LLC and company filings.

With payout ratios as low as 16%, many of the firms in Figures 1-3 already pay dividends well below their means. See Appendix 1 for more details on payout ratios.

These companies have a higher likelihood to maintain dividends through the current downcycle. The excess cash flows provide them resources and flexibility to better manage operations while returning capital to shareholders. Below we'll examine two firms in greater detail.

Williams-Sonoma Inc. (WSM) – 4.5% dividend yield

WSM currently provides a high-quality dividend yield of 4.5%. When we featured the stock as a Long Idea in February 2020, it was yielding just 2.6%. Now, with shares down nearly 50% year-to-date, investors have the opportunity to get a quality business at a discount with the added benefit of a higher dividend yield.

Profitability Improving Going into Downturn

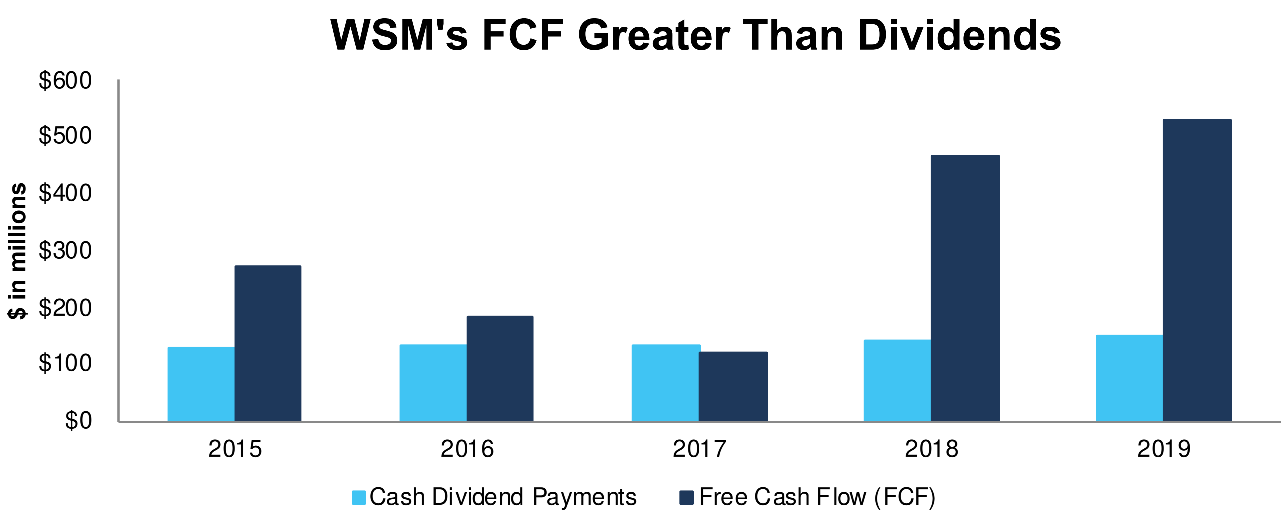
WSM's fundamentals and profitability have trended upwards in recent years, and the firm has generated ample cash flow. WSM's invested capital turns, a measure of capital efficiency, increased from 1.76 in fiscal 2018 to 1.87 in fiscal 2019. WSM's net operating profit after-tax (NOPAT) margin fell slightly from 7.0% to 6.8% over the same time. However, the improved capital efficiency was enough to offset the margin decline and WSM's ROIC improved from 12.4% in fiscal 2018 to 12.7% in fiscal 2019.

Consistent Cash Generation

WSM has generated positive free cash flow in each of the past 15 years and generated a cumulative $1.6 billion (55% of market cap) since 2015. WSM paid out $687 million in dividends over the same time. Figure 4 plots the $882 million surplus between free cash flow and dividends since 2015.

The firm's FCF yield of 11%, is well above the Consumer Cyclicals sector average of 1% and further illustrates the firm's cash generation.

Figure 4: WSM's FCF Vs. Dividends Since 2015



Sources: New Constructs, LLC and company filings

WSM's high profitability and cash generation allows the firm to operate with no net debt. In fiscal 2019, WSM had $300 million in debt and $432 million in cash and equivalents, which equates to $132 million in net cash. With net cash, and an existing credit revolver, WSM is in a better position to withstand the current economic downturn and preserve its dividend, just as it did during the 2008/2009 global recession.

Caterpillar Inc. (CAT) – 3.6% dividend yield

While Caterpillar's 3.6% dividend yield is not the highest in Figures 1-3, it is twice its January 2018 level. Investors searching for yield have the chance to get a cash flow machine at a discount with a yield last seen in late 2016.

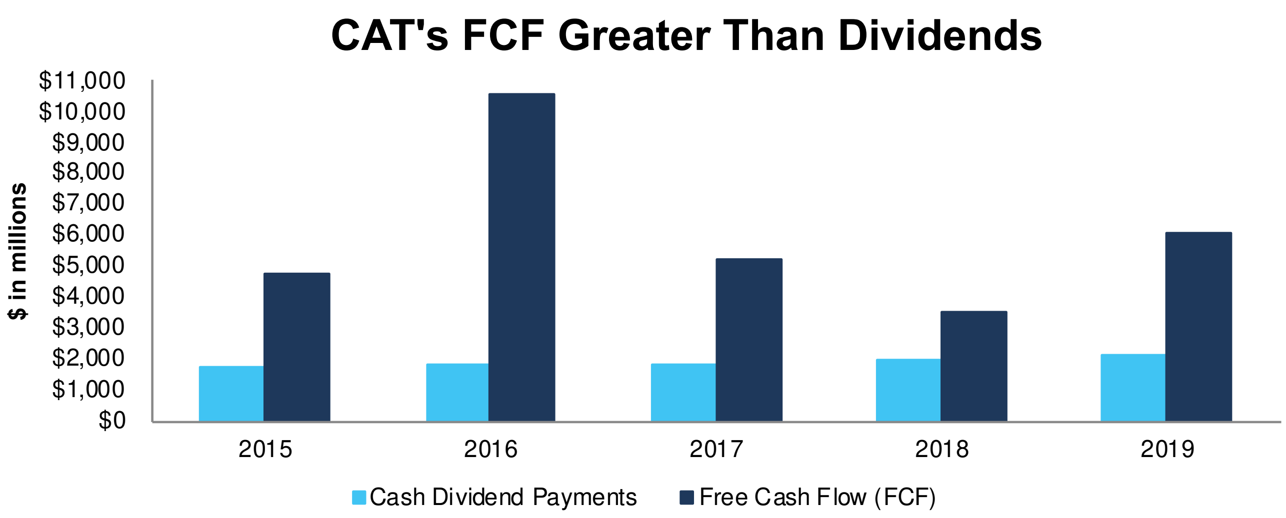
Profitability Trending in the Right Direction

Even after declining slightly in 2019, CAT's operational and capital efficiency are much improved since 2016. CAT's NOPAT margin has increased from 4.5% in 2016 to 12.1% in 2019. CAT's invested capital turns have improved from 1.05 to 1.22 over the same time. The combination of rising margin and capital turns drove CAT's ROIC from 5% in 2016 to a top-quintile 15% in 2019.

Cash Flow Machine

CAT has generated positive free cash flow in 12 of the past 15 years while generating a cumulative $30.2 billion (49% of market cap) since 2015. The firm has paid out over $9.5 billion in dividends over the same time. Figure 5 plots the $20.7 billion surplus between free cash flow and dividends since 2015. CAT's current FCF yield is 8%, which is well above the Industrials sector average of 2%, and highlights CAT's significant cash generation.

Figure 5: CAT's FCF vs. Dividends Since 2015



Sources: New Constructs, LLC and company filings

CAT's profitability and consistent cash flows provide the firm the advantage of operating with little net debt. In 2019, CAT had $9.1 billion in debt and $7.3 billion in cash and equivalents, which equates to $1.8 billion in net debt, or just 3% of market cap. In other words, CAT is well positioned to weather a downturn while persevering its dividend, as it did during 2008-2009.

This article originally published on April 1, 2020.

Disclosure: David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, sector, style, or theme.

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

Appendix 1 – "Real" Payout Ratios Revealed

The payout ratio, the amount of net income paid out as dividend, is a common metric used to analyze the safety of a dividend payment. The calculation for this metric is dividends per share divided by net income per share.

Using net income as the denominator in any calculation is problematic, due to the numerous accounting loopholes that make it easy for executives to manage earnings. In "Core Earnings: New Data and Evidence", professors at Harvard Business School and MIT Sloan empirically show that managers manipulate earnings.

Rather than using GAAP net income, we can calculate a firm's payout ratio based on its core earnings[2] to gain a more accurate view of a firm's payout ratio. Firms with understated earnings have artificially high payout ratios, while those with overstated earnings have artificially low payout ratios.

Figure I: GAAP Payout Ratio Vs. Adjusted Payout Ratio – Based on 2019 Annual Dividends

Company Name	Ticker	GAAP Payout Ratio	Adjusted Payout Ratio	Difference
Ralph Lauren Corp	RL	47%	36%	11%
Axis Capital Holdings, Ltd.	AXS	48%	38%	10%
Philip Morris International, Inc.	PM	100%	95%	6%
State Street Corp	STT	37%	34%	3%
Eaton Corporation	ETN	54%	52%	2%
Williams-Sonoma Inc.	WSM	47%	46%	1%
Evercore, Inc.	EVR	33%	32%	1%
ManpowerGroup	MAN	28%	28%	1%
Lazard, Ltd.	LAZ	95%	95%	1%
Caterpillar Inc.	CAT	37%	36%	0%
Citigroup Inc.	C	24%	24%	0%
Discover Financial Services	DFS	18%	19%	0%
Zions Bancorp	ZION	31%	31%	-1%
Omnicom Group, Inc.	OMC	43%	44%	-1%
Harley-Davidson, Inc.	HOG	56%	57%	-1%
Comerica Inc.	CMA	34%	35%	-1%
Emerson Electric Company	EMR	53%	54%	-1%
Snap-On Inc.	SNA	32%	33%	-1%
JPMorgan Chase & Company	JPM	32%	33%	-1%
MSC Industrial Direct Co, Inc.	MSM	51%	52%	-1%
Cummins Inc.	CMI	34%	35%	-1%
M&T Bank Corp	MTB	30%	31%	-2%
Foot Locker, Inc.	FL	33%	34%	-2%
PNC Financial Services Group, Inc.	PNC	37%	39%	-2%
Ally Financial Inc	ALLY	16%	19%	-3%
Ameriprise Financial, Inc.	AMP	27%	32%	-5%
NetApp Inc.	NTAP	35%	43%	-8%
Western Union Co (The)	WU	33%	48%	-16%
Seagate Technology, PLC	STX	36%	55%	-19%
Novartis AG	NVS	131%	184%	-52%

Sources: New Constructs, LLC and company filings

[2] Our core earnings are a superior measure of profits, as demonstrated in In Core Earnings: New Data & Evidence a paper by professors at Harvard Business School (HBS) & MIT Sloan. The paper empirically shows that our data is superior to IBES "Street Earnings", owned by Blackstone (BX) and Thomson Reuters (TRI), and "Income Before Special Items" from Compustat, owned by S&P Global (SPGI).

Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

HBS & MIT Sloan research reveals that:

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Corporate managers hide gains/losses in footnotes to manage earnings.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.