

Dividend Income Report

Dear Subscriber,

Welcome to the latest issue of **Dividend Income Report**.

We review a broad range of metrics to determine the most attractive investment opportunities. We find companies that meet our criteria, and individually analyse them, by scanning the history of each company's financial results over as long a period as possible (preferably more than two economic cycles) to judge the quality and cyclicity of the company's earnings and dividends.

Our [investment research process](#) is designed to throw out the companies that are not attractive as soon as possible and when a relevant investment opportunity does emerge, we perform rigorous analysis on a company's operations. We carry out as much research as is necessary to give us confidence that we have found an excellent long-term investment opportunity.

We hope you enjoy this issue of **Dividend Income Report** and please send us [feedback](#) if you have any ideas or comments.

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Please also tell your friends and family, colleagues at work, about **Dividend Income Investor**. You can even earn back your subscription and more by joining our [affiliate program](#).

Till next time,

Steven Dotsch

Steven Dotsch
Managing Editor
EMAR Publishers

Why the best time to buy is not always 'now'

You will, of course, be aware of the rise in the stock market during the latter part of 2010, and, earlier this year. In fact, the FTSE100 Index reached its highest level for 2011 at 6,077 earlier in January.

All this clearly has had a negative effect on dividend yields. It's simple: rising share prices depress dividend yields, in particular if dividends are not increased similarly in time. It is important to realise that dividend yields are not static. As share prices fluctuate, so do their current and prospective dividend yields.

All things being equal, when a company's share price goes up the dividend yield falls and if the share price goes down the dividend yield increases. The higher the share price, the lower the rate of return. The lower the share price, the higher the rate of return.

So you may ask yourself "is now the right moment to start a dividend income growth portfolio?" "Will share prices go up again or will they collapse during the next six months?" I am afraid I can't tell you.

Unless you have a working crystal ball, we will never know for sure whether today's share prices are low or high relative to tomorrow's price or any other price in the future.

My view is that when you have money to invest for the long term it's always a good time to start a dividend income growth portfolio, but only, as a dividend income investor, as long as share prices are "low" and dividend yields are high.

Dividend income but not at any price

As a long-term investor in dividend paying companies, I am sure you recognise the benefits of buying dividend-paying shares when their share prices are "low" while the dividend appears not to be in any particular danger.

Pay more, get less. Pay less, get more.

The share price you pay for a stock will determine the rate of return you are going to get from your investment.

Long-term returns depend on the price you pay for the shares when you buy. Therefore, buy “cheap” in the first place, and over time you are likely to make much more money than when you buy “dear”. This is, because:

- You will get more shares for your ‘buck’
- Your dividend amount will be more because you bought more shares
- You end up with more shares by re-investing your dividends in ever more shares by re-investing your dividends, etc.

When are share prices low?

A share price on its own means nothing. An investor must determine whether the share price of any given company at any given moment is high, low or just about right.

Dividend Income Investor.com is very much focused on a value-based investment approach that uses a company’s dividend yield as the most important measure of value.

From our perspective “undervalue” is not simply a very “low” share price. Rather, it represents a situation in which a company’s dividend yield is historically high in relation to the bottom of a major share price decline i.e. a currently low share price.

Over longer periods, share prices generally fluctuate between recurring extremes of high dividend yields and low dividend yields. What’s more, dividend yields at undervalue and overvalue tend to be repetitive. Over time, repetitive patterns start to appear.

Long term, companies with recurring annual dividends show areas of low share prices, with high dividend yields, and high share prices with low dividend yields. Either way, if and when we come across such areas, we are interested.

In conclusion, when considering buying a stock we focus on high quality companies with a track record of increasing dividends, valued at or near historically undervalued share prices.

So, with this introduction out of the way, let’s not waste any more time and get straight into the first company for our dividend income growth portfolio.

Tesco – A Dividend Growth Stock

Tesco operates multiple retail formats in 14 different countries and ranks among the top three grocery retailers in the world with US' Walmart and France's Carrefour holding top slots.

Tesco is the leading food retailer in the United Kingdom, where it operates about 2,500 of its nearly 4,900 stores worldwide. It holds more than 30% share of the UK grocery market, substantially more than Walmart, in its home market. Tesco has also expanded into the non-food market through hypermarkets and online operations.

In comparison to its homegrown competitors such as Sainsbury, Morrison, M&S and Waitrose, all with no or hardly any activities abroad, Tesco is becoming an increasingly international business. Tesco's non-UK sales recently surpassed one-third of total group revenues for the first time. The group has a large presence in many Eastern European countries and parts of Asia. Tesco entered the US market in late 2006.

In particular Tesco's already vast operation throughout Asia Pacific is starting to deliver significant profits for the group despite China not yet breaking even. Former international head Philip Clarke replaces Sir Terry Leahy in March, and he will no doubt be looking to the rapid economic growth and favourable demographic trends in the Far East.

Despite successes on the international front, Tesco still generates more than half of its overall sales and around 80% of its retail operating profits in the UK. In the current economic environment in the UK it faces continued difficulty and uncertainty. The company had been losing market share to both price discounters such as Aldi and Lidl as well as peers like Asda (owned by WalMart) and Wm Morrison Plc.

Food cost inflation and the increase in the value-added tax should weigh on near-term results in the UK, while saturation and pressures from regulators may limit UK growth over the longer term, despite gains from other businesses like Tesco Direct and Tesco Bank.

Since growth at home will probably be strained for some time, Tesco's future will increasingly be defined by its ongoing global expansion. International operations provide already more than half of its growth, and the group has invested heavily in recent years, using internal funds, new debt, and property sales/leasebacks to boost capital expenditure.

Globally, competition is intense in foreign markets from domestic local chains and other large international retailers such as Wal-Mart and Carrefour.

Share Price Development

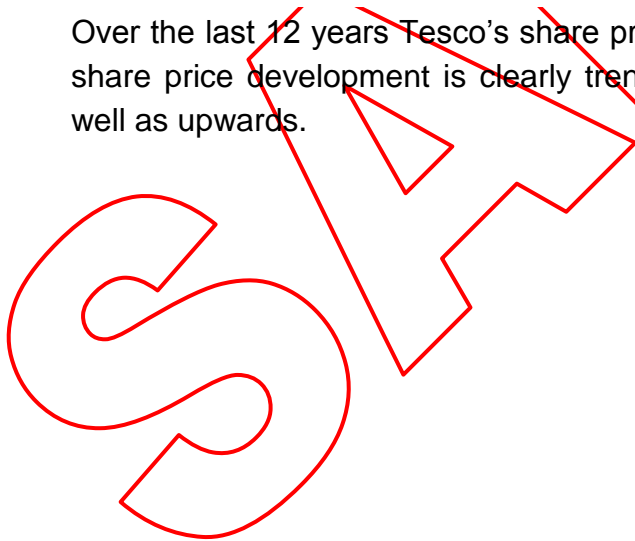
Here is Tesco's share price chart. [Click here to enlarge.](#)



Tesco Share Price Chart 1998-2011



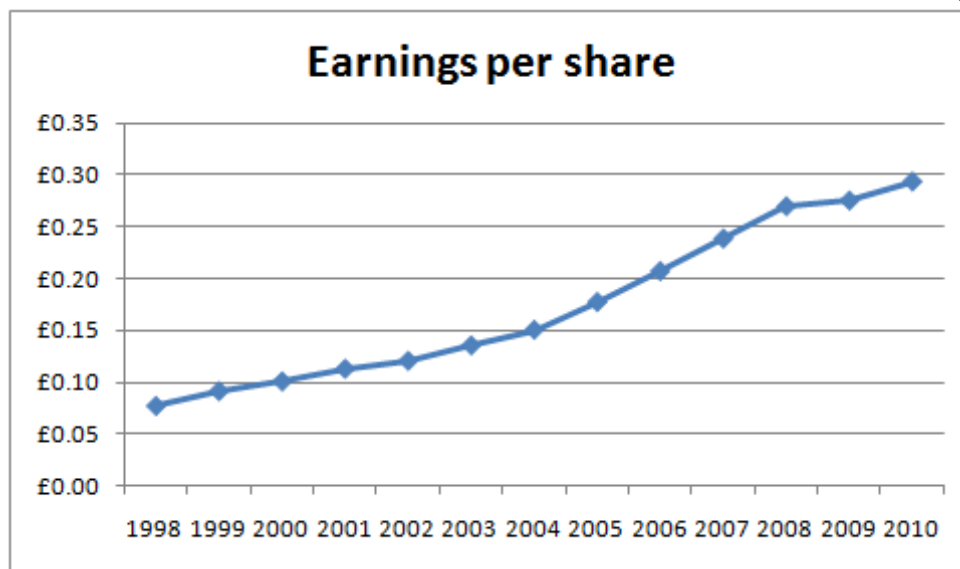
Over the last 12 years Tesco's share price has gone up more than two-fold. Tesco's long-term share price development is clearly trending upwards with the occasional spike downward as well as upwards.



Earnings per Share

I am only interested in companies that have growing earnings per share ("EPS"). In general, a company that cannot increase its EPS over time will not be able to sustain the growth in its dividend payments to shareholders.

The Earnings per Share indicator is calculated by dividing the total amount of net income for one year by the total number of shares outstanding. Normally, I look for an increase in the EPS over the past ten years.



Tesco has managed to deliver an 11.89% average annual increase in its EPS between 1998 and 2010 (year end: February 2010). For 2010/2011 Tesco is expected to earn £0.327 per share, followed by £0.365 in 2011/2012.

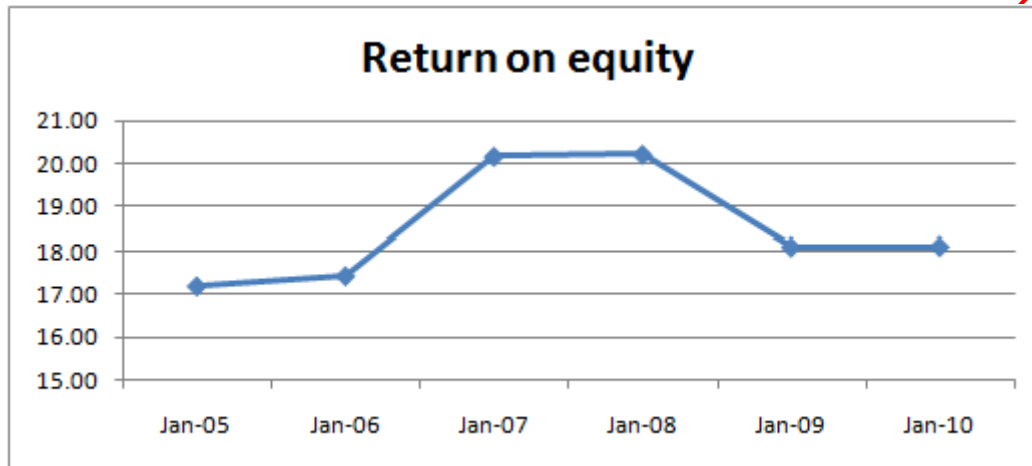
Return on Equity

Return on Equity is calculated by dividing the total amount of net income for a given year over the amount of owner's equity on the balance sheet at the end of the previous period. This shows how efficiently a company uses its money.

A consistently high return on equity is a good indication that the company's management not only can make money from the existing business but also can profitably employ retained earnings to make more money.

A very high rate of return on equity often indicates that the company benefits from possessing some very strong position in the market, often some form of (near) monopoly.

High quality companies will consistently earn high returns on shareholders' equity. I am looking for a minimum ROE of around 17% over time. A higher ROE is even better. I would be concerned to see a decreasing trending ROE over time.

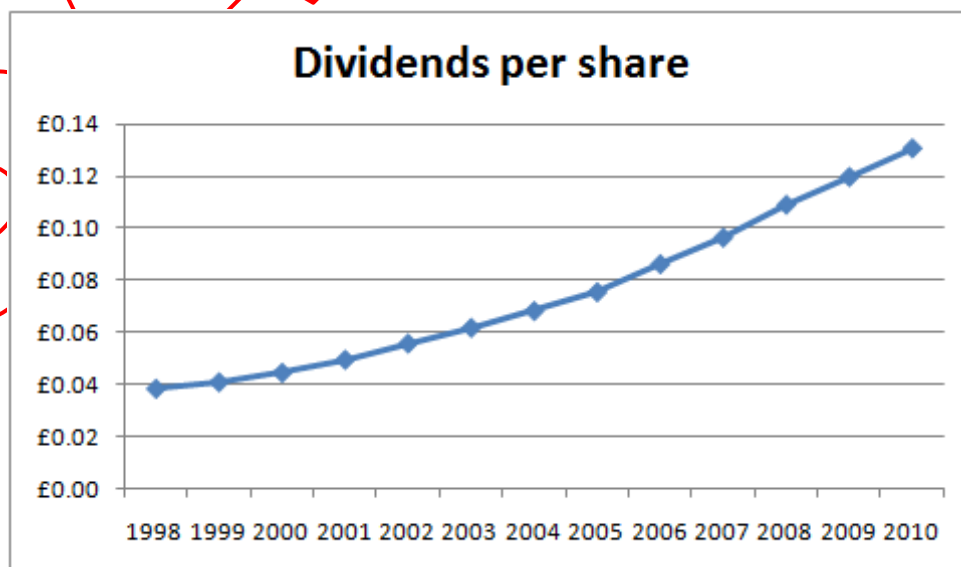


Tesco's Return on Equity has firmly remained between 17% and 20%, never nearing Walmart's 20%+, though. Rather than focus on absolute values for this indicator, I generally want to see at least a consistently high and stable return on equity over time.

Dividend per Share

Dividend growth is the hallmark of a high quality company. A company that is making profitable progress should be able to boost its dividend at least five times in a 12-year period. In general, I look for an uninterrupted growth in dividends every year for more than seven years, preferably ten. The longer the better!

A company, which hasn't been able to at least pay a stable dividend without cutting it in difficult times, is automatically off of my radar. I won't touch a company that has exhibited a lot of fluctuations in its dividend payments over the years.



Tesco is the only FTSE100 company with an unbroken 26 years track record of dividend increases. In 2006, Tesco declared a new dividend policy confirming that dividends will increase “broadly in line” with its earnings per share growth rate.

Annual dividends (total dividends paid during the calendar year) have increased by an average of 10.68% per annum since 1998, which is lower than the growth in EPS (11.89%). The disparity is mostly due to a gradual decrease in the dividend payout ratio, which I am ok with.

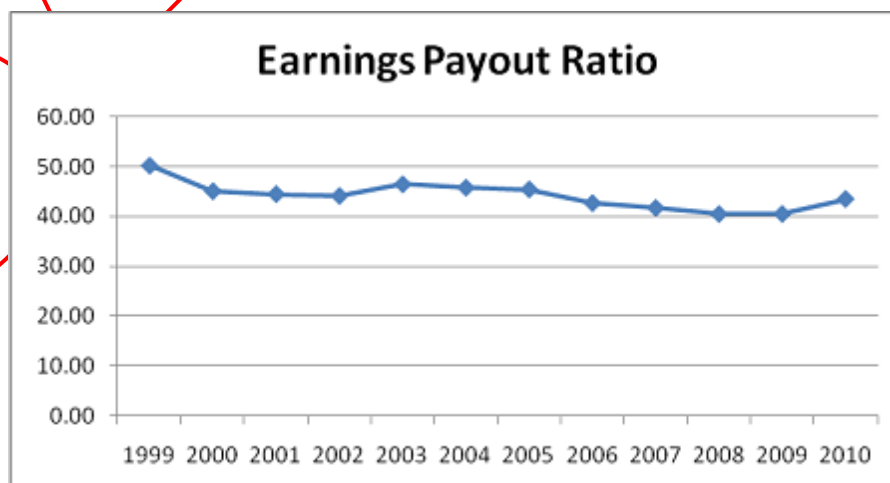
An 11% growth in dividends translates into the dividend payment doubling almost every 6 years. If we look at historical data, going as far back as 1990, Tesco has actually managed to double its dividend payment every 6 years on average. Tesco is an example of a company that has kept paying dividends while enjoying strong double-digit earnings growth for several decades.

Over the last twenty, fifteen, ten and five years Tesco’s annualised dividend growth rate has been relatively stable, averaging 11.38 per cent, whereas the last three years the annualised dividend growth rate has decreased somewhat to still a very respectful 10.64 per cent.

Despite stock analysts’ expectations for average annual EPS growth of 11.7% over the next two years, I’m unsure whether this is sustainable in the current market conditions. As well as, whether Tesco will be able to repeat double-digit dividend growth during the next decade. However, a near double-digit dividend growth rate certainly isn’t out of the question. And that’s still good for me.

Earnings Payout Ratio

Calculated by dividing dividends per share by earnings per share. If this ratio is over 100%, it means the company paid out more in dividends than it made in profits and that’s clearly not sustainable long term.

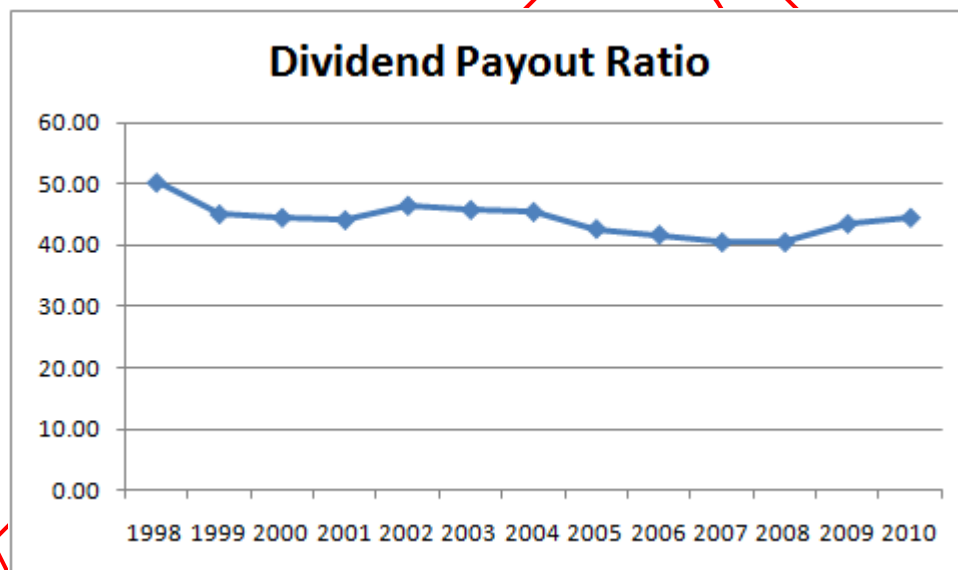


For lower-yielding shares in the 2-4% range, such as Tesco, ideally we would want to see payout ratios below 60%. For higher-yielding shares (4-7%), we'd look for less than 85%.

Dividend Payout Ratio

I calculate the Dividend Payout Ratio by dividing the DPS over the EPS. I am generally looking for a DPR that is below 50% in most companies. However, if a company has been able to maintain a higher DPR over time due to the nature of its business or the nature of its legal structure, I would consider buying shares with a much higher DPR.

A rising DPR, or even worse a DPR that moves for irrational reasons, is generally a red flag for me. A rising DPR shows me that there is not much room for future dividend growth. In addition, shares, which have an unusual high DPR, may indicate a higher risk for dividend cuts.

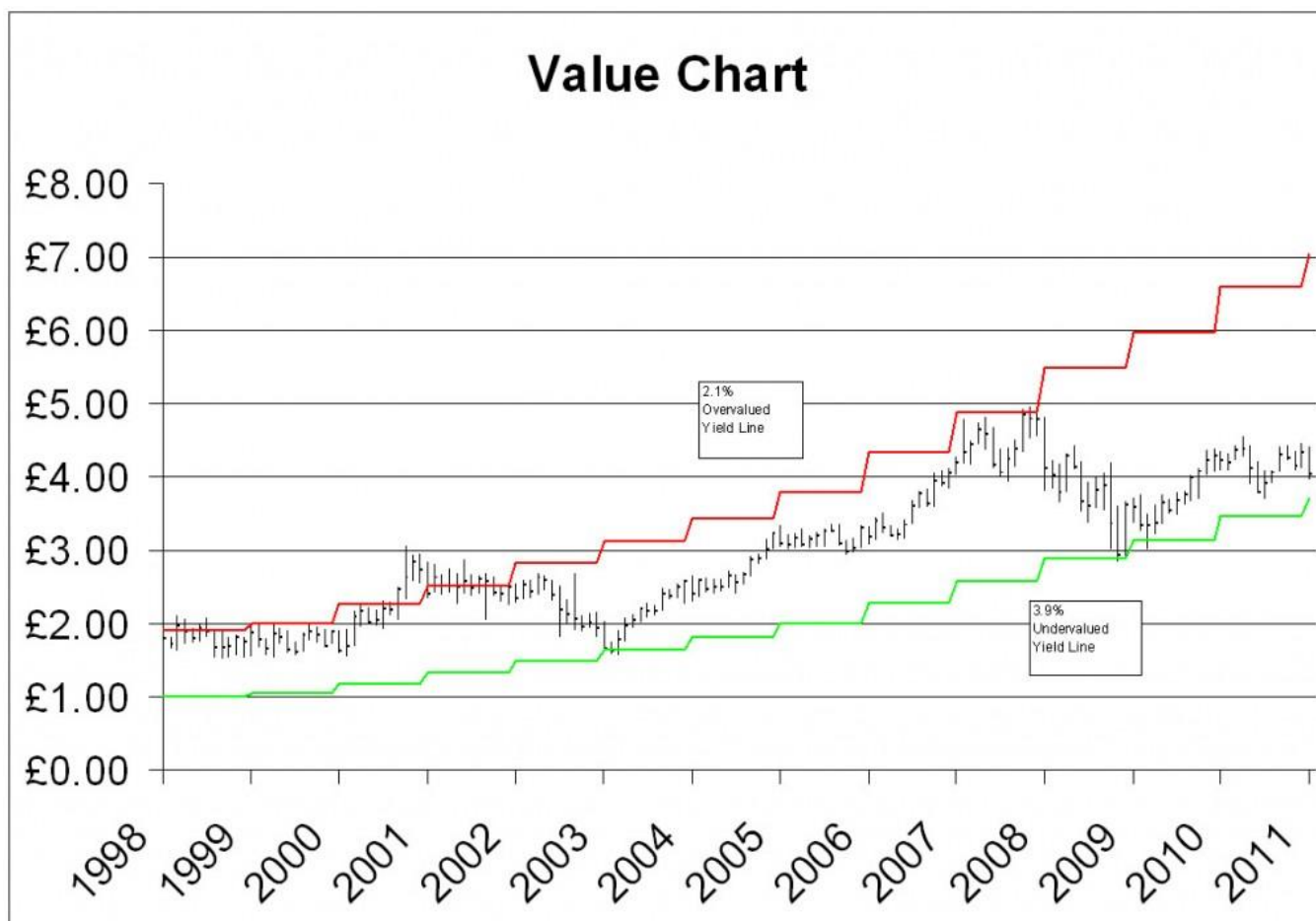


Tesco's dividend payout ratio has been gradually declining below my 50% threshold. In general, a lower payout is always a plus, since it leaves room for consistent dividend growth minimising the impact of short-term fluctuations in earnings. Dividend cover remains comfortably above 2.

Valuation

After having analysed the reliability of the trends of EPS, ROE, DPR and DPS I assume that these would continue "as is" for the foreseeable future. I then focus on specific valuation parameters in order to ascertain when a share is historically undervalued and overvalued.

Here is Tesco's value chart. A larger version is appended at the end of this report.



1990 is the base year we used to calculate the various dividend and value metrics.

The Tesco value chart has two major horizontal lines. The top line (red) represents a 2.1% dividend yield, where the share is overvalued and a sale should be considered.

The solid line at the bottom (green) represents a 3.9% dividend yield, where the share price of Tesco is undervalued and a purchase should be considered.

It's apparent that when Tesco's dividend yield moves above the red overvalue yield line or below the green undervalue yield line, a reversal in the share price trend takes place.

Tesco's Dividend Yield Metrics

Ticker	Year	Price	Div	Yld%	Undervalue				Overvalue			
					Pts Dn	% Down	Lo Pr	Hyld%	Pts Up	% Up	Hi Pr	Loyld%
TSCO.L	1990	402.5	14.51	3.60	31.4	7.8	371.1	3.91	301.9	75.0	704	2.06

Tesco's current low-price/high-yield – “undervalue” – area (LoPr) is at a share price of £3.71. The high-price/low-yield – “overvalue” – area (HiPr) is at £7.04 per share.

Tesco's closing share price (Price) on 4 February 2011 was £4.025 per share

We have used 1990 as the base year (Year) for our calculations.

Stock analysts* have estimated the total annual dividend pay-out (Div) during 2011 to be 14.51 pence as of 4th February 2011. This equals a conservative 7.25% dividend increase in comparison to the 2010 payout of 13.53 pence.

On the basis of the above, we believe that Tesco is not overvalued at these levels. Instead Tesco's share price is still within 10% (% Down), or 7.8% to be exact, to it's historically undervalued share price and so warrants an immediate purchase.

Tesco's truly historic undervalued periods have covered only several months in 2003 and most recently during early 2009.

Verdict

Tesco isn't going away for a very long time, in particular due to its intriguing continued international expansion in many potential high growth markets. Tesco is a great company. A UK success story!

Tesco has a great dividend track record increasing annually by 10%. Although for 2011, stock analysts are estimating Tesco's total dividend pay-out to increase by just 7.25%.

Getting good investment returns is about more than buying great companies. To secure the best returns long-term, one has to buy great dividend paying companies at low prices i.e. when they are:

* Hemscott Broker Sentiment - 4th February 2011

- Historically undervalued
- Within 10 per cent of the share price being historically undervalued

On that basis, I would consider purchasing shares in Tesco on any dips below £4.08, which is the 10% undervalued margin. As a result, we will issue a buy order for 735 shares at a limit price of £4.08 per share.

Thank you for reading.

Till next time,

Steven Dotsch

Steven Dotsch
Managing Editor
EMAR Publishers

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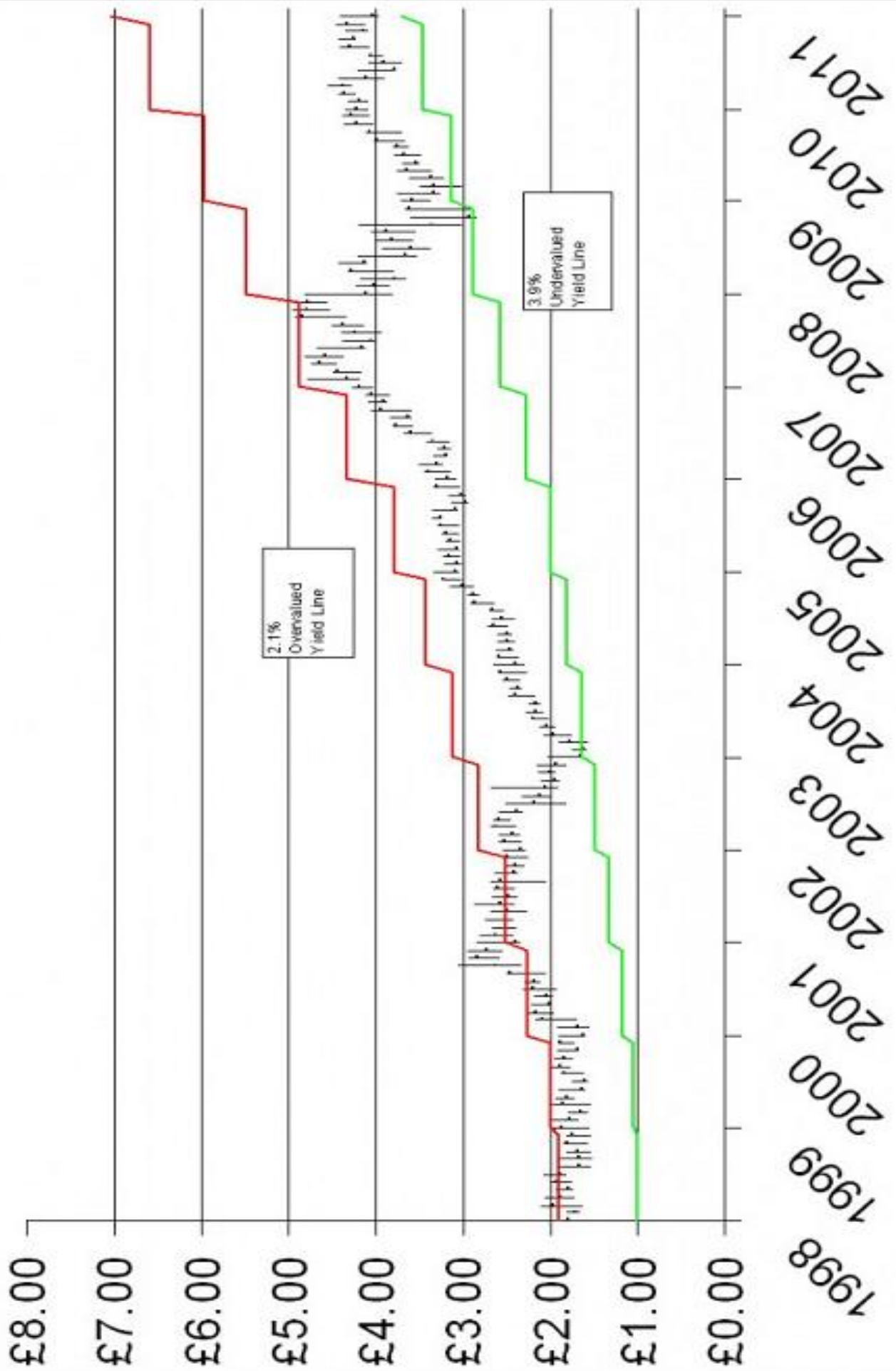
Dividend Income Investor

Value and Dividend Growth

Issue #1

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Value Chart



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