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 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 other investment opportunities. This article explores the overall characteristics of stocks with DRPs and performs a basic dividend yield screen.

This year's survey of domestic companies offering dividend reinvestment plans covers 853 firms, 841 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 24.7% and 18.7%, respectively, of the DRP stock universe. In contrast, financials make up 15.2% and utilities only 0.7% of the non-DRP universe. The other segments that make up a larger percentage of the DRP universe relative to the non-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, technology, and healthcare 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 43 firms out of a universe of 1,523 stocks offer DRPs.

Table 2 lists the characteristics of the DRP universe versus companies without DRPs. Medians are used (midpoints of the complete range of numbers) instead of averages because they are not skewed by 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 capital projects for the firm. This factor shows up on the growth rate differences for the two groups. The historical growth rates for sales and earnings, 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 18.0 for non-DRP firms versus 15.6 for the firms with DRPs. However, the dividend yield for the group with DRPs is 2.5% versus a median yield of 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. A firm with a low multiple may not be a bargain if the company has poor earnings growth prospects. 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 the price-earnings ratio is not low enough given the earnings growth rates of these firms. The

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

	DRPs		Non-DRPs	
Sector	**No. of Firms**	**Percent of Total**	**No. of Firms**	**Percent of Total**
Basic Materials	86	10.2	412	6.0
Capital Goods	49	5.8	443	6.4
Conglomerates	20	2.4	29	0.4
Consumer Cyclical	53	6.3	438	6.3
Consumer Non-Cyclical	63	7.5	241	3.5
Energy	30	3.6	288	4.2
Financial	208	24.7	1,050	15.2
Healthcare	27	3.2	771	11.2
Services	94	11.2	1,566	22.7
Technology	43	5.1	1,480	21.4
Transportation	11	1.3	143	2.1
Utilities	157	18.7	46	0.7
Total	**841**		**6,907**	

stocks of the non-DRP group have a more attractive price-earnings-to-growth ratio of 0.8 versus 1.20 for the DRPs. Many investors like to adjust the ratio by 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 0.94.

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 since profit margins are very industry-specific. Given the difference in market industry breakdowns for the two groups, the different ratios may or may not be significant.

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 growth in supplier-provided accounts payable 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. Approximately half of the shares for this group are held by institutions versus 22.6 % for the non-DRP group.

Managers and founders are more likely to own a higher portion of outstanding stock for smaller firms. It is not surprising that the insider ownership statistics are much higher for the smaller, non-DRP companies than the larger companies with DRPs.

The price statistics highlight some interesting differences. The stock prices of the non-DRP group tend to be significantly lower—$10.00 versus $31.31. Lower prices are often associated with smaller-cap stocks.

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

Size	DRPs	Non-DRPs
Market Capitalization ($ mil)	1,689.9	82.6
Sales—Latest 12 Months ($ mil)	1,386.1	67.3
Growth (5-Year Annual)		
Sales (%)	6.3	12.6
Earnings per Share (%)	11.0	14.4
Estimated Earnings per Share (%)	10.0	15.0
Dividends (%)	5.1	0.0
Valuation		
Price-Earnings (X)	15.6	18.0
Dividend Yield (%)	2.5	0.0
Price-to-Book (X)	2.12	1.83
Price-Earnings to Growth (X)	1.20	0.80
Price-Earnings to Growth—Adjusted (X)	0.94	0.57
Profitability		
Gross Profit Margin (%)	37.4	37.0
Net Profit Margin (%)	7.4	3.3
Return on Equity (%)	13.2	7.1
Financial Structure		
Long-Term Debt to Total Capital (%)	34.5	10.4
Total Liability to Total Assets (%)	67.1	50.2
Shares/Ownership		
Institutional Ownership (%)	51.3	22.6
Insider Ownership (%)	16.0	41.8
Shares Outstanding (mil)	50.3	9.5
Price		
Price ($)	31.31	10.00
Price as % of 52-Week High (%)	90.6	69.8
52-Week Relative Strength (%)	–7.0	–22.0
1-Year Price Change (%)	11.1	–6.8

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

While both groups have underperformed the S&P 500, as measured by the 52-week relative strength, the smaller-capitalization non-DRPs have been very poor relative performers. The DRP firms are up by 11.1% over the last year, while the non-DRP firms are down 6.8% over the same period.

Overall, stocks with dividend reinvestment plans 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 and sales; 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. How-

Table 3.
Highest Dividend Yield Firms: DRPs vs. Non-DRPs

Company (Exch: Ticker)	Diviend Yield Current (%)	Diviend Yield 5-Year Avg. (%)	Annual Growth Rate Dividend (%)	Annual Growth Rate EPS (%)	Annual Growth Rate Est. EPS (%)	Payout Ratio (%)	52-Week Relative Strength (%)	Price Change (1 Yr) (%)	Description
Firms With Dividend Reinvestment Plans									
Chrysler Corp. (N: C)	5.3	3.2	36.1	37.5	6.5	30.6	–26	–4.8	Mfrs, sells autos & trucks
Ford Motor Co. (N: F)	4.8	3.9	8.6	28.8	6.0	39.5	–21	–3.2	Mfrs, sells autos & trucks
Luby's Cafeterias (N: LUB)	4.4	2.9	9.5	7.0	10.0	49.0	–35	–24.0	Cafeterias in southern U.S.
Aliant Commun (M: ALNT)	4.1	3.3	8.8	8.0	11.5	49.9	–20	-8.1	Telephone servs & equip
Vulcan Materials Co. (N: VMC)	2.9	2.8	7.0	31.3	12.0	31.3	–6	13.7	Construction materials
Federal Signal Corp. (N: FSS)	2.7	2.2	16.5	14.9	15.0	43.0	–24	–7.1	Safety, signal, and commun equip
Sonoco Products (N: SON)	2.7	2.4	8.0	11.6	12.5	35.7	–21	–5.3	Paper & plastic packaging prods
Limited, Inc., The (N: LTD)	2.6	1.8	7.4	6.8	13.0	25.3	–27	–12.6	Women's & men's apparel
Bandag, Inc. (N: BDG)	2.1	1.3	10.6	3.8	8.0	26.8	–21	–6.2	Rubber & equip for tires
Cummins Engine Co. (N: CUM)	2.0	1.4	23.4	49.4	7.5	25.9	0	20.1	Diesel engines
Ferro Corp. (N: FOE)	2.0	1.9	6.2	103.4	11.0	30.3	–7	12.2	Specialty materials for industry
Medians	**2.7**	**2.4**	**8.8**	**14.9**	**11.0**	**31.3**	**–21**	**–5.3**	
Medians—All DRP Firms	**2.5**	**3.0**	**5.1**	**11.0**	**10.0**	**39.0**	**–7**	**11.1**	
Firms Without Dividend Reinvestment Plans									
Friedman Industries (A: FRD)	4.4	3.8	8.7	26.7	na	35.9	16.0	38.4	Hot rolled steel coils
A.M. Castle & Co. (A: CAS)	3.9	2.9	14.6	162.4	13.5	30.6	–47.0	–35.2	Metals service center
LeaRonal, Inc. (N: LRI)	3.3	3.0	5.3	13.6	na	40.4	–28.0	–15.9	Specialty chemical additives
Standex Int'l Corp. (N: SXI)	3.0	2.2	14.5	16.0	11.8	35.6	–24.0	–7.4	Pumps, mach'y, food serv equip
Haverty Furniture (M: HAVT)	2.9	2.5	4.1	31.7	15.0	29.1	–32.0	–21.4	Specialty furniture retailer
Excel Industries (N: EXC)	2.8	2.7	13.6	138.8	13.0	25.5	8.0	32.7	Window & door sys for autos, trucks
Shelby Williams Ind. (N: SY)	2.8	2.7	4.6	36.7	12.0	31.4	–8.0	–4.2	Contract furniture market
Bridgford Foods Corp. (M: BRID)	2.6	1.9	16.9	4.7	na	39.2	–14.0	8.8	Meat wholesaler
Schultz Sav-O Stores (M: SAVO)	2.5	1.5	43.1	25.7	na	26.6	–7.0	12.3	Food retailer & wholesaler
Synalloy Corp. (M: SYNC)	2.4	2.1	12.7	14.9	20.0	31.3	–38.0	–20.8	Stainless steel & welded pipes
Boston Acoustics (M: BOSA)	2.3	2.0	36.6	8.2	0.0	38.9	–14.0	0.0	Loudspeaker systems
Raven Industries, Inc. (M: RAVN)	2.3	1.8	15.4	5.8	na	32.9	3.0	31.7	Plastic, electronics, apparel
Wallace Computer Serv (N: WCS)	2.1	2.0	11.5	14.5	15.0	27.8	–26.0	–9.5	Office products
TCA Cable TV, Inc. (M: TCAT)	2.0	1.9	14.9	32.3	13.5	39.8	–8.0	9.4	Cable TV systems
Medians	**2.7**	**2.2**	**14.1**	**20.9**	**13.5**	**32.2**	**–14.0**	**–2.1**	
Medians—All Non-DRP Firms	**0.0**	**0.0**	**0.0**	**14.4**	**15.0**	**0.0**	**–22.0**	**–6.8**	

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

Statistics are based on figures as of April 30, 1997.
Data Source: AAII's Stock Investor/Market Guide, Inc. and I/B/E/S.

ever, applying a screen searching for out-of-favor, high relative yield stocks might be an appropriate strategy for this group.

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

Traditionally, financials and utilities trade with higher dividend yields and require separate relative dividend screens. A simple screen for high dividend yields would be heavily weighted with securities from these groups. Our first screen filtered out financials and utilities. This requirement reduced the number of non-DRP firms from 6,907 to 5,811. The effect was even more dramatic for the stocks with DRPs, cutting the group down to 476 from the starting point of 841.

The next 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 out companies just paying a token dividend. This filter cut down

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.

Growth Rate—Est. EPS: Consensus estimate of the long-term (5 years) growth rate in earnings as tracked by I/B/E/S.

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%.

Price Change (1-Yr): The percentage change in price over the last year.

our list of DRP stocks from 476 to 235, and the non-DRP stocks down to 507 from 5,811. With the market dividend yield at a low level historically, this 2% screen is currently restrictive.

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 191 and the non-DRPs to 296. 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 six years since we have had our last recession. The optimal dividend 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 well 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 than the growth rate for the overall stock universe of 3.1%. This screen cut down the list of companies to 124 DRP stocks and 112 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 58, while the number of non-DRP stocks were whittled to 67.

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 dividends 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 have high payout ratios. We screened for positive payout ratios below 50% which elimi-

Table 4.
Number of Stocks Passing Screening Criteria

	Independent	DRPs Cumulative	Non-DRPs Cumulative
Universe	7,782	841	6,907
Exclude financials	6,521	633	5,857
Exclude utilities	7,578	476	5,811
Yield at least 2%	1,491	235	507
No dividend decreases last 5 years	5,450	191	296
Dividend growth rate above average (3.1%)	1,144	124	112
Dividend yield above five-year average yield	809	58	67
Positive payout ratio less than or equal to 50%	6,522	27	35
Earnings growth above industry norm	3,059	11	14

nated about half of the firms, leaving 27 stocks with DRPs and 35 stocks without DRPs.

Our final screen 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 11 stocks with DRPS and 14 stocks without DRPs are presented in Table 4, ranked by dividend yield.

The list in Table 3 of stocks passing all screens is not a diversified portfolio. In comparison to past years, there is a much heavier concentration of cyclical firms passing the list. Cyclical firms carry more risk late into an economic cycle, the higher yield of this group bears this out. Chrysler and Ford have had strong earnings growth over the last five years, but the market is anticipating slower future growth as reflected in the estimated five year earnings growth rates. As with all contrarian screens, one's analysis should focus on whether the market is too pessimistic in its assessment of the future of these stocks.

Firms with dividend reinvestment plans offer investors advantages, but remember to buy them because you are optimistic about performance, not simply because of the dividend reinvestment feature.