HUNTING FOR SUSTAINABLE DIVIDEND GROWTH

John Kingham of UK Value Investor reveals his secrets for building a portfolio of sustainable dividend growth stocks.

In almost all cases, long-term dividend growth is unsustainable without earnings growth, earnings growth is unsustainable without revenue growth and revenue growth is unsustainable without capital employed growth.

In practice, this means companies can only produce long-term sustainable growth if they employ more capital to fund more factories, warehouses, vehicles, machines, robots, offices, computers and an endless array of other capital assets. Or to put it another way, if you’re looking for sustainable dividend growth, you should start by looking for sustainable capital employed growth.

What is sustainable capital employed growth?

Capital employed consists mostly of equity capital, debt capital and leased capital, and these differ in terms of their risk profile and sustainability.

The easiest way for a company to employ more capital is to take on more debt or leases. You just sign up for a new bank loan or rental agreement and you have access to another retail store or factory. Anyone can do that.

However, growing capital employed primarily through increased debt and lease obligations can be risky. Those funding sources come with relatively inflexible interest and rent costs, and if earnings growth doesn’t keep pace with interest and rent increases then eventually some sort of crisis is inevitable.

The alternative is equity capital growth. This is typically the most sustainable form of capital growth because equity funding doesn’t come with fixed-expense obligations. Of course, shareholders expect a return on their equity, but unlike debt interest or rent, those returns don’t have to be paid out in cash on a regular basis (management can choose to cut or suspend the dividend, although it may cost them their jobs).

We can break equity growth down into two types; equity growth from rights issues and equity growth from retained earnings.

Rights issues occur when management asks shareholders for more money, in exchange for newly issued shares. Rights issues are often used to fund long-term investments (such as a new factory or an acquisition) when the returns on those investments are highly uncertain. This can be sensible, because it matches uncertain returns from the investment with a funding source that has extremely flexible repayment terms (dividends...
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are optional and equity funding is perpetual, i.e. it never has to be repaid).

Although using rights issues to fuel growth isn’t necessarily a problem, it can be if the amounts raised are very large. If a rights issue is used to fund a very large acquisition, for example, the time and effort required to integrate the acquired company can be seriously disruptive to the acquirer’s existing business.

The most common way for management to raise additional equity funding from shareholders is to simply retain earnings instead of paying them out as a dividend. This is also the most sustainable way to grow capital employed, for two reasons.

First, as I’ve already mentioned, equity capital doesn’t come with fixed costs. Second, retained earnings are usually relatively small compared to existing capital employed (typically in the range of 5% to 20%). This is an amount of additional capital that most companies can absorb and deploy while maintaining the structural integrity of the business.

Since retained earnings are usually the most sustainable driver of long-term growth, we can use the rate of retained earnings to calculate a company’s sustainable growth rate.

**Calculating a sustainable growth rate**

Imagine we have a company with £100 million of equity capital, £50 million of debt capital and £50 million of leased capital. Total capital employed is therefore £200 million.

Over the next year, the company produces £20 million of earnings and pays a £10 million dividend, so £10 million of earnings are retained.

That £10 million is added to the company’s existing £100 million of equity, leaving year-end equity at £110 million, an increase of 10%.

With a 10% increase in equity capital, the company has the funds to invest in more assets which should drive earnings growth. Management decides that with the increased earnings potential, taking on a proportional amount of additional debt and lease obligations is prudent.

A proportional increase means that management will increase debt and lease obligations by 10%, in line with the increase in equity. And since equity capital, debt capital and leased capital are all growing at the same rate, total capital employed will grow at the same rate as equity.

This gives us the sustainable growth rate, which equals retained earnings/equity * 100%.

In other words, if a company produces a return on equity of 10%, then 10% is its maximum sustainable growth rate. Also, the more it pays out as a dividend, the lower its sustainable growth rate will be. To grow faster than its sustainable growth rate, a company must either raise additional equity through rights issues or increase debts and leases faster than equity, both of which increase risk.

This gives us a simple rule of thumb; growth which is consistently higher than average returns on equity is unlikely to be sustainable over the long term.

This is a good starting point, but there’s a problem with the sustainable growth rate. It’s based on the assumption that existing debts and leases are sustainable, and that proportional increases in those financial obligations will also be sustainable.

That is quite a large assumption, so I prefer to use a more cautious version of the sustainable growth rate, which I call the self-funded growth rate.

**Calculating a self-funded growth rate**

The self-funded growth rate is basically the same as the sustainable growth rate. The only difference is that instead of assuming debt and lease obligations can grow sustainably in proportion with equity, we assume that truly sustainable growth is funded purely by retained earnings.

This isn’t necessarily true, but it does give us a very conservative view of how a company should fund its growth.

If retained earnings are the sole driver of capital employed growth, then capital employed growth will be limited to the net return on capital employed. In other words, the calculation for the...
The self-funded growth rate is: self-funded growth rate = retained earnings/capital employed * 100%.

For example, if a company produces a net return on capital employed of 10% and retains all of those earnings, then its maximum self-funded growth rate would be 10%. As before, if some earnings are paid out as a dividend then retained earnings and the self-funded growth rate will be lower.

If you see a company where capital employed growth consistently exceeds the self-funded growth rate, then that growth has been at least partly driven by some combination of rights issues and increasing debts and leases.

In many cases that will be quite reasonable. Most growing companies will be growing their earnings and so will be capable of increasing their debt and lease burdens, at least to some extent. However, if there is a very large gap between a company’s actual capital employed growth over several years and its self-funded growth rate, then that could be storing up problems for the future.

Here’s another simple rule of thumb; growth which is consistently and significantly higher than net returns on capital employed is a red flag that needs investigating.

We can see how these ideas play out in the real world by taking a look at Ted Baker, the global fashion retailer.

**Ted Baker’s sustainable and self-funded growth rates**

Ted Baker produced impressively rapid and consistent growth over the period from 2009 to 2018, including annualised revenue and dividend growth of 17% per year and capital employed growth of 18% per year, all on a per share basis.

Using the sustainable and self-funded growth rates, we can check to see whether that growth is likely to be sustainable over the longer term.

Over that 10-year period, Ted Baker produced average earnings of 66.4p and paid an average dividend of 34.0p, leaving the company with average retained earnings of 32.4p. It also had average equity per share of 285.1p.

We can use this information to calculate the company’s sustainable growth rate as follows:

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\text{sustainable growth rate} = \frac{\text{retained earnings / equity}}{100\%}
\]

Therefore sustainable growth rate = 32.4p/285.1p * 100% = 11.4%.

With an annualised capital employed growth rate of 18% and a sustainable growth rate of 11.4%, it’s clear that Ted Baker’s growth over the last decade was fuelled to a considerable extent by increasing debt and lease obligations faster than equity (there were no rights issues during that period).

The implication is that the company’s historic capital employed growth rate of 18% will not be sustainable in the longer term, because eventually its debt and/or lease burden will become intolerable. And with such a large gap between actual and sustainable growth rates, there is a real risk that Ted Baker’s rapid growth has sown the seeds of future problems.

Let’s see how Ted Baker’s actual growth compares to the more conservative self-funded growth rate.

To calculate that we’ll need to sum up average per share debts (97.6p), leases (406.4p) and equity (285.1p), giving average capital employed per share of 789.1p. As the self-funded growth rate = retained earnings/capital employed * 100%, the self-funded growth rate in this case is 32.4p/789.1p * 100% = 4.1%.

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As you can see, the company’s self-funded growth rate is just 4.1%, compared to a sustainable growth rate of 11.4%. There is a significant difference because its capital employed is much larger than just its equity, mostly due to extensive use of leased capital, primarily in the form of rented stores.

The self-funded growth rate says that if Ted Baker were to fund its growth purely from retained earnings and without increasing its debt or lease liabilities (perhaps by leasing stores for five years or so with a single cash payment up front, paid for out of retained earnings), then it would be able to sustain a growth rate of no more than 4.1%.

That’s a very long way short of the company’s actual 18% capital employed growth rate, and it highlights just how much the company has depended on higher-risk external funding to fuel its rapid growth.

But as I’ve said before, not all external funding is bad, and some use of external debt, lease or equity funding is quite sensible for most companies. So, while fully self-funded growth may be the ideal, what I’m really interested in is the degree to which external funding has been used to drive growth.

We can measure this with the growth funding ratio.

**Calculating the growth funding ratio**

One way to measure the degree of external growth funding is to compare the amount of additional external funding taken on (ie debts, leases or equity from rights issues) to the total amount of earnings produced over a period of time.

The higher the ratio of external growth funding to earnings, the less sustainable the company’s growth has been.

Here’s the calculation:

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\text{Growth funding ratio} = \frac{\text{additional external funding}}{\text{total earnings}} \times 100\%
\]

A negative growth funding ratio means that all of the company’s growth either was or could have been funded by retained earnings. A positive growth funding ratio means that retained earnings alone were not enough to drive the company’s growth, so additional external funds were required.

As with most financial ratios, the growth funding ratio provides a more meaningful result when measured over a five or 10-year period. Let’s see how it works out for Ted Baker.

**Calculating Ted Baker’s growth funding ratio for 2009-2018**

To calculate the amount of external growth funding, we can subtract the total amount of retained earnings from the total amount of capital employed growth per share (external growth funding = capital employed growth - retained earnings).

In 2009, Ted Baker had capital employed of 381.1p and in 2018 that had grown to 1409.6p, an increase of 1028.5p. Between those two years, the company earned a total of 633.9p and paid out dividends totalling 323.3p, so...
IN MY EXPERIENCE THEN, A GROWTH FUNDING RATIO OF 100% OR MORE IS VERY LIKELY TO CAUSE OPERATIONAL PROBLEMS AT SOME POINT.

In late 2019 and early 2020, Ted Baker surprised shareholders (of which I am one) with a string of profit warnings, a dividend cut and then a full dividend suspension.

Tough trading conditions were blamed, but I now think the company’s aggressive use of external funds to drive growth far above its self-fundable and sustainable growth rates was the underlying root cause.

Rapid growth requires lots of new stores, new staff, new supply-chain partners, new customers, new processes, new management and so on, and all of these have to go through a long and expensive experience curve before they can operate anywhere near optimally. Combine all this newness with the relatively fixed costs of rapidly increasing debt and lease obligations and it’s no wonder Ted Baker eventually ran into serious problems.

To use a driving analogy, growing too fast is like driving too fast. It doesn’t matter how safe the car is. Even the sturdiest Volvo will crash and burn if it’s being driven too fast down a bumpy, twisty road late at night. Or to use a building analogy, if you build your house as quickly as possible, don’t be surprised if it falls down during the first storm.

Over the last 10 years, I have invested in two high-growth companies which subsequently collapsed and then required major repair work. In both cases they had a growth funding ratio of more than 100% (one fuelled growth through multiple rights issues and acquisitions, the other – Ted Baker – used rapidly increasing debt and lease liabilities to fund aggressive store, inventory and infrastructure expansion).

In my experience then, a growth funding ratio of 100% or more is very likely to cause operational problems at some point. The truth is that most companies simply cannot absorb and deploy that amount of capital without producing cracks that eventually cause the company to crumble.

Thanks to Ted Baker, I will no longer invest in a company if its growth funding ratio is anywhere near 100%. I’ll just look for a more sustainable growth rate elsewhere.

Here’s my rule of thumb for the growth funding ratio: only invest in a company if its growth funding ratio is below 50%.

To wrap things up, here are two examples of more sustainable growth from my portfolio. Next and Burberry have both produced high, single-digit capital employed growth over the last 10 years – funded almost entirely from retained earnings. And yes, that capital employed growth has, so far, consistently fed through into revenue, earnings and dividend growth.

About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John’s approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.


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