Calculating Dividend Cover

By BNET Editorial

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Dividend cover measures a company's ability to pay dividends to stockholders. Specifically, it calculates how many times over the company's net after-tax profits could have paid for dividends to its common stockholders.

A similar calculation, payout ratio identifies the percentage of net profit paid to stockholders in the form of dividends, over a specified timeframe.

Both dividend cover and payout ratio assess the a company's ability to sustain its dividend payments, and are therefore useful predictors of continued profitability.

Each ratio requires separate interpretation however. If dividend cover is low, it implies that the company is failing to plough sufficient funds back into the business and that if fortunes were to dip, it would be unable to sustain the same level of dividend payments. If it is high, the company is likely to be reinvesting in its future, and should be able to continue paying dividends at a similar level. A negative value is rarely seen, but it is a sure indication that the company is in difficulty.

A low payout ratio, on the other hand, represents a secure future, while a high ratio suggests that a company has failed to reinvest its profits and may not be able to sustain dividend payments.

What to Do

The term "dividend cover" describes what it does—it identifies how many times profits could have paid for (covered) the dividend. So if the result is 2, it shows that a company's profits are twice the amount of dividends shareholders received during the period in question.

The formula is:

earnings per share / dividend per share = dividend cover

So if a company's earnings per share are $24, and it pays out a dividend $8 per share, dividend cover is 3:

24 / 8 = 3

Alternatively, dividend cover can be calculated by dividing net profit by total dividend allocation. Suppose a company makes a net profit of $15 million, and $2 million is allocated for dividends:

15 / 2 = 7.5

Or if profits are $15 and it allocates $9 for dividends:

15 / 9 = 1.67

The formula for payout ratio is annual dividends (paid on common stock) divided by earnings per share:

annual dividend / earnings per share = payout ratio

So going back to the example of a company whose earnings per share are $24, and whose dividend payout is $8. The payout ratio is:

8 / 24 = 0.333 or 33.3%

What You Need to Know

- A dividend cover of at least 2 suggests that a company has sufficient funds to pay for the dividend.
- Ideally, dividends should be no higher than two thirds of a company’s net profits.
- In practice, dividend cover depends on its industry context. For example, tax laws encourage certain companies like investment trusts or utilities to pay out a higher percentage of their profits in dividends.
- A dividend cover of less than 1 suggests that the company is taking from last year’s profits to pay this year’s dividend. Any result of less than 1.5 could indicate trouble.
- A higher dividend cover indicates that a company has a cushion against any future downturn—indeed, many companies will continue to pay dividends at the same rate through a lean patch as a sign of confidence in the future.
- A high dividend cover also shows that the company is holding back on dividend payments (they might have afforded more), so investors may be put off.
- Investors naturally find high dividend payouts attractive, but if these go hand-in-hand with declining profits it could mean that the company is failing to reinvest, or that dividends are about to be reduced.
- Investors should be wary of payout ratios above 75%, because of the implication that a company is not reinvesting its profits, or profits are struggling, or the company is making desperate efforts to tempt investment.
- A new, fast-developing company may choose to reinvest all its profit into the business, and pay no dividends at all.
- It used to be the case that dividends provided over 40% of an investor’s returns. But in the last 20 years, it’s been more like 20%.

Where to Learn More

Web Sites:

finance-glossary.com: www.finance-glossary.com

moneyextra.com: www.moneyextra.com