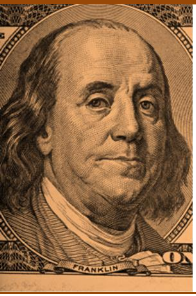

The One Indicator to Find the Best Income and Dividend Stocks

A Special Research Report from **The Dividend Hunter**

Investors Alley

Introduction

By Tim Plaehn

We are in a period of time when more and more investors are moving into the stock market in search of yield. The individual investor is often more interested in generating a cash return from his investment that can be used as income or possibly reinvested to grow the income stream over time.

However, the traditional techniques individual investors learn to evaluate stocks focus on trying to gauge the growth potential of the share price, with little regard to dividends. In fact, growth focused investors tend to view dividend payments as a waste of money that could be used as capital to grow the business.

Yet, income investors often use metrics such as earnings per share, P/E ratio and payout ratio to find and evaluate stocks for their dividend paying potential. Focusing on the accepted standards for these indicators will produce a list of stable, strong companies that should continue to pay regular dividends that increase every year. Not a bad outcome.

Unfortunately, these same indicators and the typical application of them will leave you with a list of stocks with dividend yields in the 2% to 3.5% range. That's barely going to keep you ahead of inflation and taxes. This type of return may be fine for a younger investor who plans to stuff these Blue Chip shares into an IRA and let the income grow for a couple of decades using the compounding effect. For investors who actually want to draw an income from their stock investments 2.8% or 3.1% may not be sufficient. Here is an example of the type of stock traditional stock market analysis will put on the income investor's list of candidates:

Using the S&P list of Dividend Aristocrats – stocks that have increase their payouts for at least 25 consecutive years – **Chevron (CVX)** jumps out as sporting one of the higher yields from the list of Blue Chip stocks. Here is a quick, nut-and-bolts evaluation of CVX as an income stock.

- Share Price: $114.50 – What we earn is always based on the price we paid.
- P/E Ratio: 10 – The S&P 500 P/E sits at 18, so the market puts a lower multiple and higher earnings yield on CVX.
- Earnings per share: $11.09
- Consensus 2014 estimated EPS: $11.11
- Current dividend: $1.00 per quarter, $4.00 annually
- Current yield: 3.5%
- Payout ratio: 36% of net income

2013 was a sub-par year for Chevron, and net income fell from around $13 per share earned in 2011 and 2012. However, the low payout ratio will allow the company to continue to increase the dividend each year. The payouts have been bumped by about 10% in each of the last three years.

One point of interest – that will be important later in our analysis – is that Chevron paid $14.3 billion in income tax for 2013 and about $20 billion in 2011 and 2012. The taxes Chevron pays are two to three times the amount paid out to shareholders as dividends.

In the world of corporate dividend stocks, Chevron is currently a high-yield, low-growth company with a long history of dividend increases, which the board of directors will not be willing to change anytime soon.

The Right Way to Find High Yield Dividend Stocks

If you are an investor who would like to earn more than 3% to 3.5% from stable and reliable income paying stocks, a different approach is required to analyze and select dividend paying stocks. The first step is to dive into a world of companies that function under different tax rules and types of business organization. The big name stocks you see on the financial news are almost all set up as C-type corporations. These companies pay corporate income tax, which can significantly reduce the amount of net income left over to pay dividends or reinvest into growth projects.

As alternatives on the stock exchanges, you can invest in companies set up as real estate investment trusts – REITs, business development companies – BDCs, and master limited partnerships – MLPs. A primary attribute of the 500 or so companies of these types is that they function as pass-through entities and pay little or no corporate income taxes. An additional requirement for these companies is that the largest portion of net income must be paid out to investors as dividends or distributions. As a result, you can find much better yields from quality companies among the crowd of REITs, BDCs, and MLPs.

However, you cannot use the same "50% payout ratio is safe" criteria used with corporate shares, since these companies are required to pay 90% or more of net income to investors. Also, the accounting for these companies is often more complicated and it is not uncommon for a high yield stock of this type to pay out more in distributions than the amount of net income reported per share. To determine the safety and income potential of one of these stocks – and it works well for a lot of corporation shares – I rely on a cash flow analysis strategy.

Why Use Cash Flow Analysis?

Cash flow analysis involves finding the data and calculating how much actual cash a company generates from its business after paying cash expenses and comparing that amount to the amount paid as dividends to investors. The process also looks at future projections to determine if the current distribution rate can be maintained and/or increased. Picking a stock that cuts the dividend is the number one income investing mistake to avoid. A payout reduction results in the double hit of less income than you were counting on from the stock and the resulting share price drop from investors losing confidence in the company's commitment to dividends will leave a smaller amount of your capital to reinvest and try to recover some of the lost principal and future dividend earnings.

The numbers required to accurately determine cash flow do not always show up on the income statement and some deep diving into a company's SEC-required 10-Q quarterly and 10-K annual reports may be necessary. There are also some companies that understand the importance of cash flow to pay dividends and make the information more readily available.

Next we'll cover a few examples of higher yielding companies to illustrate how cash flow analysis is used to pick stable dividend paying investments and earn a significantly higher yield than you will find on a list of corporate dividend royalty.

Real Life Cash Flow Analysis on Two High Yield Stocks

Energy Transfer Partners, LP (NYSE: ETP) owns over 20,000 miles of natural gas transport pipelines plus 6,700 miles of natural gas gathering pipelines. The company also offers natural gas storage facilities. Energy Transfer Partners is no Chevron, but it is one of the largest companies of this type in the U.S and has a market cap of $20 billion. The LP in the name shows us that ETE is a master limited partnership (MLP).

The company's business is primarily fee-based with take-or-pay contracts that guarantee the revenues ETE will earn from the use of its pipelines and storage facilities. Growth comes from the addition of new assets, funded by the issue of new shares – called units in the MLP universe – or issuing bonds.

Here is a quick-and-dirty Energy Transfer Partners cash flow breakdown:

- 2013 reported GAAP net income: **$768 million**.
- Additions: $3.2 billion. These items include interest, depreciation, income taxes and any other cash and non-cash expenses to produce the commonly quoted:
- EBITDA: $3.95 billion. Earnings before interest, taxes, depreciation and amortization is a basic measure of cash flow produced by the business.
- Subtractions: $2.04 billion. These are actual cash expenditures out of EBITDA such as interest paid on bonds or credit lines, taxes, and the costs to maintain the company's pipelines and other assets. The resulting number is the:
- **Distributable cash flow**: **$1.92 billion**.

Notice that the cash available to pay distributions is $1.15 billion greater than the GAAP net income. In 2013 ETE paid out $1.83 billion in distributions, significantly more than the reported net income but 105% covered by the distributable cash flow. Included in the numbers discussed here was $97 million of income tax, or 13% of net income and just 2.5% of EBITDA. The MLP structure leaves a lot more cash for payments to investors compared to the 35% tax rate paid by corporations like Chevron.

And the best news is that ETE has a current yield of 6.77%. Energy Transfer Partners has paid a quarterly dividend without any reductions for 12 consecutive years. Also, after four years of level dividend payments, Energy Transfer Partners has increased the distribution rate for each of the last two quarters. Which has also helped push up the share price by over 30% since then, versus a gain of only 5% and 6% for the S&P 500 and Dow, respectively.

Whitestone REIT (NYSE: WSR) is another high yield stock that would not show up well using traditional analysis techniques. For 2013, Whitestone reported net income of $0.15 per share, yet paid investors a $0.095 dividend **every month** - $1.14 for the year - which gives WSR a current 7.9% yield.

Whitestone REIT is obviously a real estate investment trust, and the company owns 50 retail and office complexes with over 5 million square feet and more than 1,200 tenants throughout the Southwest U.S. Whitestone went public in 2010 and through acquisitions has doubled its quarterly net operating income over the last three years. The company has actively purchased properties to increase its asset base. Newly acquired properties are typically redeveloped and leased out at higher rates, improving the investment return on capital.

REIT reporting simplifies the cash flow analysis, since this type of company will report Funds from Operations (FFO), which is the cash flow the company generates after non-cash accounting expenses are added back to the accounting net income.

For 2013, Whitestone reported core FFO of $1.10 per share, slightly less than the dividends paid, but also 16% higher than the $0.95 of FFO generated in 2012. The company's growth strategy has produced year-over-year FFO growth of 15% to 20% per quarter. The 2014 cash flow will handily cover the current dividend rate, and it is very possible that the dividend will be increased in the second half of this year. This is one you should watch.

These examples show that using the cash flow analysis approach on different types of dividend paying companies allowed us to double the yield when comparing investments with comparable safety levels for investors.

If your priority when investing in the stock market is to generate a high cash yield coupled with a high degree of safety or predictability, selecting stocks with higher yields backed by sufficient cash flow will work out better than the traditional stock analysis techniques.

Cash flow analysis combined with a deep evaluation of a company's business model and financial results provides the core strategy for *The Dividend Hunter* stock recommendations. This approach is a significant departure from methods used by the majority of investment letters and allows us to find and recommend stocks with higher yields coupled with a high degree of cash income reliability.