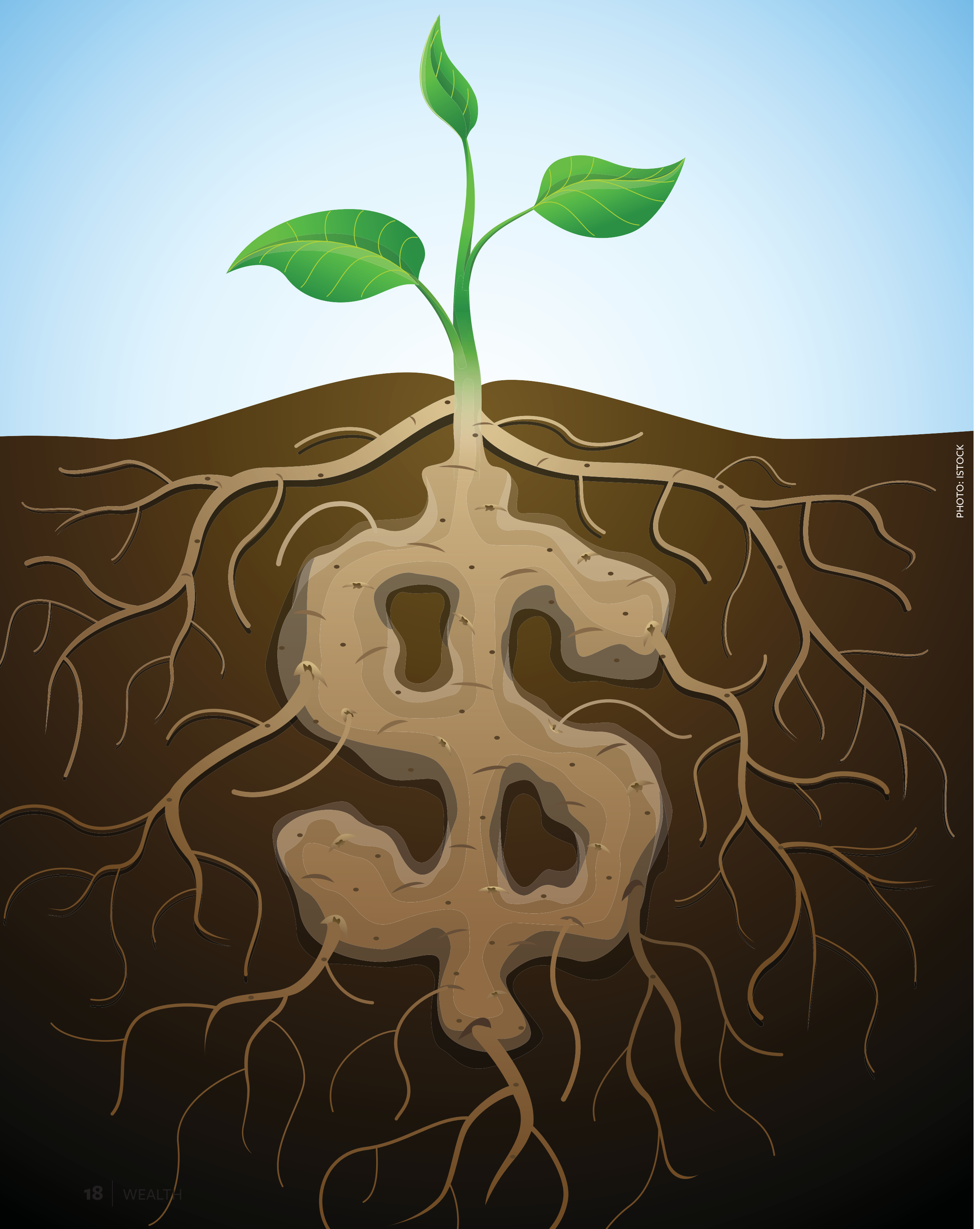
Digging deep for dividends

Our panellists give insight into capital preservation and good dividend-yielding stocks



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Dividends and income continue to be very big themes among investors, particularly for those with long-term portfolios. Our panel of experts share their best picks and tips for a sustainable long-term portfolio.

Genevieve Cua: The Singapore equity market has been muted over the past couple of years compared to developed markets and China. Please share your outlook for Singapore over the next three to six months. What do you see as drivers (or dampeners)?

Janice Chua: The easing stance adopted by numerous central banks has lifted sentiment for equities. In Singapore, the benchmark STI (Straits Times Index) rose 3.1 per cent year-to-date. We expect the Singapore equity market to remain resilient due to

a) rising possibility of a delay to the rate hike cycle till end 2015 or even early 2016;
b) positive spillover effect from the rally in HK/China;
c) the Singapore market's attractive valuation.

Our year-end target for STI is 3,720 based on an average PE of 13.8x FY16 earnings.

With US inflation risks nowhere in sight and data showing tepid recovery, earlier consensus expectations for a mid-year rate hike has been pushed back by a quarter or two. Core PCE (personal consumption expenditure), for example, has fallen from 2.1 to 1.4 per cent over the past three years with a 2.2 per cent GDP (gross domestic product) growth over the past five years. The needle pointing to the start of the rate hike cycle could shift to the right again. A further delay to the US rate hike expectation will support the SGD and Singapore equities.

For the year-to-date, the rally in HK/China equities has lifted consensus 2015 PE estimates for the Hang Seng Index to 13.64x (from 10.7x), HSCEI to 10.25x (from 8x) and Shanghai Stock Exchange A-shares to 17.4x (from 12.8x). The narrowing of the differentials in PE ratios between the Hong Kong and Singapore equity indices should support the Singapore market. However, we do not expect a surge in inflow of funds here as the Singapore equity market's PE valuation remains slightly higher on an absolute basis and growth is in the low to mid single-digit region. Rather, Singapore equities should tag along the main action in North Asia.

Carmen Lee: Over the past few years, investor interest and funds have flowed into developed markets largely because of the recovery in those key economies. However, this changed recently with the renewed strong interest in Chinese equities, the key outperformers in Asia this year. While interest in the Shanghai-Hong Kong Stock Connect was initially muted, this has since spiked in recent weeks as Hong Kong-listed stocks are also key beneficiaries of the China-exposure theme.

As quite a number of Singapore-listed companies have exposure to China, the positive sentiment has also spilled over partially to the local bourse. For example, CapitaLand, which has been hurt by Singapore property cooling measures in the last few years as well as its exposure to China, has also benefited from the recent positive trend and posted year-to-date good share price gains of 11 per cent.

Will this momentum continue into the next one to two quarters? We believe that the current positive momentum and sentiment for Asia are likely to persist for a while as the wealth effect from recent gains in the stock markets filters into the economy. In addition, valuations in Asia are generally not excessive. For example, the STI is only trading at 14.3 times this year's and 13.1 times next year's earnings, with a price-to-book of 1.3x and a consistent and decent dividend yield in excess of 3 per cent.

Similarly, despite recent strong stock market gains, the Hong Kong market is also not expensive with the Hang Seng Index trading at 13.3 times and 12.0 times this and next year's earnings.

In Singapore, apart from the reasonable market valuations, we are expecting several positive price drivers from key sectors – namely, property, banking and telecommunications. With the current SG50 celebrations and as residential property prices have already corrected for six quarters, we expect some fine-tuning to the existing property cooling measures which could be positive for homebuyers and also provide a lift for property stocks. In addition, privatisation and merger and acquisition (M&A) themes are likely to remain in play, largely as property stocks are trading at discounts to revalued net asset values.

For the banking sector, positive earnings momentum of the past few years looks likely to continue, supported by wealth, corporate banking and increased transactional activities. Despite challenging market conditions in the past three to four years, banks continue to post good earnings growth, capitalising on their regional networks and cross-selling of products and services.

Benjamin Pedley: We are attracted to the low volatility and relatively stable nature of the Singapore bourse, but have some concerns in a few areas such as labour shortages, high business costs and a cooling housing market.

In terms of the economy, the 2015 budget surpassed expectations. Development expenditure was increased to fund infrastructure, specifically Terminal 5 at Changi Airport, public transportation and health care. An increase in government expenditure will support economic growth. Also, the move to defer levy hikes for foreign workers to next year is widely seen as good news for companies facing rising business costs.

We forecast Singapore to grow 2.6 per cent in 2015, down from 2.9 per cent in 2014, before rebounding to 3.6 per cent in 2016. Inflation continues to ease due to the cooling housing market and the fall in energy prices. We expect accommodation prices to continue to decline as a result of greater supply and higher short-term interest rates. As natural gas prices tend to lag oil by a few months, we are also likely to see cheaper electricity, which is mostly generated by gas.

Genevieve: For an investor with a long-term retirement portfolio, what principles can you share in terms of screening for dividend stocks – what metrics and/or qualities should they watch for? What should they avoid?

Janice: Capital preservation and a consistent stream of dividend income are the most important considerations for investors with a long-term retirement portfolio. In screening for dividend stocks, we look for companies which fit the following criteria:

i) Companies with high dividend payout ratio of greater than 50 per cent and a sustainable dividend policy. These are generally companies with stable revenue, profits and cash flow but may not necessarily be in the high growth category as such companies require more cash to expand their businesses. The dividend payout ratio is the amount of dividends paid to stockholders relative to the amount of total net income of a company. Telecommunications, land transport and toll road operators fall into this category.

ii) Companies generating a stable and positive free cashflow, as these companies will have sufficient cash resources to reward shareholders as dividends, after setting aside the capital expenditure required to maintain or expand its asset base.

iii) Companies generating dividend yield of greater than 3 per cent, which is higher than the fixed deposit rate of less than one per cent and 10-year government bond yield of about 2.25 per cent. About 57 per cent of Singapore-listed stocks covered by DBS offers investors more than 3 per cent dividend yield, mainly in the telecommunications, banking, consumer, media, technology and shipyards.

We would avoid companies which are cyclical in nature as earnings tend to be volatile and lumpy. Companies with negative cash flow are also unlikely to pay good dividends.

Carmen: For a longer-term retirement portfolio, capital preservation should be one of the key considerations, complemented by assets yielding good recurrent income. Good dividend-yielding stocks should form part of the portfolio. Demand for defensive stocks with stable earnings and good dividends has remained strong in the past few years, largely due to the prevailing low interest-rate environment. We see this trend continuing, despite expectations that interest rates are likely to move up but at a well-managed and gradual pace. Therefore, we do not expect a gradual increase in interest rate to cause a sudden flight away from traditionally strong companies with good dividend payout track record.

A good indication of the strong demand for good yielding financial instrument is the FTSE Real Estate Investment Trust Index (FSTREI), which has been on an uptrend since the lows in 2009. From the low till now, the compounded average annual growth rate is 19 per cent. This is remarkable for a sector that is more widely known globally for providing stable yield and yet this sector has also delivered strong capital gains of 19 per cent per year for the past six years – putting real estate investment trusts (Reits) as one of the key outperforming sectors in Singapore.

Our preference is for companies with strong earnings flow, established dividend policy or track record, in defensive or non-cyclical sectors, with strong management teams and balance sheets. In Singapore, the telecommunications companies, SPH, SingPost, and ST Engineering are just some examples of such companies. For Reits and trusts, there are selective segments which will outperform the rest of the Reit sector with more defensive income, and this includes Reits with exposure to retail space or good quality office buildings.

There are several small to mid-capitalisation stocks with high dividend yields of more than 6 per cent. However, due to the lack of trading liquidity, trading float or a lack of investor familiarity with these stocks, investors looking to invest in these stocks should exercise caution and undertake to understand these companies first and not focus chiefly on just the high dividend yield. The sustainability of earnings and dividend payout should also be studied.

Benjamin: When looking for equity income strategies, one can focus on companies that:

a) provide a history of a consistent stream of dividends without any cuts in down cycles or due to company-specific reasons,
b) have grown dividend payments,
c) and offer an attractive yield. We try to avoid stocks with unsustainably high debt, or where earnings are insufficient to pay dividends and reserves may have to be eroded.

Negative earnings revisions can be a harbinger of dividend cuts, while positive earnings revisions are an additional source of alpha. We use six-month earnings revisions as we focus on the risk of dividend shortfalls or the chance of dividend hikes. We also pay attention to the ratio of dividends to earnings. The lower this payout ratio the better, because in the event of an earnings shortfall, raising the payout may prevent the dividend from being cut in line with earnings. Conversely, the company might not be willing to raise the payout if it was already high.

Genevieve: Please share your best equity picks in terms of a sustainable and growing dividend and why do you like them?

Janice:

- China Merchant Holdings (Pacific): It owns and operates five toll roads in major provinces in China. Toll revenue and earnings will continue to grow steadily as traffic increases along with China's economic growth. With management on the lookout for further acquisitions, we believe the Group could announce more acquisitions

THE BUSINESS TIMES' WEALTH ROUNDTABLE

Genevieve Cua, BT Wealth Editor poses questions to three wealth experts for their advice for a sustainable long-term portfolio.

Janice Chua is *Executive Director and Head of Research at DBS Group Research*. Under her leadership the Singapore research team has won several accolades. With more than 20 years' experience, she has covered a wide range of sectors including offshore and marine, conglomerates and industrials. In her spare time, Janice enjoys spending time with her family and reading.

Carmen Lee is *Head of Research at OCBC Investment Research*. She has over 20 years of equity research experience at local and foreign stockbroking firms. She oversees a team of analysts covering a wide range of stocks and sectors. The firm is consistently rated by Starmine, which tracks analysts' performance worldwide. Ms Lee enjoys travelling.

Benjamin Pedley is *Regional Head of Investment Strategy, Asia*, at HSBC Private Bank. He has over 20 years' experience in financial markets. Prior to HSBC Private Bank, he was head of advisory services at LGT Bank in Hong Kong. He also previously worked at Dow Jones Newswires in Sydney and Singapore. In his spare time, he visits his family in Australia and writes novels and screenplays.

in 2015 to further expand its toll road portfolio. Given its strong cashflow position, we believe the Group will maintain its DPS of seven cents even on the expanded share cap (they announced a one for 20 bonus issue), translating to a dividend payout of 74 per cent, dividend yield of 6 per cent.

- Mapletree Greater China Commercial Trust (MAGIC): A Reit investing in a diversified portfolio of income-producing commercial real estate in China. Assets are strategically located in Hong Kong (Festival Walk) and Beijing (Gateway Plaza). With visible organic growth and a portfolio of quality assets, MAGIC offers distribution yield of 6.2 per cent and trades at 0.9x book.
- Frasers Commercial Trust (FCOT): A Singapore and Australian commercial office retail Reit, with a diversified earnings base and a portfolio that enjoys high occupancy of over 90 per cent. FCOT offers forward distribution yield of about 6 to 7 per cent.

‘Capital preservation and a consistent stream of dividend income are the most important considerations for investors with a long-term retirement portfolio.’

Janice Chua, Executive Director and Head of Research, DBS Group Research

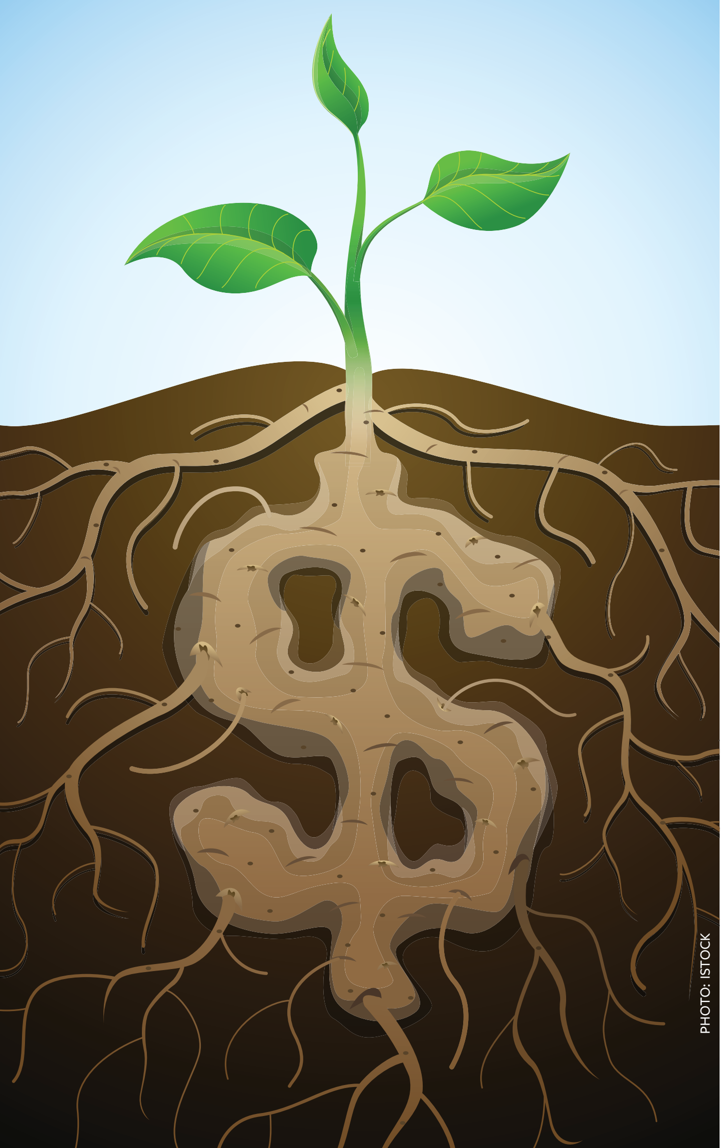
PHOTO: ISTOCK

- Sheng Siong (SSG): It operates the Sheng Siong Groceries Chain. We believe that SSG will deliver higher margins as fresh product sales mix improves over time. Longer-term growth opportunities lie in China. Supermarket businesses are non-cyclical and therefore provide stable earnings and dividends to shareholders. SSG offers an attractive dividend yield of about 4 per cent, as it pays out 90 per cent or more of its earnings as dividends.
- ST Engineering (STE): An integrated engineering group in the aerospace, electronics, land systems and marine sectors. It is a proxy to recovery in US and Europe, with 24 per cent of total sales derived from the US. A stronger US dollar is positive to STE's earnings. STE's historical dividend payout ratio is at least 80 per cent, underpinned by strong operating cash flows and healthy balance sheet (net cash of S$571 million as of end-FY14). Dividend yield is attractive at 4.2 per cent.

Carmen: Most big capitalisation companies do have established dividend payout policy or a sustainable rate of dividend payout amount. For example, the STI group of companies is giving an average dividend yield of 3.3 per cent for this year. All three listed telecommunication stocks have consistently been good dividend-yielding stocks, and current yields are still healthy at 3.9 per cent (Singtel) and 5.3 per cent (M1). Sembcorp Industries is currently providing yield of 5.2 per cent. Singapore Post's dividend yield is 3.3 per cent. DBS has performed well in the last four years in terms of its share price appreciation and it is currently providing a dividend yield of 2.8 per cent. In the Reit space, we like Frasers Centrepoint Trust as well as Frasers Commercial Trust, for their exposures to retail and office space, respectively.

Genevieve: What factors in the macro horizon might worry you in relation to Singapore and/or Asian equity markets? How do you suggest investors can mitigate those risk/s?

Janice: Global equity markets have performed well in recent years, boosted by unprecedented accommodative monetary policies by major central banks. Equities could become a victim of their own success as valuations have become elevated.

- The bull market in the US has lasted more than six years. The S&P500 Index has more than tripled since the 2009 bottom. Its PE valuation has risen from 11x to 18.5x, a five-year high even as consensus expects a 3 per cent earnings dip this year.
- The Euro STOXX 50 Index has recovered 80 per cent and PE valuation has lifted from 8.5x to 21.5x from the lowest point during the eurozone crisis, amid optimism that the ECB's QE programme will lift the region out of its economic doldrums.
- In Japan, Abenomics has powered the Nikkei 225 Index by 125 per cent and lifted PE estimates from 11.5x to 18.5x since late 2012.
- The Shanghai Composite index surged nearly 125 per cent in slightly less than a year, lifting PE valuation from 9.6x to 18.5x.

These elevated valuations make equities more susceptible to a 10-20 per cent correction should investors who are sitting on rich gains decide to take profit on the first sign of trouble. Triggers could come from:

1) concerns that the Fed will raise rates at a faster-than-expected pace,
2) corporate earnings do not recover as fast as anticipated,
3) Greece defaulting on loans.

The recent 10 per cent decline in the Jakarta Composite Index is one such example as investors grew nervous about Indonesia's ability to meet GDP growth and corporate earnings expectations. Any correction in the equity markets of the US, eurozone, China or even Japan will have a similar reaction here.

Carmen: Higher interest rates, if not executed at a well-controlled pace could cause turmoil and uncertainty in the market. In Asia, any slowdown in China will also impact Asian companies as increasingly, more Asian companies have exposure to the Chinese economy, from technology to property. Any economic slowdown or higher job cuts will also affect consumer demand in Asia. Recent austerity drives in China have also affected high-end luxury goods demand and led to slower sales at the higher end of the consumer sector. Any unexpected or prolonged geopolitical crisis could also cause disorder to the market. Higher oil prices could also affect several industries, including transportation firms and airlines, but should benefit the oil-related industries.

After the last few years of economic uncertainty and still relatively good gains for stocks, the new norm appears to be that a certain level of acceptable risk is to likely to be tolerated and expected by market participants. Therefore, while the market outlook is likely to still contain a definite level of uncertainty from any of the factors listed above, a careful stockpicking strategy is essential. The focus should be on quality and transparent companies with good corporate governance, sustainable earnings model, a good income stream, established track record to ride the down cycles, healthy balance sheet, experienced management and a manageable level of debt.

Benjamin: So far in Asia, weaker local currencies, falling inflation and lower interest rates have created a benign environment. Although we continue to expect near-term currency weakness, history also tells us that markets with significant currency depreciation can perform strongly as currencies stabilise, and certainly Singapore's currency has enjoyed a significant rebound of late against its US counterpart. Nevertheless, Asian growth remains weak ahead of an expected Fed rate hike later this year. While tightening is anticipated by investors – we believe it won't occur before September – it will be the first hike since 2006, and the actuality of it may spook some investors, especially those with leverage, for a time.

Given the current backdrop, we can identify themes that are useful for investors to note:

a) Lower interest rates: India and China (and to a lesser extent, Indonesia) should benefit the most from lower interest rates as inflation is falling fast and central banks have indicated that they will ease further. Chinese property can benefit too. We believe the fundamentals of the physical market will gradually improve in 2H15 as a result of lower land sales and slower new starts in 2014, against the backdrop of an improved credit environment.

b) Sectors with margin recovery: Asia's margins are showing signs of stabilising or improvement in selected industries where there is consolidation. In technology, we believe that the future focus will be on the Internet of Things (IoT). This is important for a broader market, including automotive, smart homes, wearables and smart cities. For example, sensors manufacturers and GPS technology providers could benefit from adoption of insurance telematics, which is currently still largely limited to the Americas and Europe.

c) Structural growth stories: In areas such as new energy, China's stricter environmental laws have been in effect since January 2015. This should facilitate a shift from coal to cleaner sources of energy such as solar and wind. Given a slide in polysilicon costs and increasing conversion efficiency, the cost of solar power has come down and demand is picking up. China's latest solar installation targets were also a positive surprise. Spending shifts are another area of focus. Spending by Asian tourists is shifting from shopping to experiences. In 2003, spending by Chinese travellers outside the country accounted for only one per cent of the global market. By 2023, this is expected to rise to 20 per cent. Given the still low passport penetration rate in China (4 per cent), we are now at a tipping point in terms of tourism flows and associated spending.