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European equity income update

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A range of uncertainties across the Eurozone – including the haircut on Greek debt, refinancing of Italian bonds and weak economic growth rates in peripheral economies within the region – suggests that Europe faces a difficult time in 2012. For us, this therefore means that a focus on companies with strong balance sheets and the opportunity for dividend growth is as important as ever. Such companies are attractive in an environment in which interest rates will remain at their current low levels for an extended period. The key to a company paying a higher dividend and growing its dividend sustainably over the long run is cashflow. Companies can make all sorts of adjustments to accounting treatment to flatter their profits, but cash does not lie. It is what is needed to fund working capital, undertake capital expenditure, pay down debt and pay the dividend.

Therefore investors should focus on sustainable cashflow to invest in companies that grow their dividends over a long period. Companies that are able to consistently grow their dividends will be the most profitable investments over time. Recent research by Deutsche Bank suggested that a pickup in dividend payout is often a sign of confidence by the company about their future prospects and I can see the logic in this argument. However, there are many cases where management teams have misread the cycle or profit outlook and hiked the dividend, only to have to then cut it or raise capital the year after; management can be wrong.

From an investment perspective, it is far more important to focus on cash generation and the characteristics of the business, including its competitive advantage and growth potential. There are certain companies that can continue to generate decent cashflow and dividend growth even in poor economic conditions. I would highlight companies such as Fugro, Bilfinger Berger, Nestlé, Atlas Copco, Reed Elsevier, Linde and Svenska Handelsbanken, who have grown their dividend or kept it flat (but never cut) over the last 12 years. Given that economic conditions are going to be poor in Europe in 2012, the geographic focus of stock selection is biased towards emerging markets, where there is still good economic growth, and a recovering US economy. From a market capitalisation perspective, the cash generation potential of smaller companies can sometimes be less attractive as they are investing to grow and thus using all their cashflow for this purpose, and therefore may not pay a dividend. However, there are plenty of mid size companies who are stepping up their payout ratios. But irrespective of geography or size, the key is a strong balance sheet and the potential to grow dividends.