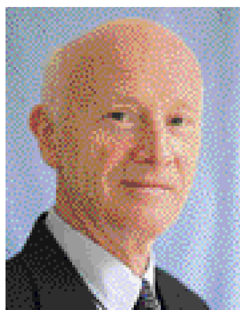
Emerging dividends

UK investors are looking for yield and dividend growth in the new world



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The funds now being launched by international money managers to invest in high dividend-yielding stocks in emerging markets reflect worries about risks-to-earnings growth in industrialised countries, as well as growing confidence in emerging markets as an asset class.

Now that BP has suspended its dividend, UK investors have suddenly realised that relying on a single company for more than 10 per cent of total dividend payments in the London market – and on six companies for about half of total cash from dividends – has left them badly exposed. With low returns on bonds and a depressing outlook for earnings in Europe, the US and Japan, why not look for yield and dividend growth in the new world instead?

These new income-oriented funds are unlikely to make India their first choice. The Indian stock market has long had a lower dividend yield than almost any other market in the world. In 2009, Indian stocks as a whole yielded 0.9 per cent, against 1.4 per cent in Russia, 1.9 per cent in China and 3 per cent in Brazil. The largest capitalisation stock in the Indian market, Reliance Industries (RIL), currently yields just 0.7 per cent. These differences are much too big to be explained away by gaps in overall market valuation.

Meagre Indian dividends are usually explained instead by invoking the Indian promoter and his or her passion for re-investing every rupee in the growth of the business. There are certainly a number of major Indian companies, RIL among them, that manage their capital as growth companies even when they reach a colossal size. India's promoter-led groups, and its fast-growing but obstacle-strewn economy, also offer much more potential for profitable diversification than elsewhere. The best-run companies can make a convincing argument that cash will often be worth more kept in the company than it will be to investors as dividends, even though these are tax-free.

But India's low dividend yields are also evidence of uncertainties in the earnings potential of some important asset-intensive sectors. The biggest dividend payers common to most of the world's stock markets – in sectors such as finance, power, and telecoms – are companies that require enormous financial or physical assets, whose growth rate is eventually limited by their own size and the structure of the market they operate in. Their assets are financed through a correspondingly large capital structure, and should earn reasonably predictable returns, helped by their size, the stability of their markets and their market power.

India has taken longer than China and Brazil to develop stable markets in areas like telecoms and power. China Mobile has a dividend yield of 3.6 per cent, compared with 0.4 per cent for India's market leader Bharti Airtel, though Bharti's operating cash flow is valued at only a 30 per cent premium to its Chinese counterpart. This mirrors the position of both companies: China Mobile's leadership in an oligopolistic market seems assured, while Bharti is fighting to preserve its returns in a market destabilised by random regulatory decisions.

The power sector in India is also immature, compared with China and Brazil. Based on its dividends, Huaneng Power is yielding more than 5 per cent, on a cash flow valuation just 25 per cent lower than NTPC and Tata Power. NTPC's generous yield (for India) of 1.9 per cent reflects its dominant position in the Indian power market, while Tata Power, now at a 0.9 per cent dividend yield, has to hoard capital for its huge expansion. A number of other companies that will become giants in Indian power are still effectively start-ups, and years away from being able to pay a dividend.

By contrast, the dividend yields available on major Indian banks reflect a more mature and stable market structure than in telecoms and power. Though Banco do Brasil has a 5 per cent yield, compared with the 1.3 per cent-1.4 per cent available on SBI and ICICI, their earnings are valued at two-to-three times the level of the Brazilian leader. Taking account of valuation differences, Chinese banks are offering higher dividend yields than Indian banks, but their earnings quality is lower.

What are the managers of the new emerging market income funds going to find attractive in India? As income funds, they will have to put opportunities in markets like Brazil, China, South Africa and Egypt first, but, if they invest in India, it will be in shares with rapid and reliable dividend growth – not in the few small sectors with high dividend payers, like the shipping companies, but in managements like the Tata Group companies that have a long-term commitment to balancing growth and investor returns. ◆

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