Investment Characteristics of Firms With Dividend Reinvestment Plans

By John Bajkowski

Every June the *AAII Journal* publishes a list of companies offering a dividend reinvestment plan (DRP). Many individuals are attracted to companies with DRPs because they feel that these firms offer a low cost approach to purchasing shares. However, an investor should purchase and hold a company with a dividend reinvestment plan only if it is still an attractive investment when considered against all investment opportunities. In this article we shall explore the overall characteristics of stocks with DRPs, and perform a basic dividend yield screen.

This year's survey of companies offering dividend reinvestment plans covers 837 firms, 831 of which are tracked by AAII's *Stock Investor*. Table 1 presents an industry breakdown of the firms with DRPs versus those without DRPs. Dividend reinvestment plans have traditionally been offered to the customers of utilities and financial institutions. These firms have a steady need for equity capital, pay an above average dividend yield, and benefit from the goodwill of turning their customers into owners. It is not surprising to see that financials and utilities make up 25.6% and 19.4%, respectively, of the DRP stock universe. In contrast, financials make up 15.5% and utilities only 0.6% of the non-DRP universe. The other segments that make up a larger percentage of the DRP universe include basic materials, conglomerates, and consumer non-cyclicals. While it is difficult to make any generalizations about conglomerates except that they tend to be larger firms, the other segments are more stable, low relative growth areas.

In the non-DRP universe, the services and technology sectors have proportions significantly higher than in the DRP universe. These are higher growth sectors that often contain smaller firms.

An investor limiting his choices to companies with dividend reinvestment plans would end up excluding these sectors from their portfolios or would be limited to the larger, more mature dividend-paying companies within the industry. In the technology sector, only 31 firms out of a universe of 1,257 stocks offer DRPs.

Table 2 lists the characteristics of the DRP universe versus companies without DRPs. The table uses median values (midpoints of the complete range of numbers) instead of averages because they are less subject to being skewed by a few extreme values.

The companies with DRPs are significantly larger, more mature firms than those firms without dividend reinvestment plans. Companies do not typically start paying cash dividends until they are past their rapid growth stage. These companies start paying a dividend when they are generating excess cash from operations and they cannot find very profitable investments. This factor shows up on the growth rate differences for the two groups. The historical growth rates for sales, earnings, and cash flow as well as the consensus earnings growth forecast reported by I/B/E/S are higher for the non-DRP stocks. The DRP firms show a higher growth rate for dividends.

The higher growth prospects of non-DRP firms are reflected in the market multiples. The price-earnings ratio is 18.6 for non-DRP firms versus 14.4 for the firms with DRPs. However the dividend yield for the group with DRPs is 2.8% versus a median yield of 0.0% for the non-DRP group. At least half of the firms without DRPs pay no dividends at all.

The ratio of price-earnings to earnings growth is often used to measure the balance between value and growth. Firms with low multiples are not bargains if the company has such poor prospects that it will not grow at all in the future. Firms with higher growth prospects are attractive if you do not pay too much for the earnings. Companies with a price-earnings-to-growth ratio of 1.0 are considered to be fairly valued; a ratio of 0.5 is considered undervalued, while a ratio of 1.5 is considered overvalued. While the stocks with DRPs have a lower price-earnings ratio, it would seem that price-earnings ratio is not low enough given the historical growth rates of these firms. The stocks of the non-DRP group would seem to have a more attractive price-earnings-to-growth ratio of 0.9. Many investors like to adjust the ratio by

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Table 1.
Industry Breakdown: DRPs vs. Non-DRPs

	DRPS		Non-DRPs	
Industry	**No. of Firms**	**Percent of Total**	**No. of Firms**	**Percent of Total**
Basic Materials	87	10.5%	384	6.3%
Capital Goods	49	5.9	422	6.9
Conglomerates	23	2.8	40	0.7
Consumer Cyclical	48	5.8	406	6.6
Consumer Non-Cyclical	62	7.5	218	3.6
Energy	29	3.5	271	4.4
Financial	213	25.6	950	15.5
Healthcare	24	2.9	662	10.8
Services	93	11.2	1,393	22.7
Technology	31	3.7	1,226	20.0
Transportation	11	1.3	130	2.1
Utilities	161	19.4	37	0.6
Total	**831**		**6,139**	

Table 2.
Characteristics of DRPs vs. Non-DRPs*

	DRPs	Non-DRPs
Size		
Market Capitalization ($ mil)	1,434.5	95.0
Sales ($ mil)	1,248.0	73.5
Total Assets ($ mil)	2,296.1	97.6
Growth		
Sales (%)	5.2	10.0
Earnings per Share (%)	7.7	11.9
Estimated Earnings per Share (%)	10.0	17.5
Cash Flow (%)	7.1	9.1
Dividends (%)	4.6	1.5
Multiples		
Price-to-Sales (x)	1.1	1.3
Price-to-Earnings per Share (x)	14.4	18.6
Dividend Yield (%)	2.8	0.0
Price-to-Book (x)	1.94	2.04
Price-Earnings to Growth (x)	1.3	0.9
Price-Earnings to Adjusted Growth (x)	1.0	0.8
Profitability		
Gross Profit Margin (%)	37.4	35.9
Net Profit Margin (%)	7.3	3.6
Return on Equity (%)	13.0	7.9
Return on Assets (%)	3.6	2.2
Financial Structure		
Long-Term Debt to Total Capital (%)	34	11
Total Liability to Total Assets (%)	67	52
Turnover		
Asset Turnover	0.7	1.0
Inventory Turnover	11.0	7.3
Shares/Ownership		
Institutional Ownership (%)	50.5	24.0
Insider Ownership (%)	15.0	40.9
Shares Outstanding ($ mil)	44.8	9.0
Price		
Price ($)	30.25	12.50
Price as % of 52-Week High	91	84
52-Week Relative Strength (%)	–7	–7
3-Month Price Change (%)	1.6	5.5
6-Month Price Change (%)	8.1	8.6
9-Month Price Change (%)	9.9	8.6
12-Month Price Change (%)	17.8	17.1

** All values are medians—the midpoints of the range.*

adding the dividend yield to the growth rate. This adjustment acknowledges the contribution that dividends make to an investor's return. This adjusted ratio is calculated by dividing the price-earnings ratio by the sum of the earnings growth rate and the dividend yield. For the DRP group this brings the ratio down to the fairly valued level of 1.0.

The DRP companies tend to have better profitability ratios than the non-DRP companies, but it is difficult to make any generalizations about these ratios. Profit margins are very industry specific. Given how different the market industry breakdowns are for the two groups, the different ratios may or may not be significant. The same holds true for the turnover ratios.

When it comes to measures of the financial structure, some observations can be made. Large, established firms with proven track records have much greater access to the debt markets than smaller firms. The differences in the ratio of long-term debt to total capital certainly bear this out. Smaller firms must rely more on equity financing, short-term bank loans, and supplier-provided accounts payable growth as sources of external funding. The ratio of total liabilities to total assets considers the complete structure of the balance sheet.

The companies with DRPs have attracted much more institutional coverage than the non-DRP group. Half of the shares for this group are held by institutions versus about a quarter of the shares for the non-DRP group.

The price-statistics highlight some interesting differences. The stock prices of the non-DRP group tend to be significantly lower—$12½ versus $30¼. Lower prices are often associated with smaller-cap stocks. As measured by the 52-week relative strength, both groups are relative underperformers compared to the S&P 500. Interest rates have gone up recently, hurting interest sensitive sectors such as utilities. The non-DRP group is composed of smaller firms that have slightly underperformed the S&P 500 over the last year.

Companies with DRPs tend to be larger companies with concentrations in the financial and utility sectors; they tend to have lower past and projected growth rates, slightly lower multiples of earnings, sales, and book value, significantly higher dividend yields; and they are heavily followed by institutions. An investor would have a difficult time constructing a completely diversified portfolio strictly from this group. An investor looking for an aggressive, high-growth portfolio must look beyond the DRP universe. However, applying a screen searching for out-of-favor, high relative yield stocks might be an

Table 3.
Screen Results: Top 20 Firms With DRPs and Firms Without DRPs

	Dividend Yield Current (%)	Dividend Yield 5-Year Avg. (%)	Growth Rate Dividend (%)	Growth Rate EPS (%)	Payout Ratio (%)	Market Cap. ($ mil)	52-Week Relative Strength (%)	Description
Firms With Dividend Reinvestment Plans								
Mellon Bank Corp. (N: MEL)	4.5	3.7	22.7	23.3	44.3	7,176.7	9	Holding co. for finc'l prod & serv
Banc One Corp. (N: ONE)	3.9	3.3	14.3	13.5	42.6	15,131.2	1	Multibank holding co.
American Recreation Ctrs. (M: AMRC)	3.9	3.4	11.6	13.5	35.5	33.4	–28	Chain of bowling centers
Chrysler Corp. (N: C)	3.8	3.3	10.8	78.8	33.3	23,561.4	18	Mfrs, sells autos & trucks
Bank of Boston Corp. (N: BKB)	3.7	2.4	9.3	22.3	28.1	5,422.2	16	Nat'l & int'l bank holding co.
Collective Bancorp (M: COFD)	3.3	2.4	45.4	39.8	29.1	491.5	5	Bank holding co.
CMS Energy Corp. (N: CMS)	3.3	2.9	16.5	18.9	39.6	2,671.9	–1	Holding co. for public utility
Associated Banc-Corp (M: ASBC)	3.0	2.9	14.4	13.7	34.3	657.2	5	Bank holding co. in WI & IL
A.O. Smith Corp. (N: AOS)	2.9	2.8	7.7	19.8	19.7	345.8	–25	Auto compon, water heaters
Pitney Bowes Inc. (N: PBI)	2.8	2.7	14.9	15.6	31.4	7,309.9	4	Business equip & serv; financing
MASSBANK Corp. (M: MASS)	2.7	2.1	16.5	33.8	22.6	90.6	7	Bank holding co.
Mercury Finance Co. (N: MFN)	2.6	1.8	36.2	35.2	39.2	1,984.7	–12	Financing for used autos
Great Southern Bancorp (M: GSBC)	2.6	2.2	58.5	71.0	29.6	121.3	21	Bank holding co.
First Federal Capital (M: FTFC)	2.6	2.5	46.4	26.1	32.1	143.8	12	Holding co. for bank in WI
Charter One Financial (M: COFI)	2.6	2.2	22.6	21.9	23.2	781.0	19	Savings & loan holding co.
Loctite Corp. (N: LOC)	2.4	1.9	26.2	20.7	40.1	1,618.1	–20	Chemical adhesives & sealants
ConAgra, Inc. (N: CAG)	2.4	2.1	15.8	10.1	39.3	9,297.7	–10	Businesses in the food indus
The West Company (N: WST)	2.3	2.1	4.6	44.9	28.9	378.6	–36	Stoppers & closures
Hormel Foods Corp. (N: HRL)	2.3	2.0	17.4	9.3	42.1	2,042.8	–22	Meat and food products
Campbell Soup Co. (N: CPB)	2.3	2.2	19.8	177.6	42.7	15,588.3	–3	Mfrs & mkts food products
Firms Without Dividend Reinvestment Plans								
Gilbert Associates (M: GILBA)	6.7	4.7	3.3	11.7	33.0	72.9	–26	Holding co. for telecom equip
Howard B. Wolf (A: HBW)	4.7	4.3	8.4	20.5	37.2	7.1	–21	Women's fashion apparel
First Financial Bncrp./OH (M: FFBC)	3.6	3.2	12.2	18.1	43.2	426.5	–24	Bank & sav & loan holding co.
Arthur J. Gallagher & Co. (N: AJG)	3.4	2.7	10.8	12.4	39.7	504.6	–26	Insurance broker
Amwest Insurance Group (A: AMW)	3.3	2.5	11.2	26.5	16.0	32.7	–25	Insurance holding co.
Bassett Furniture Ind. (M: BSET)	3.2	2.7	3.6	36.3	49.0	351.7	–22	Mfrs home & office furniture
Family Dollar Stores (N: FDO)	3.0	2.2	14.6	14.6	39.8	873.3	1	Discount store chain
PXRE Corp. (M: PXRE)	2.9	1.8	25.8	128.5	13.3	223.2	–19	Reinsurance prods & servs
Standex Int'l Corp. (N: SXI)	2.7	2.3	13.1	19.9	26.9	374.0	–32	Pumps, mach'y, food serv equip
Donnelly Corp. (A: DON)	2.7	2.0	7.8	33.7	38.8	62.7	–29	Glass prods for auto industry
Genovese Drug Stores (A: GDX.A)	2.6	1.9	6.1	26.5	27.4	53.1	–18	Discount drug store chain
Morgan Keegan (N: MOR)	2.3	1.9	36.3	310.8	16.7	251.3	–8	Holding co. for broker/dealer
The Travelers Group (N: TRV)	2.2	1.5	34.7	24.3	14.5	19,623.6	17	Diversified financial servs
Robinson Nugent (M: RNIC)	2.2	2.1	8.4	39.6	26.5	33.0	–42	Mfrs & mkts electric devices
Mercury General Corp. (M: MRCY)	2.2	2.0	27.2	14.2	26.1	1,227.7	15	Insurance holding co.
Eaton Vance Corp. (M: EAVN)	2.2	2.0	22.6	23.2	18.3	287.0	-8	Mutual funds and counsel servs
U.S. Healthcare (M: USHC)	2.1	1.8	58.6	38.2	42.3	7,272.0	46	Health maintenance org
Schultz Sav-O Stores (M: SAVO)	2.1	0.9	10.8	14.0	14.5	66.3	4	Food retailer & wholesaler
Bowne & Co. (A: BNE)	2.1	1.8	7.6	22.3	25.2	316.9	-12	Document prep for financing
American Biltrite (A: ABL)	2.1	1.0	36.1	29.7	21.8	71.6	-48	Adhesive paper & vinyl flooring

Exchange Key: N = New York Stock Exchange
A = American Stock Exchange
M = Nasdaq

Statistics are based on figures as of April 30, 1996.
Data Source: AAII's Stock Investor/Market Guide, Inc.

Definitions of Screens and Terms

The following is a short description of the screens and terms used in Table 3.

Dividend Yield—Current: Indicated dividend divided by current price. Provides a relative valuation measure when compared against historical average dividend yield.

Dividend Yield—Five-Year Average: Average company dividend yield during the last five years.

Growth Rate—Dividend: Annual growth rate in dividends per share over the last five years. An indication of the past company strength and dividend payment policy.

Growth Rate—EPS: Annual dividend growth rate in earnings per share over the last five years. A measure of how successful the firm has been in generating the bottom line, net profit.

Market Capitalization: The number of shares outstanding times the market price per share. An indication of company size.

Payout Ratio: Dividends per share for the last 12 months divided by earnings per share for the last 12 months. Provides an indication of the safety of the dividend. Figures between 0% and 50% are considered safer. Figures ranging between 50% and 100% are considered early warning flags. Negative values and values above 100% are considered red flags for a dividend cut if the levels persist. Beyond examining a single year, look for trends.

52-Week Relative Strength: The price performance of a stock during the last year relative to the performance of the S&P 500. A figure of 0% indicates the stock had the same percentage price performance as the market. A figure of 5% indicates that the stock outperformed the market by 5%.

appropriate strategy for this group.

To make for an interesting comparison, the same screening criteria were applied to the DRP and the non-DRP universe. The screen searched for companies with high relative dividend yields, reasonable payout ratios, and above average dividend and earnings growth. The top 20 companies in each group passing this screen are presented in Table 3 with the companies ranked by the current dividend yield.

The first filter specified that companies have a minimum dividend yield of 2.0%. Dividend analysis is geared toward established firms that are past their explosive growth and capital-intensive stage. The 2% minimum helps to filter companies paying a token dividend. This filter cut down our list of DRP stocks from 831 to 585, and the non-DRP stocks down to 922 from 6,139.

The next screen looked for companies that have paid a dividend for each of the last five years and have not reduced their dividend over the period. This screen cut down our DRP list to 460 and the non-DRPs to 316. Dividend levels are set by the board of directors taking the company, industry, and economic conditions into account. Dividends are set at levels that the company should be able to afford throughout the economic cycle. However, it has been five years since we have had our last general economic recession. The optimal screen should cover a complete economic cycle. It is common for cyclical firms like Chrysler, which passed the screen, to trade with high yields and low multiples late into an economic expansion.

It is important that the companies show the ability to increase dividend payments over time. The next screen looked for companies with a dividend growth rate greater then the growth rate for the overall stock universe of 3.1%. This screen cut down the list of companies to 306 DRP stocks and 213 non-DRP stocks. A quick scan of the final list shows that most of these companies have significantly higher dividend growth rates, as would be expected during an economic expansion.

The next filter required that the company's current dividend yield be higher than its five-year average dividend yield. This filter seeks companies whose dividends have increased faster than increases in share price, or whose current share price has dipped recently. This contrarian filter tries to identify stocks that are out-of-favor, hopefully due to a short-term overreaction to bad news. This criterion cut down the list of DRP stocks to 107, while the number of non-DRP stocks were whittled to 100.

The safety of the dividend is also important. A high dividend yield may be a signal that the market expects the dividend to be cut shortly and has pushed down the price of the stock accordingly. A high relative dividend yield is attractive only if the dividend level is expected to be sustained and even increased.

The payout ratio is the most common measure of dividend safety. It is computed by dividing the dividend per share by the earnings per share. The lower the ratio, the more secure the dividend. Any ratio above 50% is generally considered a warning flag, however some stable industries such as utilities trade with higher payout ratios. The payout ratio screen eliminated about half of the firms, leaving 57 stocks with DRPs and 52 stocks without DRPs.

Our final screening filter required a minimum level of earnings growth. The screen looked for firms with earnings growth rates in the upper half of their respective industries. This type of filter recognizes the differences between industries and tends to lead to more meaningful screening results.

The passing list of DRP stocks reads like a who's who of consumer-oriented companies. It is also obvious that this list is not a diversified portfolio, as it is heavily weighted toward financial stocks. In contrast, non-DRP companies are smaller, but still have a heavy financial emphasis.

Firms with dividend reinvestment plans can add an interesting flavor to your portfolio provided you give them the same level of scrutiny you give to all of your stock purchases.