2016 Dividend Kings

http://www.simplysafedividends.com/dividend-kings-list/

Dividend kings are a rare breed of companies that have raised their dividend for more than 50 consecutive years.

Dividend kings have survived periods of inflation, oil booms, technology busts, rising interest rates, economic recessions, terrorist attacks, market crashes, evolving consumer tastes, major technology advancements, and more. Any business that has made it through every environment imaginable while maintaining regular dividend increases is worth analyzing.

Dividend kings are outstanding businesses that have demonstrated resiliency, consistent free cash flow generation, stable returns on capital, and (of course) predictable dividend growth. Many of them are included in the list of our favorite blue chip dividend stocks.

While there are 51 stocks in the S&P Dividend Aristocrats Index, which includes companies in the S&P 500 Index that have raised their dividend for at least 25 consecutive years, there are fewer than 20 dividend kings.

Hormel (HRL) was the 18th company to join the dividend kings list with its 50th consecutive dividend increase in January 2016, and Tootsie Roll (TR) will likely to be crowned later this year.

Dividend growth investors seeking safe, growing income would be wise to familiarize themselves with the list of dividend kings. Companies that share characteristics with the dividend kings will likely go on to be some of the best performing stocks and most consistent sources of dividend growth over the coming decades.

Dividend Kings Performance

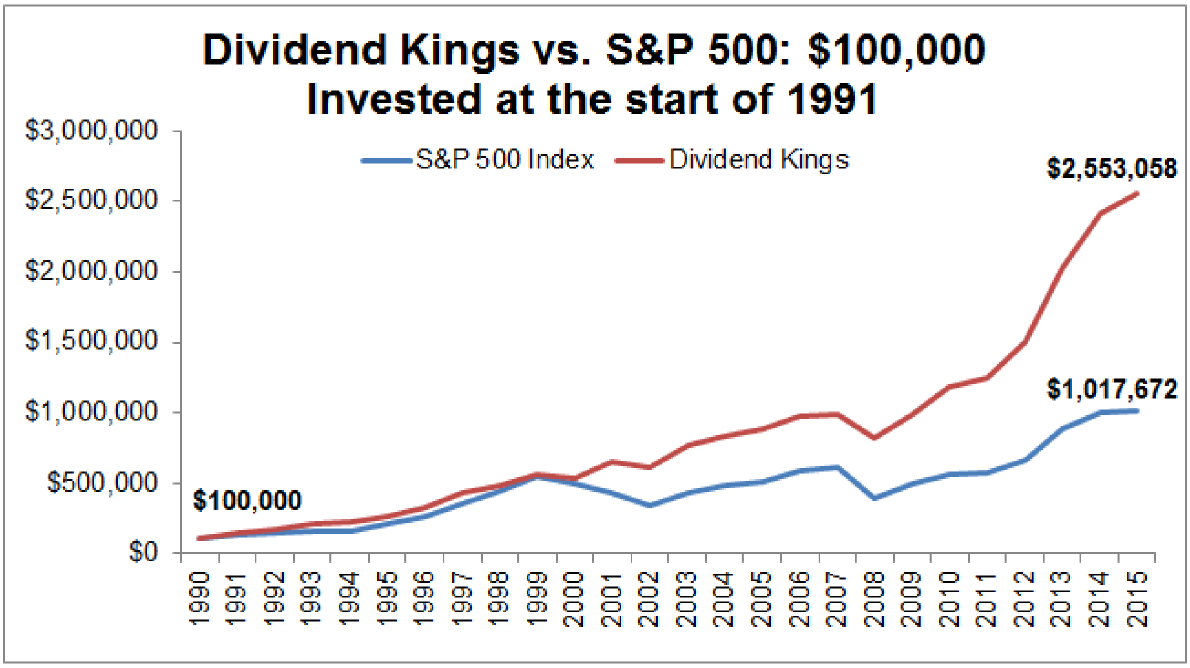
Imagine you had $200,000 to invest 25 years ago at the beginning of 1991. Suppose you put half into the S&P 500 Index and invested the other $100,000 equally across each of the current 17 dividend kings that trade on the major stock exchanges (FMCB trades over-the-counter and was excluded for liquidity purposes).

After making your initial investment in each of the dividend kings, you reinvested dividends (ideally through a dividend reinvestment plan) but did nothing else – no rebalancing, no additional capital contributions. You simply bought and forgot.

From 1991 through 2015, your $100,000 in the S&P 500 Index would have compounded at a 9.7% annual rate and grown to just over $1 million at the end of 2015. Not bad at all!

But what about your portfolio of dividend kings?

This portfolio grew from $100,000 in 1991 to reach an outstanding value of $2.6 million at the end of 2015, representing a 13.8% annual return.

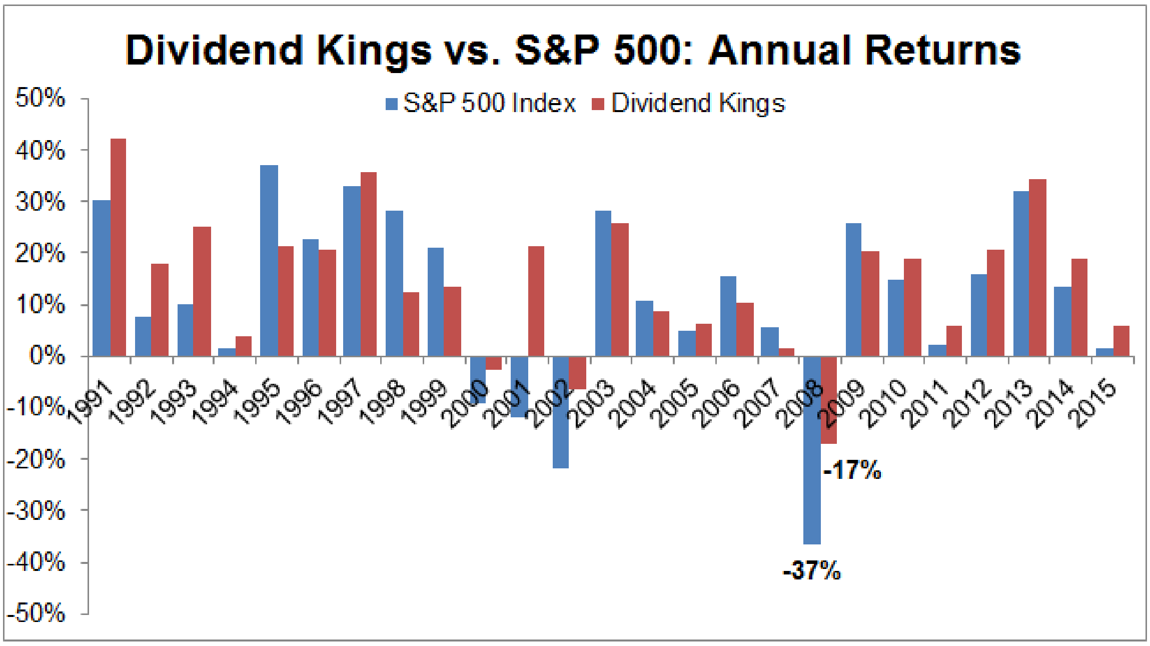


Source: Simply Safe Dividends

Even better, the portfolio of dividend kings had annual volatility of 13.5%, much lower than the S&P 500's 18.0% volatility during that 25-year period.

Lower volatility means that the value of your dividend kings portfolio would have fluctuated less than the value of your portfolio holding the S&P 500 Index.

As seen below, the dividend kings significantly outperformed each of the four years that the S&P 500 Index (represented by the blue lines) declined in value. For example, the dividend kings portfolio returned -17% during 2008, easily beating the S&P 500's total return of -37%. Dividend kings are high quality businesses with defensive characteristics that serve them well during bear markets.



Source: Simply Safe Dividends

Of course, the performance data above contains a good deal of hindsight bias. After all, who can predict which of the current dividend kings will be able to continue increasing their dividends for the next 25 years?

However, the information does illustrate the correlation between companies that are able to consistently raise their dividends and the value they create for shareholders.

Best Performing Dividend Kings

The best dividend kings from 1991 through 2015 were Lowe's (LOW), Lancaster (LANC), and Hormel (HRL). These stocks generated annualized returns of 21.4%, 17.4%, and 14.1%, respectively.

Impressively, each of these dividend kings still maintains a payout ratio less than 50%, leaving plenty of room for them to continue increasing their dividends for years to come.

Worst Performing Dividend Kings

From 1991 through 2015, only one dividend king underperformed the S&P 500 – Vectren Corporation (VVC). Vectren is a utility company that primarily provides energy delivery services to natural gas companies located throughout Indiana and Ohio. This dividend king's stock compounded at a 7.4% annual rate from 1991 through 2015, trailing the S&P 500's annual return by about 2.4% per year.

All of the other dividend kings compounded faster than the market, although Emerson Electric (EMR) generated a return in line with the market (9.7% per year).

Fastest Growing Dividend Kings

The fastest growing dividend kings, as measured by annual sales growth over the last five years, are Nordson (NDSN), General Parts (GPC), Dover (DOV), Coca-Cola (KO), and 3M Corporation (MMM). Their sales have compounded at annual rates of 10%, 9%, 8%, 8%, and 7%, respectively. After more than 50 years of dividend growth in the bag, these growth rates are remarkable.

Interestingly, only two of these dividend kings are also in the top five when ranked by fastest dividend growth over the last five years. Lowe's (LOW), Hormel (HRL), Parker-Hannifin (PH), Nordson (NDSN), and 3M Corporation (MMM) have compounded their dividends the fastest at rates of 20%, 19%, 19%, 18%, and 14%, respectively.

Aside from 3M Corporation, none of these dividend kings had payout ratios greater than 40% as of 12/31/15, suggesting they have plenty of room for continued dividend growth.

Sector Mix of the Dividend Kings List

Analyzing where each of the dividend kings comes from can be quite insightful. By equal-weighting each of the current 18 dividend kings, we were able to compose the sector mix of the dividend kings list and compare it to the S&P 500.

As seen below, not a single technology stock is to be found in the list of dividend kings. The rapid pace of change and continuous need to invest for growth make consistent dividend payouts less common in this sector. Warren Buffett is notorious for refusing to invest in the technology sector (aside from IBM) because he is uncomfortable forecasting the fast-changing industry's dynamics several years out.

The consumer staples, industrials, and utilities sectors are weighted much more heavily in the dividend kings list than they are in the S&P 500 Index. These sectors evolve at a much slower pace, providing a more attractive environment for long-term dividend growth.

Sector Mix	Dividend Kings	S&P 500	Difference
Information Technology	0.0%	20.7%	-20.7%
Financials	11.1%	16.5%	-5.4%
Health Care	5.6%	15.2%	-9.6%
Consumer Discretionary	11.1%	12.9%	-1.8%
Consumer Staples	27.8%	10.1%	17.7%
Industrials	27.8%	10.0%	17.8%
Energy	0.0%	6.5%	-6.5%
Utilities	16.7%	3.0%	13.7%
Materials	0.0%	2.8%	-2.8%
Telecom	0.0%	2.4%	-2.4%

As of 12/31/15

Source: Simply Safe Dividends, S&P

How to Analyze Dividend Kings

Just because a company has increased its dividend for at least 50 consecutive years to qualify as a dividend king does not mean it is an attractive investment opportunity.

With at least 50 consecutive years of dividend increases, dividend kings have already proven their durability. However, the world is constantly evolving. An industry that was slow-moving over the last decade could experience much faster change over the next 10 years as technology advances, consumer preferences evolve, markets become saturated, and new competitive threats emerge.

We like to start our evaluation of the dividend kings by reading more about their businesses and asking ourselves how the world's changing forces could challenge them. Essentially, what is changing that could make the next 50 years much more difficult for this industry or company?

If we are comfortable with the company's competitive advantages and the forces shaping its industry, we can begin to analyze its financials. Simply put, we want to invest in businesses that earn high returns on invested capital (e.g. over 10%), have numerous growth opportunities to keep earnings moving higher (earnings drive long-term dividend growth), and maintain conservative balance sheets (e.g. debt-to-capital ratio less than 50% for most business models). A lower payout ratio (e.g. below 60%) is also preferable.

Many dividend kings possess these characteristics, which makes valuation the more challenging factor in most cases. Even the best businesses can reach such high prices that your future returns will be disappointing regardless of the company's fundamental performance. The best time to buy dividend kings are when their stock prices get hit by temporary factors that do not impede their long-term earnings power. Such occurrences are unusual but worth waiting for. Otherwise, as a general rule of thumb, we hesitate to pay more than 20 times earnings for most businesses. A margin of safety is always desirable.

Stock Analysis of the Dividend Kings

You can view data (updated daily) on all of the dividend kings in the table found at the bottom of this page. Historical results are one thing, but understanding each dividend king's future dividend growth potential and business outlook is even more important.

We analysed the business models, dividend safety, dividend growth, key risks, and more of the dividend kings below.

JNJ – A Rock Solid 3% Dividend Yield

August 19th, 2015|High Safety

JNJ is a core holding in our Conservative Retirees dividend portfolio due to its 3% dividend yield, low business volatility, reasonable valuation, and rock solid fundamentals. The Conservative Retirees dividend portfolio contains 25 stocks with extremely safe dividends and above average dividend yields, providing steady and predictable income while preserving your capital. JNJ was added to the portfolio on 6/25/15 at a price of $99.12 (the stock closed at $99.36 on 8/18/15).

To quickly view the 25+ years of JNJ's dividend data and 10+ years of critical fundamental data we look at to analyze the company, click here.

Business Overview

With over $70 billion in sales spread between pharmaceuticals (43% of sales, 36% operating margin – immunology, infectious diseases, neuroscience, oncology, and cardiovascular and metabolic diseases), consumer (20% of sales, 13% operating margin – baby care, oral care, skin care, OTC pharma), and medical devices (37% of sales, 20%+ operating margin – surgery, orthopedics, and consumer medical devices), JNJ is one of the largest and most diversified health care companies. International sales account for just over half of JNJ's total sales, and the company runs a decentralized management structure with more than 265 operating companies spread across 60 countries.

Stock Performance

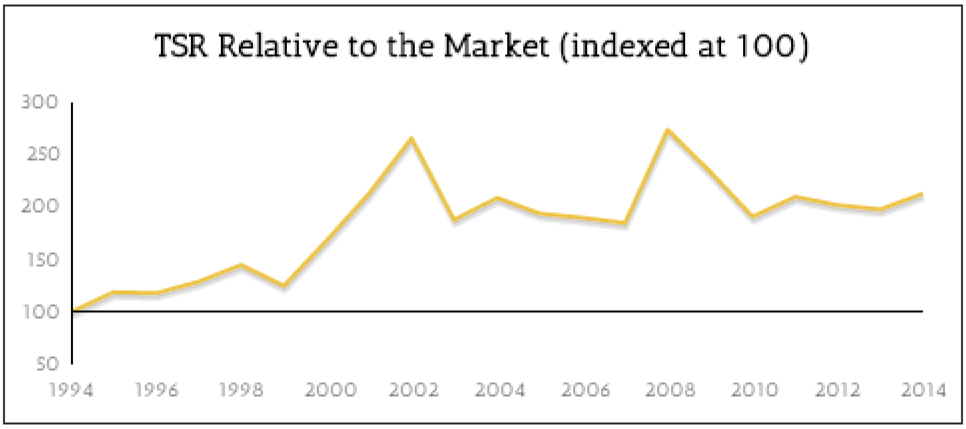
Over most periods of time, JNJ has kept up with or outperformed the market. The stock's performance has been more moderate over the past year, returning just 1.5% and trailing large caps by more than 5%.

Total Shareholder Return (TSR)

1-month	6-months	1-year
-0.2%	0.9%	1.5%

TSR Compound Annual Growth Rate

Time Period	JNJ	Market
2012-2014	20.5%	20.1%
2010-2014	13.8%	16.1%
2005-2014	8.3%	8.1%



Dividend Analysis

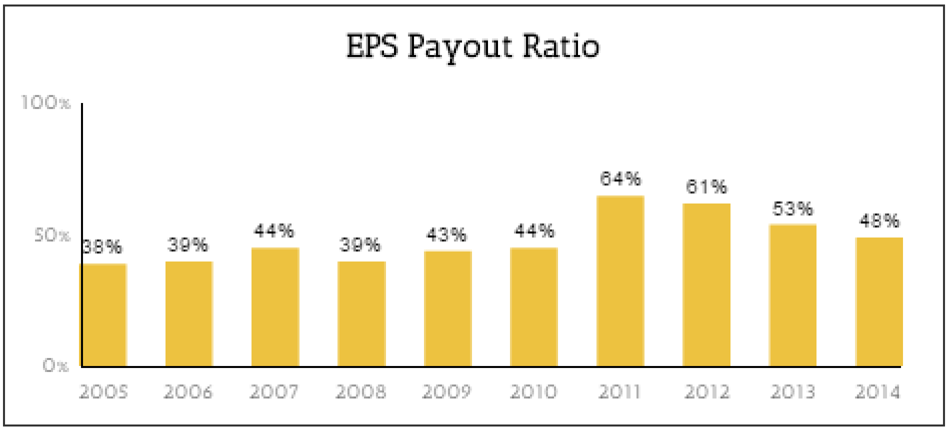
We analyze 25+ years of dividend data and 10+ years of fundamental data to understand the safety and growth prospects of a dividend. JNJ's long-term dividend and fundamental data charts can all be seen here.

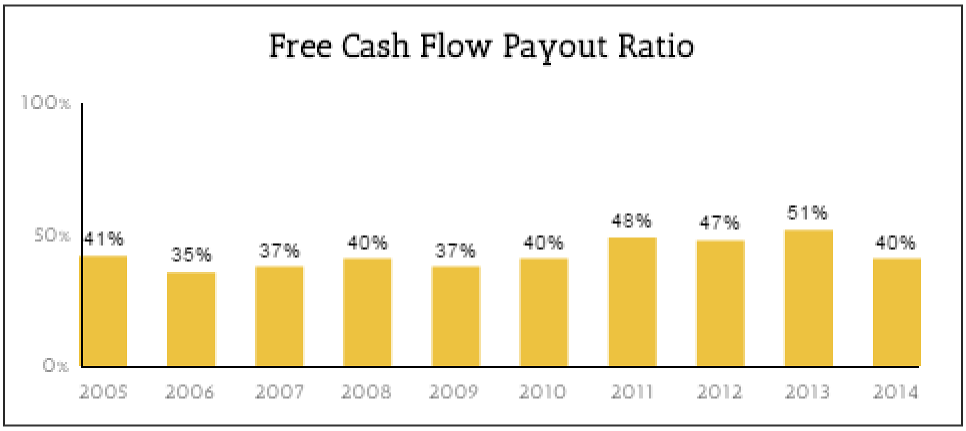
Dividend Safety Score

Our Safety Score answers the question, "Is the current dividend payment safe?" We look at factors such as current and historical EPS and FCF payout ratios, debt levels, free cash flow generation, industry cyclicality, ROIC trends, and more.

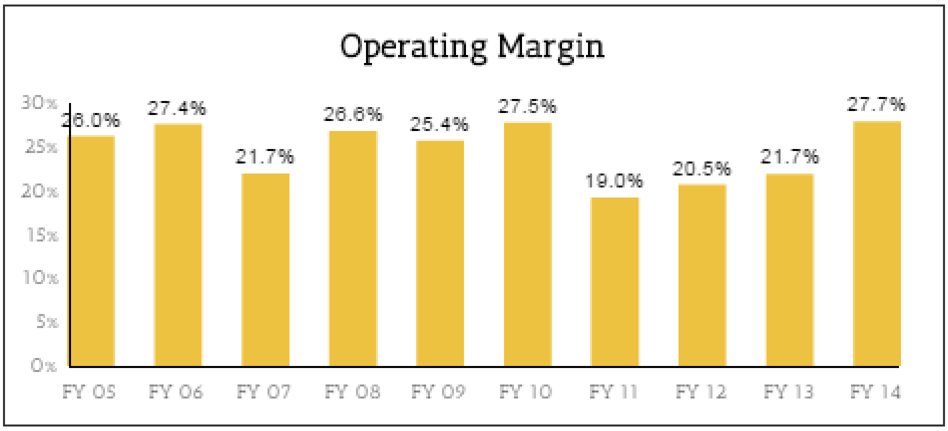
JNJ scored a premier Safety Score of 99, meaning its dividend is safer than 99% of all other dividend stocks. Dividend investors need not worry about losing sleep if they own JNJ.

As seen below, JNJ has generally maintained EPS and free cash flow payout ratios between 40-60% over the past decade, suggesting there is reasonable cushion to continue paying and growing the dividend, even in the event of an unexpected decline in the business. Although we are dealing with "non-GAAP" figures, JNJ has impressively grown its adjusted earnings for over 30 consecutive years. A business doesn't get much safer than that.

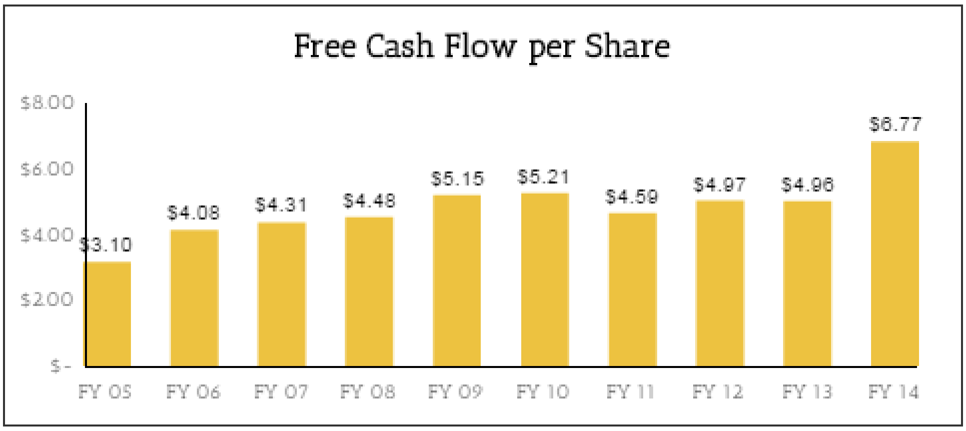




Many of JNJ's products are fairly recession proof in nature, which helped the company limit sales and EPS declines to just 3% and 4%, respectively, in fiscal year 2009 while raising the dividend by more than 5%. As seen below, operating margins hardly budged during the recession:



High operating margins and even moderate sales growth are usually a recipe for nice free cash flow growth, and we see that is certainly the case with JNJ:



While payout ratios, margins, industry cyclicality, free cash flow generation, and business performance during the recession help give us a better sense of a dividend's safety, the balance sheet is an extremely important indicator as well.

JNJ’s debt to capital ratio has oscillated between 10% and 20% over much of the past decade, maintaining a conservative amount of leverage (especially given the lower volatility of the business). With all of the free cash flow that JNJ throws off, it has built up quite a fortress on the balance sheet. As seen below, JNJ has nearly $20 billion in net debt, the equivalent of more than 7% of the company’s current market cap. The balance sheet provides a solid foundation for JNJ to continue paying and growing its dividend while investing in opportunities for growth.

Credit Metrics

Current Ratio: 2.5 Net Debt / EBIT: -0.9 EBIT / Interest Expense: N/A
Cash ($ millions): $33,954 Last Fiscal Year Free Cash Flow: $19,388
Total Book Debt: $14,085 TTM Interest Expense: N/A

Dividend Growth Score

Our Growth Score answers the question, “How fast is the dividend likely to grow?” It considers many of the same fundamental factors as the Safety Score but places more weight on growth-centric metrics like sales and earnings growth and payout ratios.

JNJ’s Growth Score is 52, meaning its dividend’s growth potential ranks about in line with the average dividend stock’s growth potential (a score of 50 is “average”).

While JNJ has raised its dividend for over 50 consecutive years, the rate of increases has gradually slowed. As seen below, JNJ’s dividend compounded at a 9% clip over the past decade but has since come down to a 6-7% growth rate.

Dividend Growth Streak	1-Year Growth	3-Year CAGR	5-Year CAGR	10-Year CAGR
20+ Years	6%	7%	7%	9%

The company’s sheer size (over $70 billion in revenue) also makes it difficult to see a future in which JNJ’s dividend can grow faster than current rates. JNJ’s sales compounded at a 3.7% annualized clip over the last five years, and sales growth seems likely to remain in the 2-5% range going forward.

Yield Score

Our Yield Score simply ranks a stock's current dividend yield against all of the other dividend yields in the market. A score of 50 means the stock's yield is right in the middle of the pack. A score of 100 means it has the highest yield. The Yield Score helps assess a dividend stock's relative value.

JNJ's Yield Score is currently 60, meaning its 3% dividend yield is higher than 60% of all other dividend stocks. For a company with great dividend safety but modest growth prospects, this appears to be reasonable.

Competitive Strengths

Few companies ever come close to growing as large as JNJ has become. Generating $70 billion in sales has numerous advantages that will keep JNJ relevant for a long time to come.

Starting at the top, JNJ's management team is very focused on investing only in markets that the company can dominate. Today, roughly 70% of JNJ's sales are from #1 or #2 global market share positions, and management has shown a willingness to divest underperforming or non-core parts of the business. With nearly $20 billion in net cash, management can also remain opportunistic with buybacks and M&A opportunities, especially as the biopharma industry evolves.

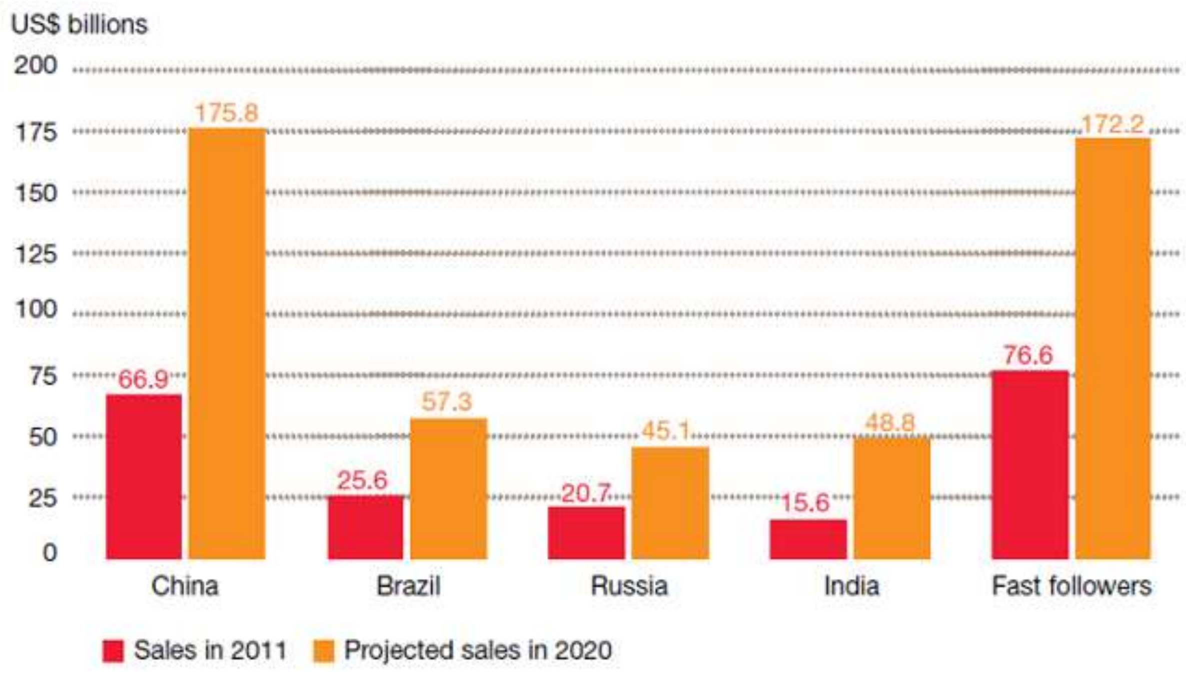
This approach has been a successful one and helped JNJ develop 24 brands with over $1 billion in sales (including a consumer portfolio with some of most well-known global brands – Tylenol, Motrin, etc). In addition to a wide array of successful brands, JNJ's three operating segments are each driven by different factors, with the consumer business providing predictable cash flow to fund growth in pharmaceutical investments. This adds to JNJ's resilience to economic cycles and helps fund innovation.

Speaking of innovation, JNJ invests over $8 billion in R&D each year. As the largest pharma company in the US, JNJ has the most FDA approvals since 2009, releasing 14 new products, but also boasts that 25% of its sales are from products launched in the past five years. With $70 billion in revenue, that means JNJ successfully commercialized $18 billion of new products in five years, more than $3 billion per year. Such results are a testament to JNJ's innovation, R&D processes, brand strength, and scale advantages.

Pharma has been JNJ's growth driver, and it is one of the widest-margin industries to be in. Competition is somewhat limited due to tough governmental regulations (testing and documentation requirements for FDA clearance of new drugs are only increasing) and the R&D intensity of the industry (biopharma companies invest more than 10x the amount of R&D per employee than all manufacturing industries overall). If a drug reaches final approval and is successfully commercialized, favourable patent protection allows for a nice ramp of cash flow to more than recoup R&D efforts.

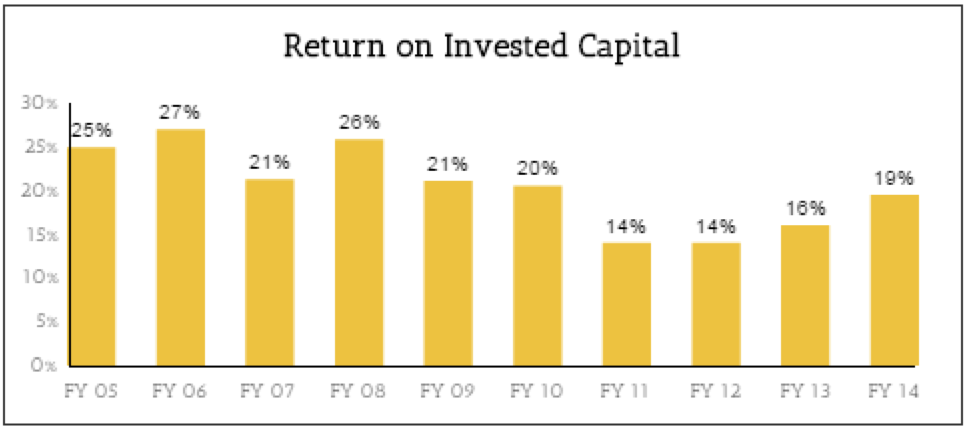
While generics are taking more share and regulations can always change, there are several fundamental factors that make this space appear to be a good long-term bet for JNJ. The elderly population drives about a third of industry sales and should see secular growth as the average age of people increases around the world. Ground-breaking discoveries in genomics and biotech will also catalyze new drug development. FDA approvals of new molecular entities are also happening at a faster pace, with 41 approvals in 2014 (up from 27 in 2013 and 39 in 2012).

Perhaps one of the biggest long-term tailwinds is JNJ's exposure to international markets (over 50% of sales). As seen below, courtesy of PWC, demand for medicines is rising rapidly in emerging markets:

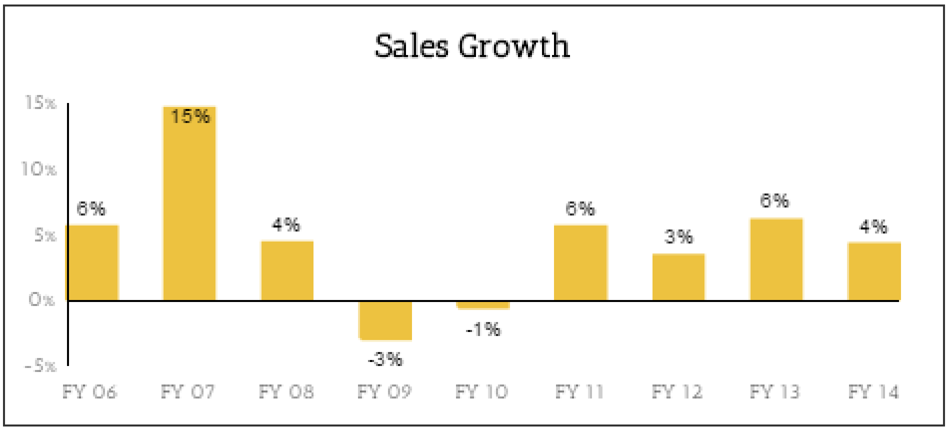


Even with all of these competitive strengths, JNJ is not always invincible. One area of recent weakness is JNJ's Hepatitis C drug Olysio, which got off to a really hot start last year (recorded over $800M in revs in Q2 2014 but only $264M in Q2 2015) but has since collapsed in the face of competing products that were approved later by Gilead and Abbvie. JNJ's diversification helped cushion this blow, and it has a handful of drugs in the pipeline that it expects will help it grow its drug sales above the industry average for the next five years. JNJ also partnered with Achillion to try and develop a better Hepatitis C product (Hepatitis C is a huge market – potential to reach $32 billion in drug sales by 2018), but any impact from these efforts is likely several years away.

Altogether, one of the quickest ways to assess the strength of a business model is to evaluate the level and durability of a company's return on invested capital. As seen below, JNJ has generally maintained a return on invested capital in the teens or higher for the past decade, signs of a durable and consistent business.



Looking at growth, it's important to remember the $95 billion drop in sales the industry experienced from 2010 to 2013 due to the patent cliff of expiring blockbuster drugs. A peak of 48 drugs lost exclusivity in 2012, but only 20 did in 2013 and around 25 in 2014. JNJ weathered this storm fairly well, with sales dipping just 1% in fiscal year 2010:



Near-term growth has been impacted by weak Hepatitis C sales and unfavourable currency movements. Adjusting for the impact of Hepatitis C sales and acquisitions and divestitures, core growth was 6% last quarter (+1.7% including Hepatitis C impact).

Key Risks

Each of JNJ's operating segments has a unique risk profile. Let's start with the consumer business (20% of sales, 13% operating margin), which owns an assortment of well-known brands including Tylenol, Zyrtec, Band-Aid, Neutrogena, Listerine, Motrin, and Aveeno.

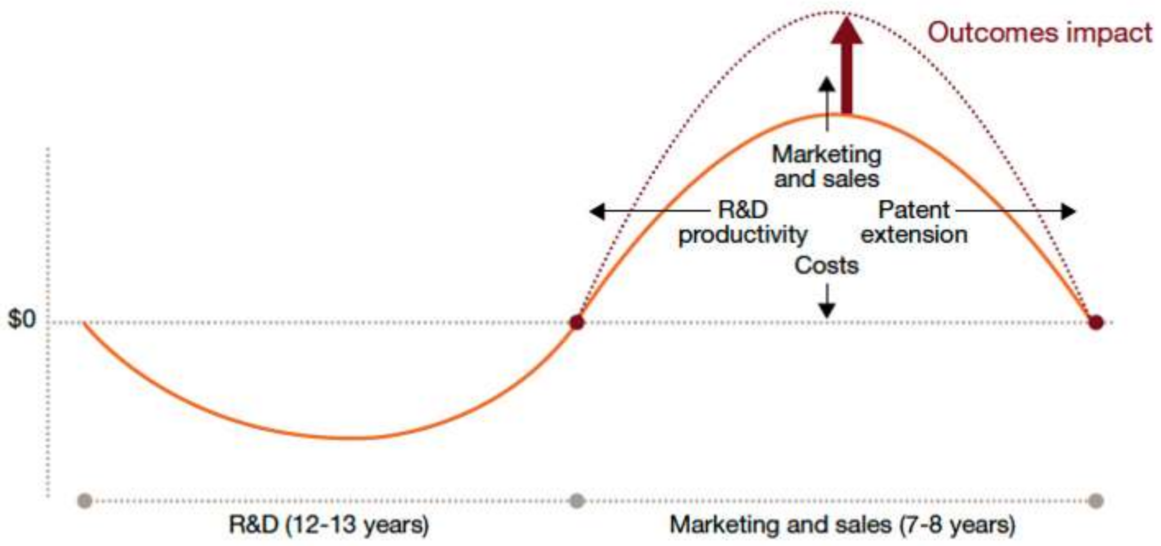
In 2010, JNJ's consumer business fell into a world of trouble. Several of its plants were closed after JNJ recalled tens of millions of products, including its Tylenol and Motrin brands, in response to continued complaints about strange odors coming from the products (manufacturing issue). The company had to spend $100 million to upgrade the plant and correct the issues, but its OTC consumer business lost basically its entire market share in certain categories.

After several years of underperformance, the consumer business appears to be back on track today (organic sales up 4% YTD) and able to play the role of predictable cash cow to fuel investment in JNJ's higher-margin pharmaceuticals segment. With its strong brands and global reach, the consumer business should continue reducing JNJ's business volatility (provides a solid base to help offset the occasional drug patent cliff) while providing modest growth.

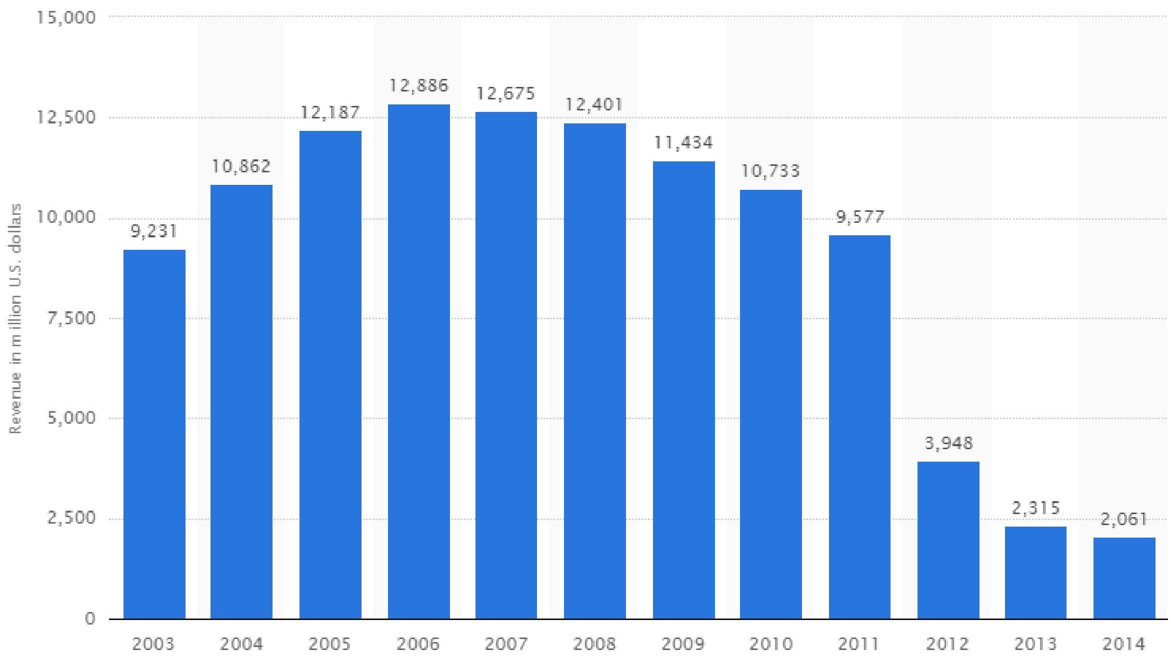
JNJ's medical devices business (37% of sales, 20%+ operating margin) appears to carry a bit more risk than the consumer segment. This business has underperformed peers in recent years and carries less exposure to areas that are exhibiting higher growth rates (e.g. robotics). With ongoing consolidation among health systems and insurance providers, pricing has also come under some pressure. However, this segment is still #1 or #2 in the majority of the categories in which it competes and has ten $1 billion plus platforms.

JNJ's most important business is its pharmaceutical segment, which has generated 30%+ operating margins in each of the past two years and been a key growth driver. This business also seems to face the most risk, in part due to its outsized contribution to company profits.

First, the nature of the pharma industry can create some volatility. Pharma companies spend years and hundreds of millions or even billions of dollars developing a drug. If the drug is one of the lucky few that gains FDA approval, the pharma company can rely on patents and IP rights to gain a nice return on the heavy R&D investment (R&D is typically 15-20% of pharma companies' revenues) needed to bring the product to market. PWC's chart illustrates this long cycle:

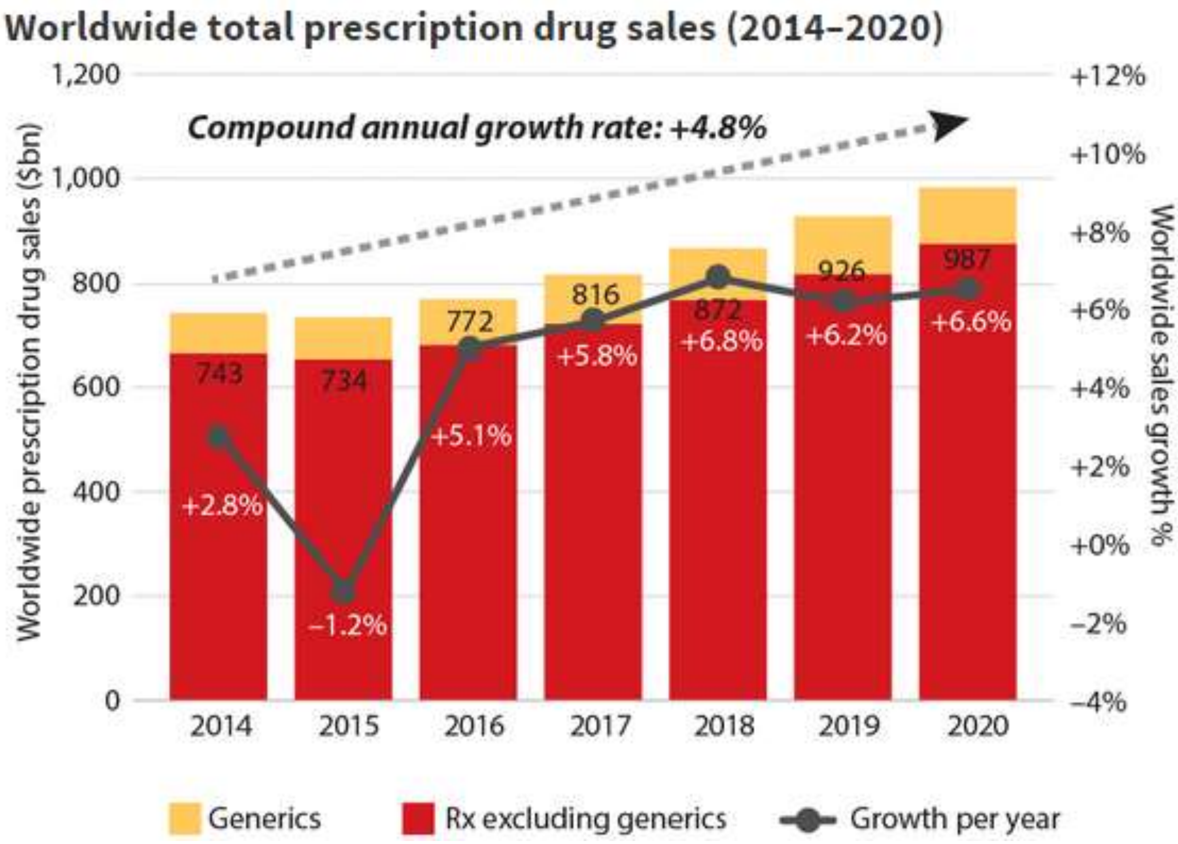


Once the patent expires, competition in form of cheaper generic drugs typically enters the market, taking share and creating price pressure. As such, a drug's revenue follows a bell curve pattern and requires the pharma company to consistently invent new drugs to replace revenue losses due to patent expiry. Depending on the size of the drug, this is not always an easy task and pipeline disappointments can be a risk. The following chart, courtesy of Statista, highlights the revenue curve of Lipitor from 2003-2014.



JNJ's drug portfolio is fairly diversified, with REMICADE representing its largest drug by far with $6.8 billion in sales last year (around 9% of JNJ's total revenue). However, no other drug is over $3 billion in sales. With REMICADE's European patent expiring earlier this year, biosimilars could pose a threat to this drug's market share. Longer-term, however, JNJ believes it will file 10 new drug filings by 2019, each with the potential to reach $1 billion in annual sales. Continued innovation is needed to keep growing the pharma business, and JNJ has one of the best track records.

Besides patent expirations, the pharma business faces regulatory risk. Insurance companies and governments pay for the majority of drugs and, with an ever-increasing desire to take costs out of the healthcare system, seem likely to increasingly view many branded drugs as overpriced medications. Generics provide greater savings and are seeing their drug spending as a proportion of total health spending continuing to creep up. As seen below, generics are growing faster, but branded prescriptions are also expected to show steady growth in coming years. This is also a massive market – $1 trillion in size and only getting bigger.



Source: EvaluatePharma

As long as JNJ's $8.5 billion R&D budget and drug development processes remain effective and industry regulations don't quickly change to crimp JNJ's juicy operating margins, this division should see continued growth, although some years might be better or worse than others due to drug timing issues. Favorable industry trends include increasing healthcare expenditures, an aging population, the rising prevalence of chronic diseases such as diabetes and obesity, reimbursement for pharmaceutical product costs, and the Affordable Care Act (it might pressure drug pricing lower, but new coverage will be provided to 25+ million currently uninsured Americans, expanding the prescription drug market).

Outside of JNJ's operating segments, risk is also posed by the company's international mix (over 50% of sales are outside of the US) as the US dollar continues to strengthen. While fiscal year 2015 sales growth is being impacted, currency headwinds should ultimately prove to be a short-term issue.

JNJ has also been highly acquisitive throughout its history (bought orthopedic products business Synthes for $20 billion in 2012; bought PFE's consumer health care business for $17 billion in late 2006), investing about 30% of its free cash flow over the past decade on deals. Large acquisitions can make or break a company, but JNJ has proven to be a disciplined dealmaker – over the last 20 years, it has acquired 130 companies but only 13 of those deals were greater than a billion dollars.

It seems unlikely that JNJ would blow its excess cash on an uneconomical large deal, and the company has shown willingness to part ways with non-core or underperforming businesses (i.e. the management team doesn't appear to have an empire builder mentality).

Product liability claims and lawsuits are another risk shareholders should be aware of, but these events are difficult to predict and JNJ's cash pile is more than enough to cover any damages.

Valuation

With a 3% dividend yield, JNJ has a higher yield than 60% of the 2,700+ dividend stocks we monitor. However, given the company's modest growth profile (52 Growth Score), the stock does not appear to be cheap on yield alone.

Looking at other metrics, JNJ trades at 17.5x last year's earnings and about 16x FY15 EPS estimates; both multiples are a slight discount compared to the market but look more favourable after factoring in JNJ's nearly $20 billion in net cash ($7 per share; "net cash adjusted" forward P/E multiple is more like 15x).

If JNJ can continue growing 3-5% organically while maintaining current profitability levels, today's valuation seems fair and positions the stock for upper-single digit total returns going forward (3% dividend yield plus 5-8% annual EPS growth) with less volatility than many other stocks.

Conclusion

JNJ seems most appropriate for dividend investors looking for extremely safe current income from a stock that will let them sleep well at night. From the company's disciplined capital allocation to its nearly $20 billion in net cash, JNJ will be a diversified force in health care for many years to come. The current price seems fair for a company of this quality, albeit one with a modest growth profile. For these reasons, JNJ is a core holding in our Conservative Retirees dividend portfolio.

Hormel (HRL): The Newest Dividend King

January 26th, 2016|Dividend Aristocrats, Dividend Ideas, Dividend Kings, High Growth

Hormel (HRL) is the most recent dividend king to be crowned. The company recently raised its dividend by 16%, marking its 50th consecutive dividend increase.

Any company that manages such an accomplishment is worth becoming familiar with, and HRL is no exception. The company has one of the safest dividends around and has grown its dividend by 18% per year over the last five years.

While we don't yet own HRL in our Top 20 Dividend Stocks portfolio, dividend investors might want to keep an eye on the company for several reasons.

Business Overview

HRL has been in operation for 125 years and is a multinational manufacturer and marketer of consumer-branded food and meat products. Some of the company's well-known brands include Skippy peanut butter, SPAM meat, Dinty Moore stew, Muscle Milk protein drinks, Wholly Guacamole dips, Jennie-O turkey, and numerous Hormel-branded products.

Roughly 53% of HRL's products are perishable (fresh meats, frozen items, refrigerated meals, sausages, hams, guacamole, and bacon), 19% are poultry (Jennie-O turkey), 18% are shelf-stable (canned luncheon meats, microwaveable meals, stews, chilies, hash, tortillas, and peanut butter), and 10% are miscellaneous (nutritional food products and supplements, sugar, dessert mixes, and drink mixes).

Segments

Grocery Products (17% of sales, 20% profit): sells shelf-stable food products predominantly in the retail market (Walmart accounted for 14% of company-wide sales last year).

Refrigerated Foods (47% of sales, 38% profit): sells branded and unbranded pork and beef products for retail, foodservice, and fresh product customers.

Jennie-O Turkey Store (18% of sales, 28% profit): sells branded and unbranded turkey products for retail, foodservice, and fresh product customers.

Specialty Foods (12% of sales, 9% profit): sells private label shelf stable products, nutritional products, sugar, and condiments to industrial, retail, and foodservice customers.

International and Other (6% of sales, 8% profit): sales of HRL's products in international markets such as China.

Business Analysis

Few companies survive for 125 years. HRL's competitive advantages are not about patents (HRL only has 63) or innovation (HRL spent $32 million on R&D last year).

As one of the largest consumer-branded food and meat manufacturers, HRL's key to success is favorably altering customers' perceptions of its products to gain loyalty and market share. The company spent approximately $145 million on advertising last year, an amount nearly five times greater than HRL's spending on R&D.

With many of its brands dating back over 50 years (e.g. SPAM and Dinty Moore were introduced in the 1930s) and supported by billions of advertising dollars over the years, consumers know and trust HRL's products. As a result, more than 30 of HRL's brands have #1 or #2 market share positions in their category.

Beyond brand recognition, retailer relationships, and shelf space market share, HRL also benefits from economies of scale. As one of the larger players in the market, HRL is able to achieve lower production costs than smaller rivals and squeezes more value out of each advertising dollar it spends by extending well-known brands into adjacent product categories. Extensive regulations by the U.S. Department of Agriculture also disadvantage smaller competitors.

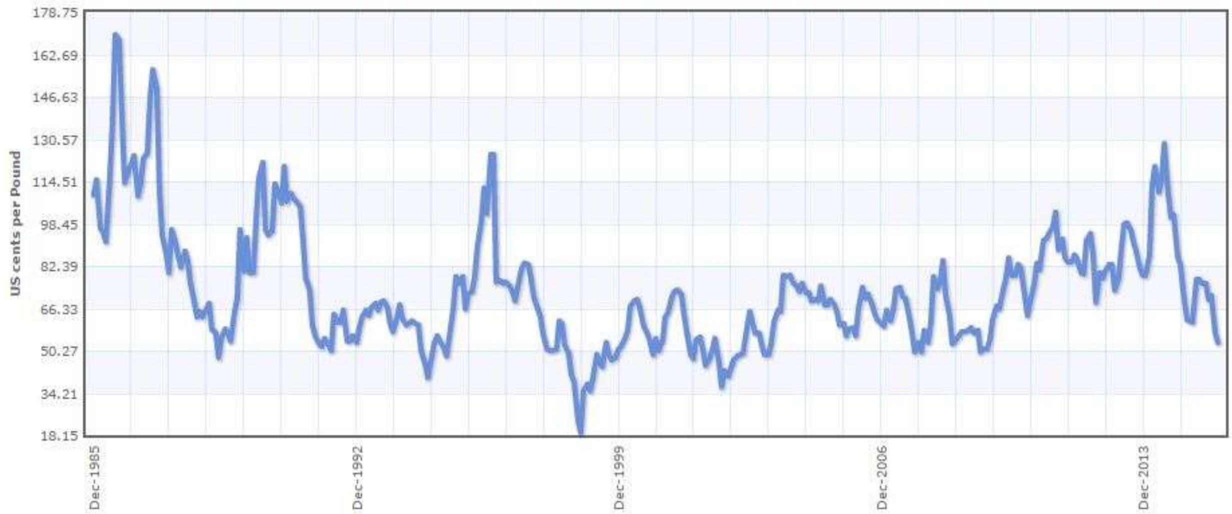
HRL's global distribution channels and economies of scale also help the company's growth and diversification efforts. HRL has made several large acquisitions over the last five years to expand its business further beyond meat products. It acquired sports nutrition products company CytoSport for $450 million in 2014, Skippy peanut butter for over $700 million in 2013, and organic meat company Applegate Farms for $774 million in 2015. HRL can sell these new brands and products to its existing customers and improve the cost profile of each acquired company once they are integrated.

With the company's mix of higher-margin products increasing, HRL recently boosted its company margins guidance from 9-12% to 10-13%. As long as consumers need to eat, HRL's well-known brands will be there for them.

Key Risks

Over the near term, HRL's results are strongly affected by the cost and supply of pork, a key raw material input. Retail prices of many of HRL's products don't fluctuate by more than a few percentage points each year, but its input costs are notoriously volatile.

A virus that kills young pigs sent pork costs flying in 2013-2014 and crimped HRL's profitability (see the spike in the graph below, which shows swine prices over the last 30 years). However, pork prices have since plunged to reach levels last seen nearly 10 years ago. The price of corn, a key feedstock used in raising hogs, is also near its lowest level since 2010, which encourages hog farmers to expand their herds.



Source: IndexMundi

With stable retail prices and plunging pork costs, it's no wonder that HRL reported 2015 profit growth of 18% despite a 1% decline in sales. The company's stock also soared by nearly 50% in 2015.

In our opinion, this was driven primarily by luck, not skill. At some point, input cost trends will reverse again. However, with HRL's stock trading at a forward P/E multiple of 26, investors could be in for a rude awakening whenever an input cost reversal occurs.

Beyond swings in commodity prices, one of the biggest risks facing HRL is shifting consumer preferences for healthier, natural, and organic foods. Walk through just about any grocery store today, and you will notice more organic products on the shelves. Consumers are becoming more aware of what they are eating and are reading more labels. They want to know how their food gets to their plates and how ethical its production process is, especially with meats.

In many cases, this shift is creating opportunities for new players to enter the market. The incumbents have brands associated with processed, unhealthy foods (e.g. SPAM, Dinty Moore). However, they do have size, massive marketing budgets, long-standing customer relationships, and shelf space.

Many incumbents are responding to this threat by acquiring new organic players, and HRL is no exception. For example, in May 2015, HRL bought Applegate Farms, the nation's leading branded natural and organic meat company, for $774 million. This acquisition provided its Refrigerated Foods segment with a meaningful entrance into the high-growth natural and organic space.

Whether or not HRL can achieve success by acquiring and attempting to grow natural and organic brands is anyone's guess. We would imagine that these businesses have very different cultures and processes, but it could turn out to be a successful capital allocation decision.

For now, we will continue watching HRL's organic sales growth rate to see if the company can successfully adapt its product mix to meet consumers' increased desire for healthier foods. The company already has exposure to some of the "healthier" areas of the market (e.g. turkey, natural peanut butter, perishables), but we estimate that the majority of its sales mix is neutral at best.

Dividend Analysis

We analyze 25+ years of dividend data and 10+ years of fundamental data to understand the safety and growth prospects of a dividend. HRL's long-term dividend and fundamental data charts can all be seen by clicking here.

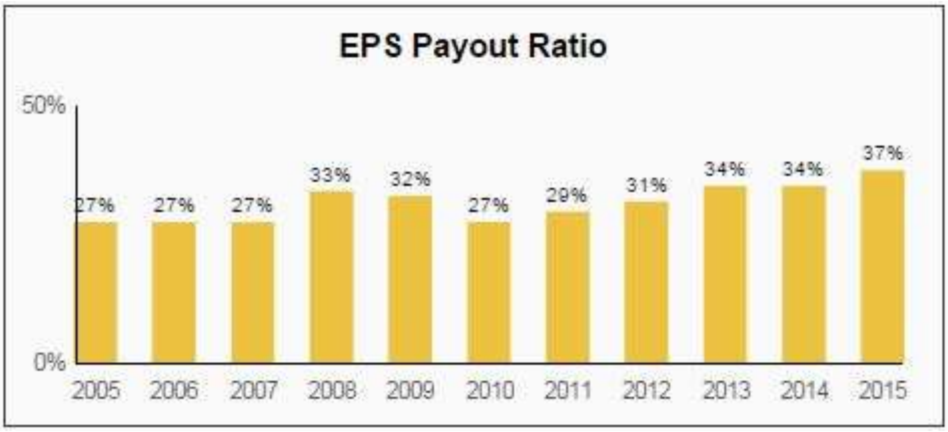
Dividend Safety Score

Our Safety Score answers the question, "Is the current dividend payment safe?" We look at factors such as current and historical EPS and FCF payout ratios, debt levels, free cash flow generation, industry cyclicality, ROIC trends, and more. Scores of 50 are average, 75 or higher is very good, and 25 or lower is considered weak.

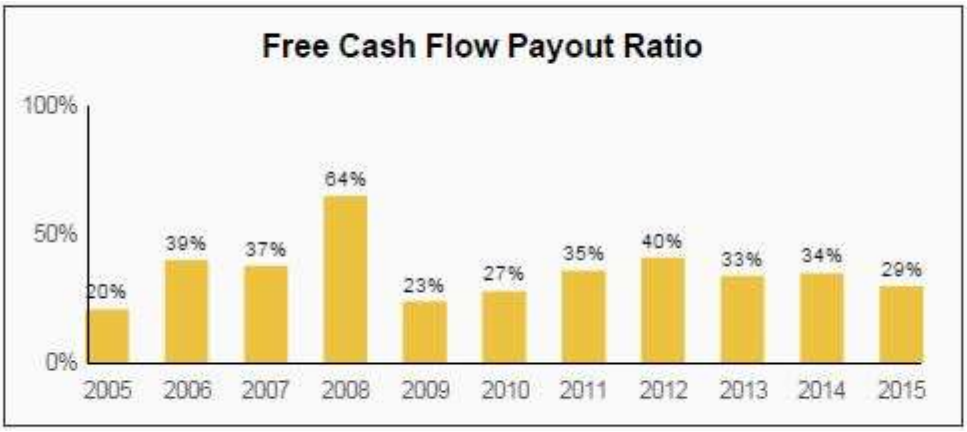
HRL has one of the safest dividends investors can find with a dividend Safety Score of 98.

Over the last four quarters, HRL's dividend has consumed 41% of its earnings and 31% of its free cash flow. These low payout ratios provide plenty of safety and room for HRL to keep growing its dividend.

Over the last decade, HRL's payout ratios have increased by about 10%. The company has grown its dividend somewhat faster than its underlying earnings, but not by much. If it wanted to, HRL could continue growing its dividend faster than its earnings because its payout ratio is still pretty low.



Source: Simply Safe Dividends



Source: Simply Safe Dividends

HRL's high dividend Safety Score is further bolstered by the stability of the company's business. HRL has recorded earnings growth in 27 of the last 30 years and saw its sales fall by just 3% during the financial crisis. The company's stock also outperformed the S&P 500 by 15% in 2008. Even when times get tough, consumers still need to eat.

Source: Simply Safe Dividends

HRL has also been a free cash flow machine. Free cash flow per share has nearly tripled over the last decade, providing the firepower needed for acquisitions, dividend growth, and share repurchases. The best companies generate consistent free cash flow, and HRL is no exception.

Source: Simply Safe Dividends

HRL's branding and efficient operations have also helped the company achieve extraordinarily high and stable returns on invested capital over the last decade. This is often a sign of a strong economic moat and a business that is creating meaningful shareholder value.

Source: Simply Safe Dividends

HRL's balance sheet is also in excellent shape. As seen below, the company could cover its entire net debt with cash on hand and less than half a year's worth of earnings before interest and taxes (EBIT). A healthy balance sheet enables HRL to continue searching for the right acquisitions to further growth the business.

Credit Metrics

Current Ratio: 1.70 **Debt / Equity:** 0.11 **Net Debt / EBIT:** 0.2 **EBIT / Interest Expense:** 81.4
Cash ($ millions): $347 **Last Fiscal Year Free Cash Flow:** $866 **Last Fiscal Year Net Income:** $687
Total Book Debt: $600 **TTM Interest Expense:** $13 **Last Fiscal Year Dividends Paid:** $252

Source: Simply Safe Dividends

HRL's dividend is one of the safest in the market. The company has relatively low payout ratios, sells recession-resistant products, generates excellent free cash flow, and has a very healthy balance sheet.

Dividend Growth Score

Our Growth Score answers the question, "How fast is the dividend likely to grow?" It considers many of the same fundamental factors as the Safety Score but places more weight on growth-centric metrics like sales and earnings growth and payout ratios. Scores of 50 are average, 75 or higher is very good, and 25 or lower is considered weak.

HRL's dividend Growth Score of 85 indicates that the company has excellent dividend growth potential. HRL has paid dividends every year since 1928 and recently achieved its 50th consecutive increase, qualifying it for the exclusive list of dividend kings (companies with at least 50 straight years of dividend growth). Of course, HRL is also one of the dividend aristocrats.

As seen below, HRL's dividend growth has accelerated over its last 10 fiscal years. The company's dividend increase for 2016 is 16%, and we believe HRL can continue delivering double-digit dividend hikes for at least the next several years given its relatively low payout ratios and decent earnings growth.

Historical Dividend Growth

Dividend Growth Streak	1-Year Growth	3-Year CAGR	5-Year CAGR	10-Year CAGR
20+ Years	25.0%	18.6%	18.9%	14.4%

Source: Simply Safe Dividends

Valuation

HRL trades at 26x forward earnings and has a dividend yield of 1.5%, which is below its five year average dividend yield of 1.7%.

HRL is no doubt a great business, but it's really hard to justify the stock's current valuation. At the end of the day, this is a business that seems unlikely to grow sales much faster than GDP and has significantly benefited from plunging raw material costs over the last year. Is that really worth paying 26 times earnings for?

With company margins at a 10-year high and bumping up against the top of HRL's long-term margin guidance, fundamentals could be about as good as they will get. We plan on watching HRL from the sidelines and would become more interested if raw material cost trends reverse and the earnings multiple comes way down.

Conclusion

HRL is a great company that will likely be around for a very long time to come, but its current valuation is hard to get comfortable with, especially in light of the raw material cost benefits it has enjoyed over the last year. For now, we remain more interested in some of our other favorite blue chip dividend stocks.

Blue Chip Dividend Stocks

November 23rd, 2015|Dividend Investing, Investing Principles

Blue chip dividend stocks can be some of the most appealing investment opportunities for income and capital appreciation. If you have ever wondered what blue chip dividend stocks are, why they are attractive, where you can find them, and what the best ones are, you have come to the right place.

What are Blue Chip Dividend Stocks?

The term “blue chip” is said to have originated in the 1920s by Dow Jones reporter Oliver Gingold. The story goes that Gingold was at a brokerage firm when he observed several trades that took place at high prices (e.g. $200 per share) and said to nearby securities analyst Lucien Hooper that he planned to write about these “blue chip stocks” when he returned to his office. The term initially referenced stocks with high share prices but is more commonly associated with high quality today.

The “blue chip” term used by Gingold actually comes from the game of poker. The simplest set of poker chips comes in three colors – red, white and blue. As you might have guessed, the blue chips are the highest in value. While not all blue chip stocks pay a dividend, most do because they are generally mature businesses and have significant retained earnings and cash flow to distribute.

Blue chip dividend stocks are typically large in size (e.g. market caps exceeding $10 billion), have tremendous financial strength, maintain leading roles in the economy, generate dependable earnings, and are thought to be much safer and more durable than the average stock. Most of these companies have paid and increased their dividends for many years as well, a signal of financial strength and stability.

Blue chip dividend stocks are popular in part because of the contribution dividends have had to the market’s overall return. According to S&P, since 1926, dividends have contributed nearly a third of total equity return while capital gains have contributed two-thirds. Dividends also suggest a company is profitable, stable, and confident in its long-term outlook.

Blue chip dividend stocks have generally proven to be some of the most durable companies around and appeal especially to conservative investors interested in holding stocks for many decades. While blue chip stocks aren't guaranteed to be great investments, it is a good starting place for identifying high quality businesses.

How to Find Blue Chip Dividend Stocks

Many investors simplify their search for blue chip dividend stocks by targeting companies that have increased their dividend for at least 10 consecutive years. Famous value investor Ben Graham noted in his book "The Intelligent Investor" that conservative investors should seek out companies that have been paying out steady dividends for at least 20 years.

Consistent dividend increases are often a sign of dependable profits and management's confidence in the future of the business. Not surprisingly, the pool of companies that has achieved such a feat is rather limited. According to our database containing thousands of dividend-paying stocks, just over 150 have increased their dividend for at least 20 consecutive years. You can see that list by clicking here.

Other investors prefer to search for the best blue chip dividend stocks in the list of dividend aristocrats, which consists of members of the S&P 500 that have raised their dividend for at least 25 consecutive years. On an annualized basis, the S&P 500 Dividend Aristocrats Index has outperformed the S&P 500 by 2.83% per year over the last 10 years and beat the market by 15% in 2008 (see below). It's no wonder why income investors are attracted to these companies.

While these lists are great to places to start your hunt for blue chip dividend stocks, it is important to remember that analyzing dividend growth streaks is akin to looking in the rearview mirror. Many blue chip dividend stocks have overcome numerous business challenges in the past, but that does not guarantee their future safety or survival.

Shocks such as the global recession of 2008 highlight the occasional vulnerability of even the “best” perceived companies (e.g. General Electric). The effects of capitalism and the “creative destruction” it induces result in business risk as well.

Comparing the list of Fortune 500 companies in 1955 to the most recent Fortune 500 list, we can see that only 61 companies are on both lists. Said another way, about 88% of the companies from 1955 either went bankrupt, merged, or fell from the top 500 companies as their businesses shrank.

According to a study of the S&P 500 Index conducted by consulting firm Innosight, the rapid pace of technological change, increased globalization of economies, and intensified pressure from startups is shortening the average life of companies even more today. The report noted that the 61-year tenure for the average firm in 1958 shrank to 25 years in 1980 and 18 years in 2011. In other words, using the churn rate observed in 2011, 75% of the S&P 500 would be replaced by 2030!

A Wall Street Journal article about blue chip dividend stocks in 2014 highlighted some of the challenges recently faced by these massive businesses. It notes that many of these companies were so successful that the large revenue base they built up made them too big to switch strategies quickly when market conditions changed. Some examples it lists of blue chip companies struggling for profitable growth are Walmart, IBM, AT&T, and Coca-Cola.

While they are all still cash cows, blue chip dividend stocks must reinvest and shift their sales mix to rejuvenate their prospects for long-term earnings growth. Otherwise, over the next several decades, they risk becoming just another statistic.

Capitalism makes our lives better every day in the form of new products, increased conveniences, lower prices, and more. However, it can create headaches with our investments if we are not careful with our diligence process.

Blue Chip Dividend Stocks – Investment Checklist

Reviewing the following checklist can help you avoid blue chip dividend stocks that carry higher amounts of business risk. While it's far from exhaustive, it hits on many critical issues that can be quickly researched using our Stock Analyzer tool.

Item 1: Has the company's rise to success been driven more by luck or skill?

Some companies found themselves in the right place at the right time. Think about the housing market boom or the commodities market fueled by China's debt-fueled infrastructure binge. Sometimes the best-performing, most consistent dividend growth stocks are tied to a long-tailed cycle that is about to end – either from demand reaching a peak or new supply entering the market (e.g. changing consumer preferences, new competition, technological change, etc.). What macro factors is the stock sensitive to? Have those factors been benefiting from unsustainable sources of demand or unreasonably constrained supply? Most things in life are cyclical – understand what cycles might be driving your stocks and where they are in their lifecycle. On the flip side, investing in long-tailed themes that are closer to their beginning than their end can be a great investment strategy.

Item 2: Do recent business trends raise any red flags about how the world is changing?

As they say, the "proof is in the pudding." A company's financial results offer a glimpse into how the changing world is impacting its ability to survive and grow. If sales have started declining or profitability has stalled, you need to determine if the factors causing those results are temporary or the start of a long-tailed headwind. If it's the latter, remember how difficult it is and how long it takes for large blue chip dividend stocks to shift their mix into profitable areas of growth. There might be an even better entry point six months down the road.

Item 3: Does the company generate reliable free cash flow?

The best blue chip dividend stocks will generate free cash flow year in, year out. Cash is money in the bank and allows the company to create value in many different ways – reinvestment into new products (increases durability), dividend increases, debt reductions, share repurchases, and acquisitions. Without free cash flow, companies have fewer resources at their disposable to continuously reinvent themselves and can also be more dependent on access to credit markets. Both of these factors can significantly shorten a company's lifespan.

Item 4: Is the company's balance sheet healthy enough to survive the next storm?

Surprises happen. That is one reason why investing is so hard. If a negative shock occurs and a business is saddled with heavy amounts of debt, limited cash reserves, and declining cash flow, the value of your investment can plummet. The dividend could also come under pressure, depending on the severity of the struggle.

Item 5: How large is the market?

The bigger the market, the more opportunity blue chip dividend stocks have to continue growing. Think about how fast end markets are growing (e.g. about in line with GDP), what secular themes support long-term growth (e.g. rising consumer wealth in emerging markets), the reasonable paths a company has to expand into adjacent markets (e.g. Coca-Cola using its distribution network to launch healthier beverages), and the ease at which new competition could enter or change the market's dynamics (e.g. imports from new China, technology advancements, etc.).

Item 6: How has the payout ratio trended over time?

A company can grow its dividend using different means – free cash flow growth, raising debt, or issuing shares of stock. The only sustainable form of dividend growth is free cash flow growth. The payout ratio measures how much cash flow or earnings a company's dividend is consuming. We prefer to see dividend growth in excess of the rate of inflation (3%+ per year) and stable payout ratios, meaning the dividend is growing in line with cash flow growth. For cyclical companies, we like payout ratios below 50% (and healthy balance sheets). For more stable businesses, payout ratios less than 70% are desirable to us. Lower payout ratios provide more cushion for the dividend and opportunity for growth, even if earnings growth temporarily slows.

The Best Blue Chip Dividend Stocks

Applying our checklist from above and screening through the various lists of dividend growth streaks, we created the following list of blue chip dividend stocks that look interesting for further research. These businesses generate consistent free cash flow, maintain conservative balance sheets, have exhibited stable payout ratios, operate in large markets, and appear to play in industries with slower rates of change.

Conclusion

Blue chip dividend stocks can be great investments, especially for investors living off dividends in retirement. However, purchasing stocks simply because they are a dividend aristocrat or part of the Dow Jones is an unnecessarily risky activity. Data shows that the average lifespan of an S&P 500 company has dropped from 61 years in 1958 to less than 20 years more recently. Companies that were once dominant giants are more vulnerable to change than ever before. Run each of your ideas through our blue chip checklist and conduct additional research to give yourself the best chance of investing in dividend stocks that will not only survive the next storm but emerge with higher dividend payments and more cash flow coming in the door.

Dividend Portfolio Objective

The Top 20 Dividend Stocks portfolio seeks to outperform the S&P 500 by at least 1% per year over any five-year rolling time horizon while generating safe, growing dividend income every year.

We expect the portfolio to underperform in bull markets and outperform in bear markets due to the higher quality level of its holdings.

Total return is expected to be composed of:

- 2.5% – 3.5% dividend yield
- 7% – 9% earnings growth

Investment Philosphy

We invest in high quality companies with enduring competitive advantages, long operating histories, shareholder-aligned management, and large markets that provide opportunity for long-term growth. These businesses maintain reasonable payout ratios, generate consistent free cash flow, and have healthy balance sheets, providing a sturdy foundation for consistent dividend increases.

When we make an investment, we take a patient, long term investment horizon and expect to hold the stock for at least five years, keeping portfolio turnover low. Generally speaking, we will only sell a stock if the safety of the dividend payment has come into question, the company's long term earnings power appears to have become impaired, the stock's valuation reaches seemingly excessive levels, or we find a more attractive idea.

Dividend Stocks (low beta & low vola) for diversification

CORRELATION PLOT TABLE

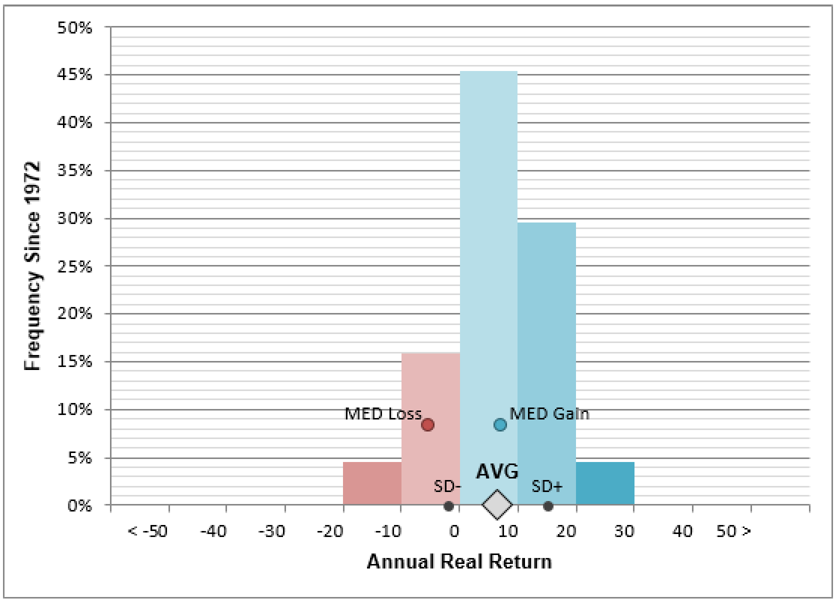
		GLD	SPY	EFA	EEM	IEF	VNQ	JNJ	HRL
GLD	SPDR Gold Trust	1.000	-	-	-	-	-	-	-
SPY	SPDR S&P 500	0.048	1.000	-	-	-	-	-	-
EFA	iShares MSCI EAFE ETF	0.146	0.906	1.000	-	-	-	-	-
EEM	iShares MSCI Emerging Index Fund	0.267	0.820	0.893	1.000	-	-	-	-
IEF	iShares 7-10 Year Treasury Bond ETF	0.290	-0.295	-0.207	-0.208	1.000	-	-	-
VNQ	Vanguard REIT ETF - DNQ	0.078	0.739	0.705	0.623	-0.043	1.000	-	-
JNJ	Johnson & Johnson	-0.102	0.038	0.081	0.130	0.113	0.058	1.000	-
HRL	Hormel Foods Corporation	0.011	-0.016	0.007	0.016	0.138	-0.064	0.454	1.000

ANALYSIS	Sharpe Ratio efficiency	Return projected annual	Volatility annual stdev
EEM	-0.09	-0.8%	25.23
EFA	0.06	2.89%	22.12
GLD	0.25	6.02%	18.2
HRL	1.05	19.5%	17.08
IEF	0.55	5.44%	7.11
JNJ Johnson & Johnson	0.74	11.45%	13.43
LQD	1.11	8.17%	6.01
SPY	0.42	8.51%	16.8
VNQ	0.36	10.82%	25.64

PortfolioCharts.com

Modify cells in **BLACK**

6.5%	AVG	8.5%	StDev

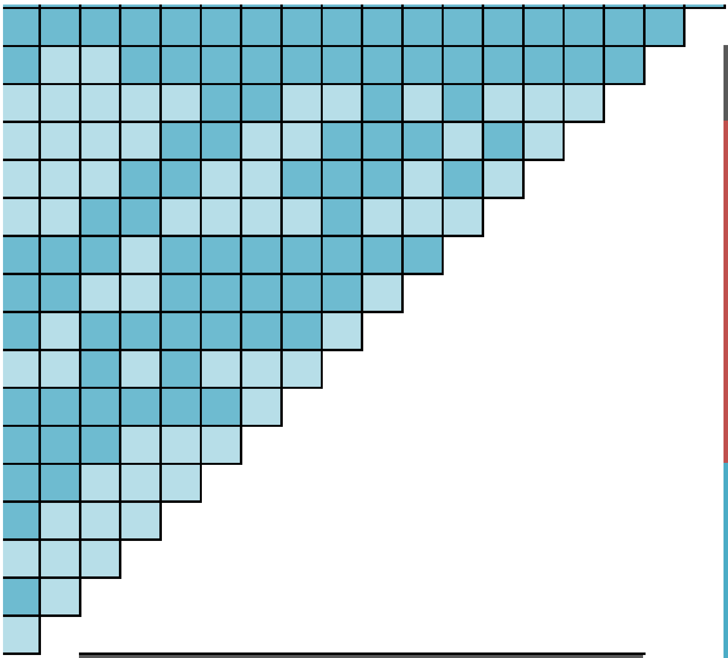


Lost Money	20%	of the time	Made the AVG	48%	of the time

within +/- 5%

20160207

Asset Allocation	
0	Total Stock Market
10	Large Cap Value
10	Large Cap Blend
0	Large Cap Growth
5	Mid Cap Blend
0	Small Cap Value
0	Small Cap Blend
0	Small Cap Growth
0	Micro Cap Blend
5	Total Int'l
0	Int'l Developed
5	Emerging Market
0	Pacific
0	Europe
0	Int'l Value
0	Int'l Small
0	Total Bond Market
15	Long Term Treasury
15	10 Year Treasury
0	5 Year Treasury
5	Short Term Treasury
0	Synthetic TIPS
0	Commodities
20	GOLD
10	REIT
0	Treasury Money Mkt
100	TOTAL



Asset Allocation

0	Total Stock Market
10	Large Cap Value
10	Large Cap Blend
0	Large Cap Growth
5	Mid Cap Blend
0	Small Cap Value
0	Small Cap Blend
0	Small Cap Growth
0	Micro Cap Blend
5	Total Int'l
0	Int'l Developed
5	Emerging Market
0	Pacific
0	Europe
0	Int'l Value
0	Int'l Small
0	Total Bond Market
15	Long Term Treasury
15	10 Year Treasury
0	5 Year Treasury
5	Short Term Treasury
0	Synthetic TIPS
0	Commodities
20	GOLD
10	REIT
0	Treasury Money Mkt
100	TOTAL

Performance Since 1972

23.7%	Best Year
-11.6%	Worst Year
2 yrs	Longest Drawdown

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