The Calculation Of The Dividend Cushion Ratio

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|

Example: Kimberly-Clark Corporation (KMB)

Brian Nelson

Summary

We wanted to walk through the Dividend Cushion calculation in depth for an example company, Kimberly Clark, in this article.

The Dividend Cushion is a forward-looking ratio (with a numerator and a denominator).

Companies with high dividend yields and strong Dividend Cushion ratios are ones with relatively large income streams that are poised for continued expansion.

This article is for educational purposes only to explain the nuts-and-bolts behind the calculation of the Dividend Cushion ratio. To access our updated opinion on Kimberly-Clark, please view its 16-page report and dividend report.

If the SEC inquiry into Linn Energy's (NASDAQ:LINE) non-GAAP cash-flow accounting has done anything, it has illustrated the importance of cash-flow analysis--not only with respect to valuation but also with respect to assessing the health of a company's dividend. We've received a significant amount of interest in the Dividend Cushion measure from Seeking Alpha followers since the SEC inquiry, and we wanted to walk through the Dividend Cushion calculation in depth for an example company, Kimberly Clark (NYSE:KMB), in this article. This article is for educational purposes only. We hope you enjoy!

Evaluating Kimberly-Clark's Dividend

Kimberly-Clark KMB FAIRLY VALUED

Valuentum Buying Index™ 6 | Valuentum Value Rating

Last Close	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
$103.51	$66.00 - $110.00	HEALTHY	GOOD / 1.3	EXCELLENT	3.13%

Kimberly-Clark boasts a nice dividend yield, and the firm's Dividend Cushion score suggests decent future dividend growth.

Stock Chart (weekly)

Company Vitals	
Market Cap (USD)	$41,000
Avg Weekly Vol (30 wks)	10,404
30-week Range (USD)	82.15 - 106.54
Valuentum Sector	Consumer Staples
Last Fiscal Year Revenue	21,063
Last Fiscal Year EPS	4.42
Last Fiscal Year EBITDA	3,537
Forward Revenue Growth (5-yr)	3.2%
Forward EPS Growth (5-yr)	11.1%

Dividend Vitals	
Current Annual Dividend Yield %	3.1%
Annual Dividends Per Share	3.24
Forward Dividend Payout Ratio	56.0%
3-yr Historical Dividend CAGR	7.1%
15-yr Historical Dividend CAGR	8.2%
3-yr Hist Median Div Payout Ratio	67.0%
15-yr Hist Median Div Payout Ratio	50.9%

NMF = Not Meaningful; Est. = Estimated; FY = Fiscal Year

Initial Annual Income Per Investment ($)

# of Shares	Investment ($)	Annual Div's ($)
25	2,587.75	81.00
50	5,175.50	162.00
100	10,351.00	324.00
200	20,702.00	648.00
300	31,053.00	972.00
400	41,404.00	1,296.00
500	51,755.00	1,620.00
1,000	103,510.00	3,240.00
2,000	207,020.00	6,480.00
5,000	517,550.00	16,200.00
10,000	1,035,100.00	32,400.00
50,000	5,175,500.00	162,000.00
100,000	10,351,000	324,000.00

Initial annual income is based on the firm's current forward annual dividend yield and could be subject to change.

Dividend Safety / Cushion — GOOD / 1.3

We assess the safety of a firm's dividend by adding the company's net cash to our forecast of its free cash flows over the next five years. We then divide that sum by the total expected dividends over the next five years. This process results in our Dividend Cushion™ ratio. A Dividend Cushion™ above 1 indicates a firm can cover its future dividends with net cash on hand and future free cash flow, while a score below 1 signals trouble may be on the horizon. And by extension, the greater the score, the safer the dividend, as excess cash can be used to offset any unexpected earnings shortfall. Kimberly-Clark scores a 1.3 on our Dividend Cushion™, which is GOOD.

Dividend Growth Potential — EXCELLENT

We judge the future potential growth of the dividend by evaluating the capacity for future increases, as measured by the Dividend Cushion™, and management's willingness to consistently raise the dividend, as measured by the firm's dividend track record. Kimberly-Clark registers an EXCELLENT rating on our scale, and we think the firm's annual dividend will be $4.09 per share within the next several years.

Risk of Capital Loss — MEDIUM

We assess the risk of capital loss based on our analysis of a firm's intrinsic value at this point in time. If the stock is undervalued (based on our DCF process), we think the risk of failing to recoup one's original capital investment (ex dividends) is relatively LOW. If the stock is fairly valued (it falls within our fair value estimate range), we think the likelihood of losing capital (ex dividends) is MEDIUM. If the stock is trading above our estimate of its intrinsic value, we think the likelihood of losing at least a portion of one's original investment (ex dividends) is HIGH. Kimberly-Clark registers a score of MEDIUM on our scale.

Key Dividend Considerations	
Current Annual Dividend Yield	3.13%
Annual Dividends per Share	$3.24
Initial Annual Div's Paid, $10k Investment	$313.01
Dividend Track Record	HEALTHY
Dividend Safety	GOOD
Valuentum Dividend Cushion™	1.3
Dividend Growth Potential	EXCELLENT
Risk of Capital Loss	MEDIUM
ValueRisk™ (Equity Margin of Safety)	MEDIUM

The Valuentum Dividend Cushion is a ratio that compares the firm's excess cash and cash flow to its future dividend stream. A score above 1 indicates cash flow is sufficient to cover future dividends (higher is better).

Dividend Strength — Dividend Growth

Dividend Safety	Very Poor	Poor	Good	Excellent
Excellent				
Good				
Poor				
Very Poor				

Firms that have safe and growing dividends score at the top right of our scale.

Dividend Track Record — HEALTHY

Fiscal Year	Div's/Share ($)	Div Growth %	EPS ($)	Payout Ratio
Dec-98	0.99	0.0	2.13	46.5%
Dec-99	1.03	4.0	3.09	33.3%
Dec-00	1.07	3.9	3.31	32.3%
Dec-01	1.11	3.7	3.05	36.4%
Dec-02	1.18	6.3	3.24	36.4%
Dec-03	1.32	11.9	3.33	39.6%
Dec-04	1.54	16.7	3.55	43.4%
Dec-05	1.75	13.6	3.31	52.9%
Dec-06	1.92	9.7	3.25	59.1%
Dec-07	2.08	8.3	4.09	50.9%
Dec-08	2.27	9.1	4.06	55.9%
Dec-09	2.40	5.7	4.52	53.1%
Dec-10	2.64	10.0	4.45	59.3%
Dec-11	2.80	6.1	3.99	70.2%
Dec-12	2.96	5.7	4.42	67.0%
Dec-13	*3.24*	*9.5*	*5.79*	*56.0%*
Jan-15	*3.45*	*6.0*	*6.18*	*55.6%*
Jan-16	*3.64*	*6.0*	*6.62*	*55.0%*
Dec-16	*3.86*	*6.0*	*7.05*	*54.7%*
Dec-17	*4.09*	*6.0*	*7.48*	*54.7%*

Light green shading denotes a dividend increase, while light red shading denotes a dividend decrease. Heavy green shading denotes a significant dividend increase, while heavy red shading denotes a significant dividend decrease or an excessive payout ratio. NA = Not Applicable.

To view our full 16-page equity report on Kimberly-Clark, please visit our website at www.valuentum.com

Kimberly-Clark is a Dividend Aristocrat, meaning it has raised its dividend in each of the past 25+ years (40+ years in Kimberly Clark's case). The company's dividend yield is above the ~2% average for S&P 500 companies, offering a 3.3% annual payout at recent price levels. As with most dividend growth investors, we prefer annual yields above 3% and *generally* don't include companies with yields below 2% in our dividend growth portfolio (unless they have significant valuation upside while paying a fast-growing dividend). Absent valuation and technical considerations (at the moment), Kimberly-Clark would fit the criteria to be considered for inclusion into the Dividend Growth portfolio.

Dividend Safety

We think the safety of Kimberly-Clark's dividend is GOOD (please see our definitions at the bottom of this article). We measure the safety of the dividend in a unique but very straightforward fashion. As many know, earnings can fluctuate significantly through the course of an economic cycle, so using the dividend payout ratio (dividends per share divided by earnings per share) in any given year has limitations. Plus, companies can often encounter unforeseen charges, which makes *accounting* (reported) earnings a less-than-predictable measure of the safety of the dividend.

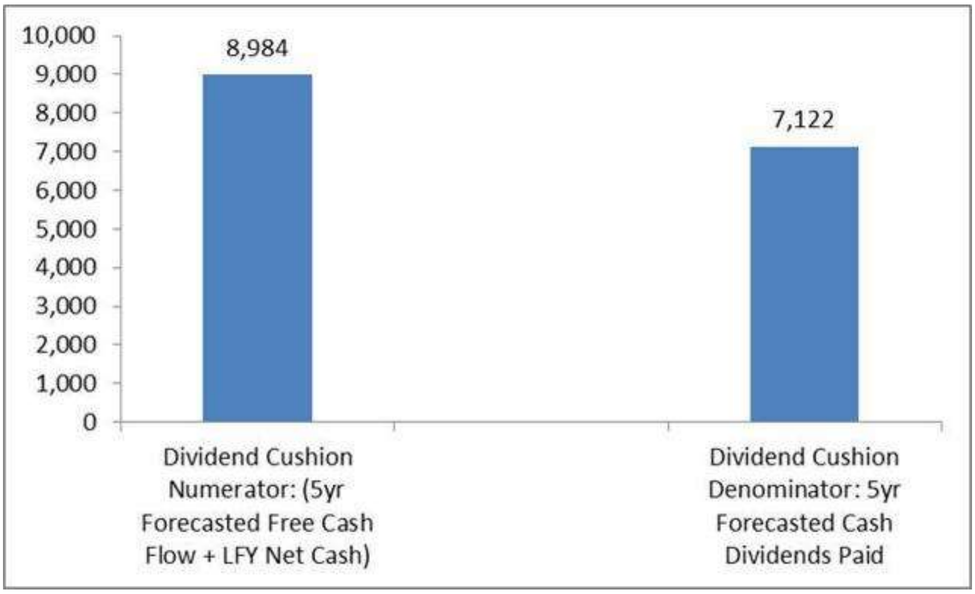
We also know that companies won't cut the dividend just because earnings have declined or a company had a restructuring charge that put it in the red for a quarter (or year or two). We therefore believe that assessing the cash-flow dynamics of a business, in conjuction with the company's dividend payout ratio, allows us to better determine whether a company has the capacity to continue paying dividends (and how much capacity to keep growing the dividend) well into the future.

That has led us to develop the forward-looking [Dividend Cushion](). The measure is a ratio that sums the existing net cash (total cash less total debt) a company has on hand (on its balance sheet) plus its expected future free cash flows (cash from operations less capital expenditures) over the next five years and divides that sum by future expected cash dividends (including expected growth in them, where applicable) over the same time period. Basically, if the score is above 1, the company has the capacity to pay out its expected future dividends.

As income investors, however, we'd like to see a score much larger than 1 for a couple of reasons: 1) the higher the ratio, the more "cushion" the company has against unexpected earnings shortfalls, and 2) the higher the ratio, the greater capacity a dividend-payer has in boosting the dividend in the future. For Kimberly-Clark, this score is 1.3, revealing that on its current path the company should be able to cover its future dividends (and the expected growth in them) with net cash on hand and future free cash flow.

To arrive at the Dividend Cushion ratio, please divide the numerator ($8,984 billion) by the denominator ($7,122 billion) in the graph below. The numerator represents the sum of a company's net cash position and its cumulative 5-year free cash flows. The denominator represents the sum of a company's cumulative 5-year cash dividends paid. A score of 1.3 for Kimberly-Clark can be considered GOOD. The higher the ratio above 1, the better. The difference between the numerator and denominator is the company's 'total cumulative 5-year forecasted distributable excess cash after dividends paid, ex buybacks.' The difference represents the excess cash that can be applied to more dividend increases (above that which are forecast in the analysis) during the 5-year measurement period.

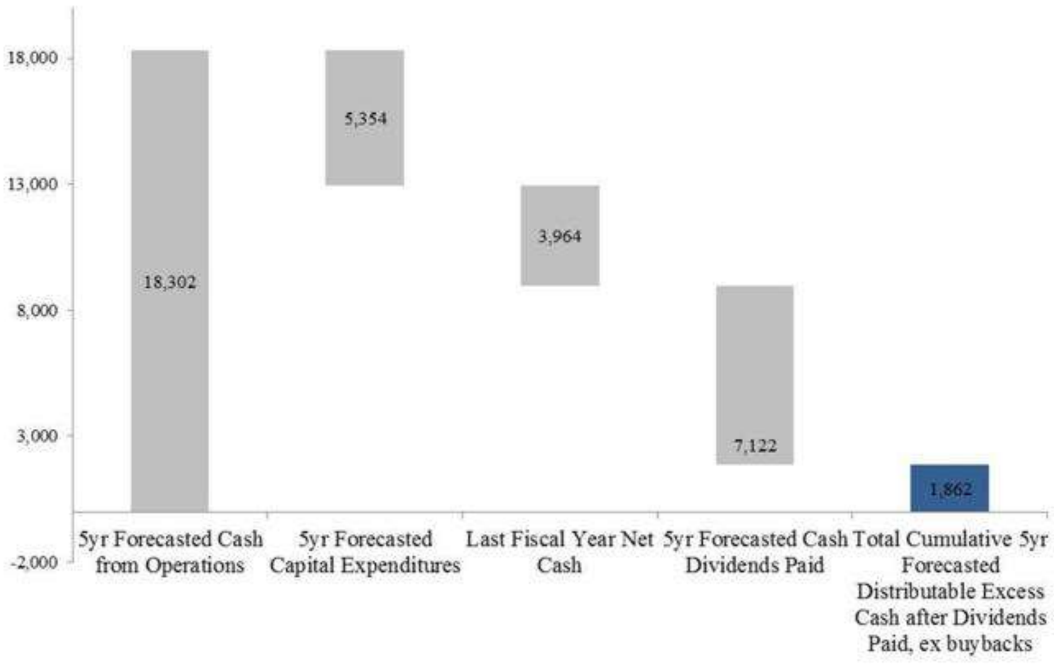
Derivation of Kimberly-Clark's Dividend Cushion - $ mil



Source: Valuentum

The following build in the graph below is a mapping of the company's residual free cash flow after deducting both capital spending and cash dividends (and after considering debt obligations). The build up below illustrates why Kimberly-Clark has a relatively 'slim' Dividend Cushion. The residual blue bar at the right of the chart, the difference between the numerator and the denominator in the above graph, is modest in the context of the company's robust cash-flow dynamics. Companies that have high Dividend Cushion ratios have a significantly larger 'blue bar.' They have significantly more excess cash that can be applied to future dividend increases.

Derivation of Kimberly-Clark's Total Cumulative 5-year Forecasted Distributable Excess Cash after Dividends Paid, ex buybacks - $ mil



Source: Valuentum

In the chart immediately above, it becomes evident that Kimberly-Clark has a significant amount of dividends to pay out in the coming years relative to its future free cash flows over this time frame (the dividends paid is the fourth bar from the left and absorbs cash generated from operations, the first bar on the left).

The above analysis considers a 6% annual future growth rate in the dividend, as shown on the front page of the company's dividend report--meaning the analysis is forward-looking and considers growth expectations in the dividend. This is an important consideration. The Dividend Cushion therefore measures the safety and growth of the dividend payout above and beyond expected dividend growth rates.

We prefer companies that have a very large residual cash position over the next five years, or a very large measure of 'total cumulative 5-year forecasted distributable excess cash after dividends paid, ex buybacks' -- the blue bar in the graph immediately above. The companies with the largest 'blue bars' are the ones with the strongest future dividend-growth prospects. Investors should consider equities that have a good balance of a strong dividend yield and a strong Dividend Cushion ratio to capture both income and dividend growth dynamics. Such companies have nice income streams that are poised for material expansion.

Dividend Growth

Now on to the potential growth of Kimberly-Clark's dividend. As mentioned above, the greater the "cushion," the greater capacity a company has to raise the dividend. Such dividend growth analysis is not complete, however, until we consider management's willingness to increase the dividend. To do so, we evaluate the company's historical dividend track record. If a) there have been no dividend cuts in 10 years, b) the company has had a nice growth rate in recent years, and c) the company boasts a strong Dividend Cushion ratio, we'd rate its future potential dividend growth as EXCELLENT, which is the case for Kimberly-Clark. After all, the company is a Dividend Aristocrat--meaning it has raised its dividend in at least each of the past 25 years.

Capital preservation is also an important consideration for income investors. We therefore assess the risk associated with the potential for capital loss. In Kimberly-Clark's case, we currently think the shares are fairly valued (the company's price falls within our estimated fair value range), so the risk of capital loss is MEDIUM. If we thought the shares were undervalued, the risk of capital loss would be LOW. In fact, under this valuation condition (i.e. a low risk of capital loss), the company would likely find its way into either the Best Ideas portfolio or Dividend Growth portfolio.

Wrapping Things Up

The Dividend Cushion is a forward-looking ratio (with a numerator and a denominator). It tells investors how many times future free cash flow (cash from operations less capital spending) will cover future cash dividend payments after considering the net cash on the balance sheet, which is also a key source of dividend strength. It is *purely* fundamentally-based and driven from items taken directly from the financial statements. The Dividend Cushion ratio should be assessed at least quarterly and is a measure of health and safety of a company's dividend payout. Companies with high dividend yields and strong Dividend Cushion ratios are ones with relatively large income streams that are poised for continued expansion.

Note: Our assessment of Kimberly-Clark's dividend has been borderline between good/poor in the past few years due to its Dividend Cushion consistently being so close to our cutoff of 1.25 for good (see definitions below). The score is 1.26 at the time of this writing. Evaluating the numerical score can be a value-add for readers -- in addition to considering our qualitative 'word' assessment.

Fair Value Range. The fair value range represents an upper bound and lower bound, between which we would consider the firm to be fairly valued. The range considers our estimate of the firm's fair value and the margin of safety suggested by the volatility of key valuation drivers, including revenue, gross margin, earnings before interest, and enterprise free cash flow (the determinants behind our ValueRisk™ rating).

ValueRisk™. This is a proprietary Valuentum measure. ValueRisk™ indicates the historical volatility of key valuation drivers, including revenue, gross margin, earnings before interest, and enterprise free cash flow. The standard deviation of each measure is calculated and scaled against last year's measure to arrive at a percentage deviation for each item. These percentage deviations are weighted equally to arrive at the corresponding fair value range for each stock, measured in percentage terms. The firm's performance is measured along the scale of LOW, MEDIUM, HIGH, and VERY HIGH. The ValueRisk™ rating for each firm also determines the fundamental beta of each firm along the following scale: LOW (0.85), MEDIUM (1), HIGH (1.15), VERY HIGH (1.3).

Dividend Track Record. We assess each firm's dividend track record based on whether the fundamentals of the firm have ever forced it to cut its dividend. If the firm has ever cut its dividend (within the last 10 years), we view its track record as RISKY. If the firm has maintained and/or raised its dividend each year (over the past 10 years), we view its track record as HEALTHY.

Dividend Safety. We measure the safety of a firm's dividend by adding its net cash to our forecast of its future cash flows and divide that sum by our forecast of its future dividend payments. This process results in a ratio called the Dividend Cushion™. Scale: Above 2.75 = EXCELLENT; Between 1.25 and 2.75 = GOOD; Between 0.5 and 1.25 = POOR; Below 0.5 = VERY POOR.

Valuentum Dividend Cushion™. This is a proprietary Valuentum measure that drives our assessment of the firm's Dividend Safety rating. The forward-looking measure assesses dividend coverage via the cash characteristics of the business.

Dividend Growth Potential. We blend our analysis of a firm's Dividend Safety with its historical Track Record, while also considering historical dividend growth trends. We believe such a combination captures a firm's capacity (cash flow) and willingness (track record) to raise its dividend in the future. Scale: EXCELLENT, GOOD, POOR, VERY POOR.

Risk of Capital Loss. We think capital preservation is key for the dividend investor. As such, we evalute the risk of capital loss by assessing the intrinsic value of each firm based on our discounted cash-flow process. If a firm is significantly OVERVALUED, we think the risk of capital loss is HIGH. If a firm is FAIRLY VALUED, we think the risk of capital loss is MEDIUM, and if a firm is UNDERVALUED, we think the risk of capital loss is LOW.

Dividend Strength. Our assessment of the firm's dividend strength is expressed in a matrix. If the safety of a firm's dividend is EXCELLENT and its growth prospects are also EXCELLENT, it scores high on our matrix (top right). If the firm's dividend safety and the potential future growth are VERY POOR, it scores lower on our scale (bottom left).

Northrop Grumman: Strong Dividend Cushion But Yield Could Be Better

Jan. 13, 2016 3:15 PM ET

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Summary

Though recent top-line trends have not been positive, Northrop Grumman's focus on margins has led to solid earnings per share and operating margin growth.

Investors should be careful not to fall in love with positive trends in earnings per share given the pace of share buybacks, however.

Management points to superior program performance and portfolio shaping coupled with an ongoing reduction in its cost structure as reasons to be optimistic.

Let's take a look at the firm's investment considerations as we attempt to:

uncover the drivers behind its Dividend Cushion ratio.

By The Valuentum Team

As with many of its defense peers, Northrop Grumman has a very nice dividend growth profile.

Northrop Grumman (NYSE:NOC) is a leading global security company providing innovative systems, products and solutions in unmanned systems, cyber security, C4ISR, and logistics and modernization to government and commercial customers worldwide. Technology and innovation form the backbone of the company.

Though recent top-line trends have not been positive, the firm's focus on margins has led to solid EPS and operating margin growth. In 2014, for example, earnings per share grew ~17%, and the company realized a record pension-adjusted operating margin despite a decline in revenue.

Northrop Grumman's business quality (an evaluation of our ValueCreation and ValueRisk ratings) ranks among the best of the firms in our coverage universe. The firm has been generating economic value for shareholders with relatively stable operating results for the past few years, a combination we view very positively.

The company has positions on a number of large, long-term franchise programs: F-35, E-2D, F/A-18, EA-18G, B-2 and JSTARS. Its unmanned platforms include the Global Hawk, BAMS, N-UCAS, and Fire Scout. Northrop also has strong core ISR sensor capabilities and a solid information processing position.

Two of the more interesting things to know about Northrop Grumman is that shares outstanding have been reduced by a third since 2008 while its annual dividend has advanced at a 9% CAGR over the same time. The firm is very shareholder friendly.

Note: Northrop Grumman's annual dividend yield is below average, offering a ~1.7% yield at recent price levels. We prefer yields above 3% and generally don't include firms with yields below 2% in the dividend growth portfolio. We love Northrop Grumman's bottom line performance and dividend potential, but sometimes a yield is not high enough, all things considered. Let's take a look at the company's dividend health nonetheless should managment turn up the gears on the payout.

Dividend Strengths

You're not going to hear us say many bad things about Northrop Grumman. The company has a solid position across a number of defense platforms, and we're particularly fond of its opportunities in unmanned systems, cyber and C4ISR. Technology and innovation remain its core, and while revenue, adjusted cash flow from operations and free cash flow have faced pressure in recent years as US security spending has been reduced, the company's cash-generating capacity remains top notch. Investors should be careful not to fall in love with positive trends in earnings per share given the pace of share buybacks, however.

Dividend Weaknesses

There's something to be said about an executive suite that can take a sales decline of 13% from 2009 to the end of 2014 as a result of a reduction in US government spending and turn that difficult environment into an ~18% increase in absolute segment operating income. Management points to superior program performance and portfolio shaping coupled with an ongoing reduction in its cost structure as reasons to be optimistic. We like Northrop Grumman's international opportunities, and a return to top-line growth would ensure the dividend is on solid ground, if a Dividend Cushion of 2.4 doesn't already speak to substantial resilience already. Buybacks will be forthcoming in any case.

From the Comments Section: How to Interpret the Dividend Cushion Ratio - A Ranking of Risk

As for how to interpret the Dividend Cushion ratio itself, it is a measure of financial risk to the dividend, much like a credit rating is a measure of the default risk of the entity. Said differently, a poor Dividend Cushion ratio of below 1 or negative doesn't imply the company will cut the dividend tomorrow no more than a junk credit rating implies a company will default tomorrow. That said, the Dividend Cushion ratio does punish companies for outsize debt loads because in times of adverse conditions entities often need to shore up cash, and that means the dividend becomes increasingly more risky.

We think investors should look at a variety of different metrics in assessing the sustainability of the dividend. Because the Dividend Cushion ratio is systematically applied across our coverage, it can be used to compare entities on an apples-to-apples basis. Dividend payers with significant free cash flow generation and substantial net cash on the balance sheet often register the highest Dividend Cushion ratios, as they should. These companies have substantial financial flexibility to keep raising the dividend.

Dividend Safety

We think the safety of Northrop Grumman's dividend is **good**. Please let us explain.

First, we measure the safety of the dividend in a unique but very straightforward fashion. As many know, earnings can fluctuate, so using the payout ratio in any given year has some limitations. Plus, companies can often encounter unforeseen charges, which makes earnings an even less-than-predictable measure of the safety of the dividend. We know that companies won't cut the dividend just because earnings have declined or they had a restructuring charge that put them in the red for the quarter (year). As such, we think that assessing the cash flows of a business allows us to determine whether it has the capacity to continue paying dividends well into the future.

That has led us to develop the forward-looking Dividend Cushion ratio, which we make available on our website. The measure is a ratio that sums the existing net cash a company has on hand (on its balance sheet) plus its expected future free cash flows (cash flow from operations less capital expenditures) over the next five years and divides that sum by future expected cash dividends over the same time period. Basically, if the score is above 1, the company has the capacity to pay out its expected future dividends and the expected growth in them.

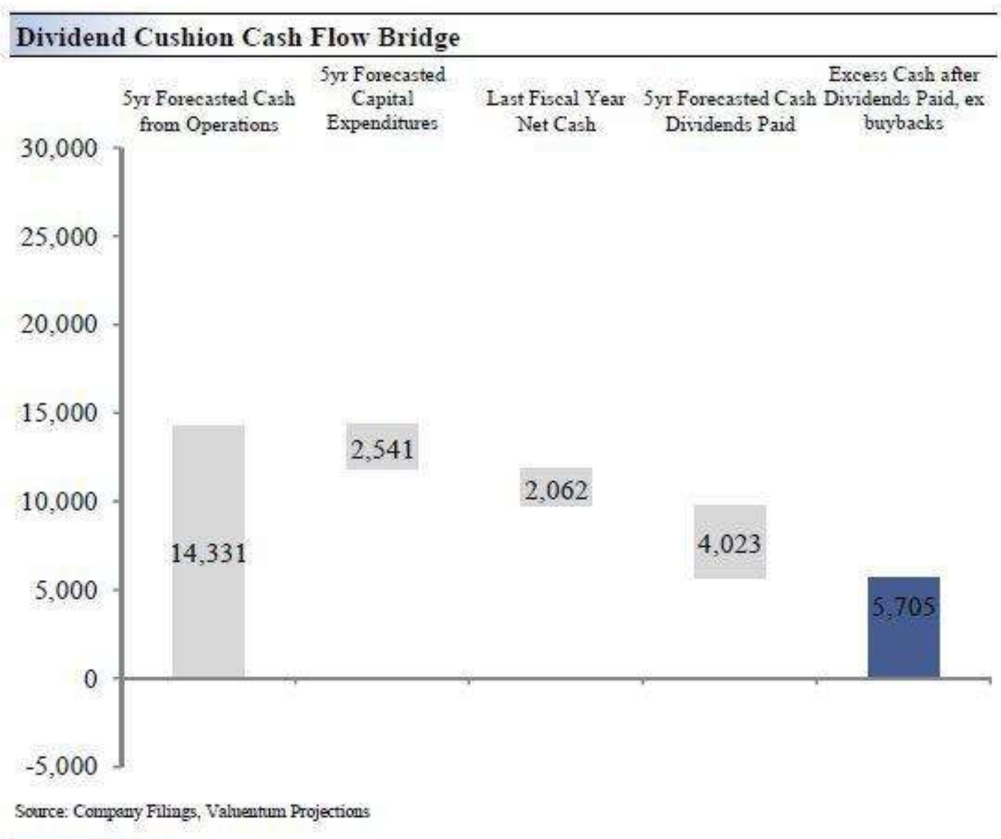
As income investors, however, we'd like to see a ratio much larger than 1 for a couple of reasons: 1) the higher the ratio, the more "cushion" the company has against unexpected earnings shortfalls, and 2) the higher the ratio, the greater capacity a dividend payer has in boosting the dividend in the future. For Northrop Grumman, **this ratio is 2.4**, revealing that on its current path the firm should be able to cover its future dividends and growth in them with net cash on hand and future free cash flow.

Dividend Cushion Ratio Cash Flow Bridge

The Dividend Cushion Cash Flow Bridge, shown in the image, illustrates the components of the Dividend Cushion ratio and highlights in detail the many drivers behind it. Northrop Grumman's Dividend Cushion Cash Flow Bridge reveals that the sum of the company's five-year cumulative free cash flow generation, as measured by cash flow from operations less all capital spending, plus its net cash/debt position on the balance sheet, as of the last fiscal year, is greater than the sum of the next five years of expected cash dividends paid.

Because the Dividend Cushion ratio is forward-looking and captures the trajectory of the company's free cash flow generation and dividend growth, it reveals whether there will be a cash surplus or a cash shortfall at the end of the five-year period, taking into consideration the leverage on the balance sheet, a key source of risk. On a fundamental basis, we believe companies that have a strong net cash position on the balance sheet and are generating a significant amount of free cash flow are better able to pay and grow their dividend over time.

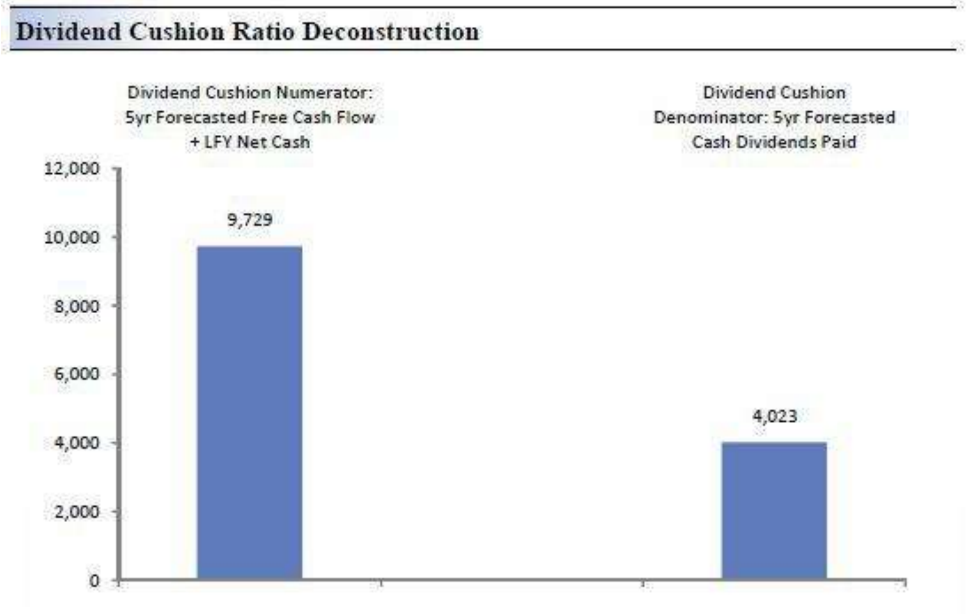
Firms that are buried under a mountain of debt and do not sufficiently cover their dividend with free cash flow are more at risk of a dividend cut or a suspension of growth, all else equal, in our opinion. Generally speaking, the greater the "blue bar" to the right is in the positive, the more durable a company's dividend, and the greater the "blue bar" to the right is in the negative, the less durable a company's dividend.



Dividend Cushion Ratio Deconstruction

The Dividend Cushion Ratio Deconstruction, shown in the image to the right, reveals the numerator and denominator of the Dividend Cushion ratio. At the core, the larger the numerator, or the healthier a company's balance sheet and future free cash flow generation, relative to the denominator, or a company's cash dividend obligations, the more durable the dividend. In the context of the Dividend Cushion ratio, Northrop Grumman's numerator is larger than its denominator suggesting strong dividend coverage in the future. The Dividend Cushion Ratio Deconstruction image puts sources of free cash in the context of financial obligations next to expected cash dividend payments over the next five years on a side-by-side comparison. Because the Dividend Cushion ratio and many of its components are forward-looking, our dividend evaluation may change upon subsequent updates as future forecasts are altered to reflect new information.

Please note that to arrive at the Dividend Cushion ratio, divide the numerator by the denominator in the graph below. The difference between the numerator and denominator is the firm's "total cumulative five-year forecasted distributable excess cash after dividends paid, ex buybacks."



Dividend Growth

Now on to the potential growth of Northrop Grumman's dividend. As we mentioned above, we think the larger the "cushion" the larger capacity the company has to raise the dividend. However, such dividend growth analysis is not complete until after considering management's willingness to increase the dividend. To do so, we evaluate the company's historical dividend track record. If there have been no dividend cuts in the past 10 years, the company has a nice dividend growth rate, and a solid Dividend Cushion ratio, we characterize its future potential dividend growth as **excellent**, which is the case for Northrop Grumman.

Because capital preservation also is an important consideration to any income strategy, we use our estimate of the company's fair value range to assess the risk associated with the potential for capital loss. In Northrop Grumman's case, we currently think shares are fairly valued, meaning the share price falls within our estimate of the fair value range, so the risk of capital loss is medium. If we thought the shares were undervalued, the risk of capital loss would be low.

Wrapping Things Up

We've been impressed by management's ability to continue to grow earnings per share in the face of falling revenue in recent years. This has helped Northrop Grumman's dividend potential despite US security spending having fallen. The company's cash-generating capacity remains strong, and we like its international growth opportunities. Though we feel the firm's dividend is already on solid ground, a return to top-line growth will provide additional stability. However, we are not interested in the firm *from an income standpoint* at this point - its yield is below average, and shares are overvalued, in our opinion.

Breakpoints: Dividend safety. We measure the safety of a firm's dividend by adding its net cash to our forecast of its future cash flows and divide that sum by our forecast of its future dividend payments. This process results in a ratio called the Dividend Cushion. Scale: Above 2.75 = EXCELLENT; Between 1.25 and 2.75 = GOOD; Between 0.5 and 1.25 = POOR; Below 0.5 = VERY POOR.

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How to Use the Dividend Payout Ratio Metric

BY MICHAEL JOHNSTON

The dividend payout ratio can be very useful, but is limited in several key ways.

While dividend yields capture the attention of bargain shoppers, most serious dividend investors consider a range of other metrics when searching out potentially attractive opportunities. Among these is the dividend payout ratio, an extremely basic calculation that summarizes a company's use of its available cash.

Payout Ratio 101

The calculation for the dividend payout ratio is relatively straightforward:

Payout Ratio = Cash Dividends Paid / Net Income

In other words, the payout ratio shows the percentage of a company's profits that are paid out to shareholders. Management has a number of options for using any cash generated by its operations, including:

1. Investing in machinery, equipment, or other capital expenditures that will increase future revenue;
2. Paying down debt;
3. Paying dividends to shareholders;
4. Repurchasing shares;
5. Purchasing other companies, patents, or brands; and
6. Adding to cash reserves.

The payout ratio reflects a summary of these corporate decisions — specifically the priority given to dividends compared to the other options. As such, it can be useful in evaluating dividend stocks for a couple of reasons:

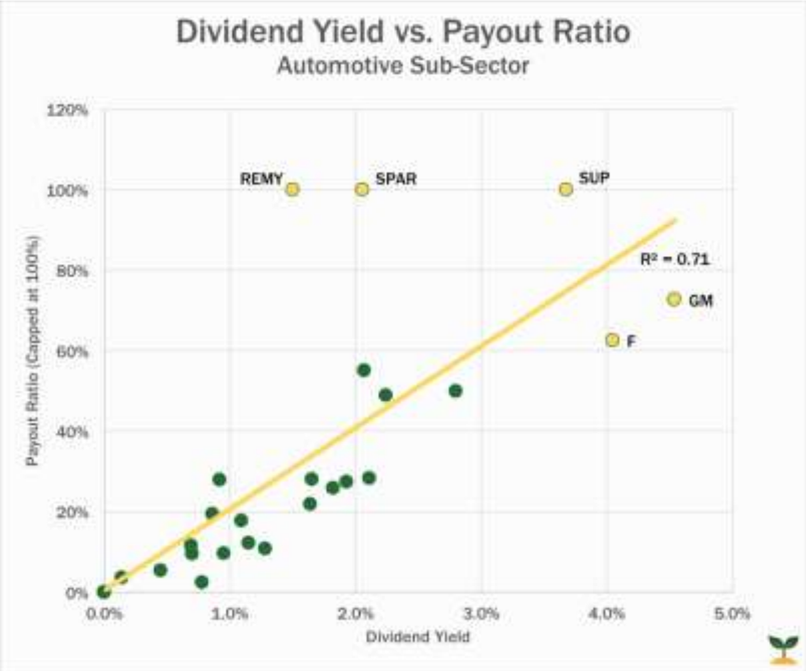
1. **Opportunity for dividend growth.** Companies with payout ratios near 100 percent are already distributing most available cash to shareholders. This indicates that in order to grow dividends in the future they will need to increase revenue, lower expenses, or eat into cash reserves. Conversely, companies with low payout ratios typically have some "cushion" to grow their dividend even if revenue and expenses remain stable.
2. **Opportunity for revenue growth.** Perhaps more importantly, the payout ratio indicates the extent to which companies have other uses of capital. A company that pays out all of its income to shareholders may not have any available projects — such as a new factory or international expansion — that would require an initial cash investment but could increase long-term earnings potential.

Here are also a number of limitations to the dividend payout ratio that should be considered as well.

1. **Ignores cash pile.** There are other factors that can impact the size of the "cushion" a company has that will allow it to increase future dividend payments. Most notably, the size of cash reserves merit consideration here.
2. **Buybacks excluded.** Dividends represent just one of the ways that companies can create value for shareholders. (For more on the concept of shareholder yield, see this interview with Meb Faber.)
3. **Earnings manipulation.** The numerator in the payout ratio calculation (dividends) is hard to manipulate, but the same can't be said for the denominator. Net income (or earnings per share) can be impacted by various non-cash and non-recurring items, which can overstate or understate the total pool of cash available.

Payout Ratio vs. Dividend Yield in Practice

One way that investors can use the payout ratio in stock analysis is consider it in context of dividend yields across all stocks in a sector or industry. Take for example, the following chart that plots the payout ratio against the dividend yield for [stocks in the Automotive sub-sector](#).



While most of these Automotive stocks more or less hug the trend line, there are a few outliers worthy of further analysis:

- Remy International ([REMY](#)), Spartan Motors ([SPAR](#)), and Superior Industries International ([SUP](#)) have payout ratios greater than 100 percent, which should raise a red flag and compel an investor to do further research before buying.
- Ford ([F](#)) and General Motors ([GM](#)) have dividend yields much higher than the rest of the sub-sector, and though their payout ratios are both above 60 percent, they do sit comfortably below the trend line. This evidence may indicate that these stocks are a good value, though further research into each stock's fundamentals is advised.

Alternative Ratios

The dividend payout ratio is one of the preferred metrics for evaluating potential investments, as it summarizes a relevant segment of the company's cash flow using standardized metrics. But for more in-depth analysis, other variations on this calculation may be worthwhile as well.

Dividends / (Cash Flow from Operations – Cash Flow from Investing)

This ratio removes earnings from the equation and instead uses a better indication of the company's actual cash flow. It also excludes capital expenditures from the denominator, better reflecting the cash available after investments in future revenue streams have been made.

(Dividends + Buybacks) / (Cash Flow from Operations – Cash Flow from Investing)

This slight variation to the formula above includes buybacks as part of the numerator, which results in an indication of the cash used in a broader definition of "yield."

Dividends / (Dividends + Increase in Cash)

This version of the payout ratio only considers the cash available after all other opportunities — such repayment of debt, buybacks, and capital expenditures — have been considered. This gives a more accurate representation of how companies prioritize cash distributions against building up a base of cash reserves.

The dividend payout ratio is one of the featured metrics in the Dividend Reference stock database because it allows for the comparison of key financial information among companies in a particular sector or industry. But while it is useful for initial screens to identify potential value buys, more customized analysis may be required before making a buy decision.