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How to think about dividend cuts

A spate of dividend cuts or postponements has raised concerns among investors globally, especially those focused on income strategies. But not all dividend cuts are created equal. Companies are feeling the pressure differently, and their responses are just as varied.

Matthew Jennings Investment Director, **Jochen Breuer** Portfolio Manager, **Kate Howitt** Portfolio Manager,
Catherine Yeung Investment Director, **Yi Hu** Investment Writer

Sign of the times

In normal times, dividend cuts can signal a company in distress. But when it's the economy itself that's in distress, cutting or delaying dividend payments can be a sign of corporate prudence.

Companies around the world are tightening purse strings as they brace for a global recession in the wake of the Covid-19 pandemic. Some, like financial institutions in the UK, Europe and New Zealand, are acting on instructions from their regulators. Others are responding protectively to an actual or feared reduction in cashflows. And some others are delaying because social distancing means they've been unable to hold shareholder meetings to formally approve their payouts.

Still, not all companies are trimming dividends. Many firms are going ahead with payments as planned, while some have even announced increased payouts - a contrarian trend that's notable in several global markets including China (more on this below). In Europe, there are examples of stable businesses within sectors like pharmaceuticals, consumer staples and industrials where we expect dividends to be relatively safe.

But the fact remains that dividends are under pressure globally. In the 2008 global financial crisis, dividends were cut by over 20 per cent on average, a figure likely to be more than doubled in this downturn.

Focus on fundamentals

Investors focused on the regular income distributions that higher dividend stocks can offer may find the size and frequency of these payments delayed or disrupted due to Covid-19. But this won't be the case across all companies.

Equity is a long duration asset and a single year's dividend is not a major part of the intrinsic value of a business. In this environment, where indiscriminate selling is producing huge dislocations to valuations, being able to identify the well-run and well-capitalised companies is key, as these are likely to emerge in a position of relative strength on the other side of this crisis. Indeed, firms with the strongest balance sheets, those that are also best positioned to resist pressure on dividends (see Chart 1), are already showing signs of relative outperformance.

Chart 1: Companies with strong balance sheets are outperforming

Relative performance of US companies: strong vs. weak balance sheets



Source: Fidelity International, Goldman Sachs, Bloomberg, April 2020

This paper outlines the various forces weighing on dividends and why some are cause for greater concern than others. We also highlight a few bright spots where payouts are ongoing as normal or even rising, notably China.

Regulatory pressure

Regulators in several jurisdictions have recently taken the position that banks should be focused on supporting the economy and not paying dividends. Regulators in the UK, Europe and New Zealand have already asked banks to suspend dividend payments while UK and euro zone insurers have also been asked to suspend dividends and share buybacks.

Other sectors are starting to come under pressure, for example in some European economies where governments have pledged more broadly to withhold state aid for companies that pay dividends. In the US, the \$2 trillion-plus CARES act explicitly forbids loan recipients from conducting share buybacks or paying dividends until 12 months after the debts are repaid. Companies are reacting to this pressure in a variety of ways. Some not only accede to reducing their dividend payouts but respond with proactive additional measures of their own (see Suez case study below). Other firms have indicated they don't plan to alter dividend payments, suggesting they see no need for state support.

Case study in solidarity: Suez

On 8 April, executives at the French environmental multinational Suez responded to French government calls to curtail dividend payments by announcing not just a temporary reduction of the dividend, but a broad package of measures designed to deliver financial support to employees and partners globally.

The sweeping, global 'solidarity plan' announced by the water and waste giant included measures to:

- Reduce the dividend by payment by nearly a third
- Donate a quarter of the salaries of its CEO and executive committee members during the lockdown period to charities to finance research and support for healthcare workers
- Provide direct financial support to staff around the world who are placed on partial unemployment that's equal to at least 50 per cent of their salaries

In addition, within France, Suez will pay a €1,000 bonus to all its teams that have been mobilized to provide business continuity, as well as ensure full salary for employees put on partial unemployment.

The measures are at the progressive end of the spectrum when it comes to how companies and investors are responding to Covid-19 relief efforts, but they could be an indication of what's to come as government support to the private sector expands. As we have seen, there is an inherent quid pro quo for companies accepting state support, and in many markets reduced or delayed dividend payments may be part of that equation. But companies can also surprise with more proactive measures of their own.

Financial prudence

For many companies globally, the recent decision to reduce or postpone dividend payments has been taken out of financial prudence. The uncertainties over the length and depth of disruption to cashflows of many businesses - either realised or anticipated disruptions - means companies need to act quickly and defensively to conserve cash.

Indeed, some companies won't be able to navigate the short-term evaporation of their cashflows and may be compelled to cease trading. But many others are perfectly healthy and will emerge on the other side of the current outbreak in good shape. As such, for fundamental investors, delaying dividend payments in this environment shouldn't set off the same warning bells that it would during more normal times.

Logistical challenges

Even in cases where companies are otherwise happy to continue with their usual dividend payments, the Covid-19 outbreak has created logistical challenges. Corporate boards are having to adjust to unconventional or remote ways of working just like underlying businesses. In response to the outbreak, securities regulators in several markets have already issued guidance allowing more flexibility around when and how companies hold their annual general meetings (AGMs). But in many cases, cancellations or delays to shareholders' meetings have also meant companies have been unable to approve dividend payouts. As of March 31, the total number of AGMs postponed or cancelled globally because of Covid-19 was approximately 557, while the number of announced virtual-only or proxy-only meetings in the same period rose to 560, up from 286 last year, according to a recent paper by ISS Corporate Solutions.

For example, the German chemical and consumer goods company Henkel, the French cosmetics giant L'Oreal, and the Singapore banking group DBS all recently had to postpone their AGMs because of social distancing considerations, therefore delaying the approval of dividend payments.

Where regulations and other logistical considerations permit, other companies are finding ways to conduct their shareholder meetings virtually. One example is Beiersdorf,

the German personal care conglomerate, which intends to go ahead with its AGM and proposed dividend at the end of April as planned, but will hold a virtual meeting only. By and large, we view these as temporary disruptions due to logistical challenges - ones that don't alter the capital return profile of a given investment, especially where the delays in approving dividend payments can be resolved in a reasonable amount of time.

Australia's example

Even in markets known for offering high dividends, companies are coming under pressure. Consider Australia, where bank dividend payments are a large and regular form of cash inflow to the Australian economy, given equities in the sector are a popular holding among yield-driven retail investors.

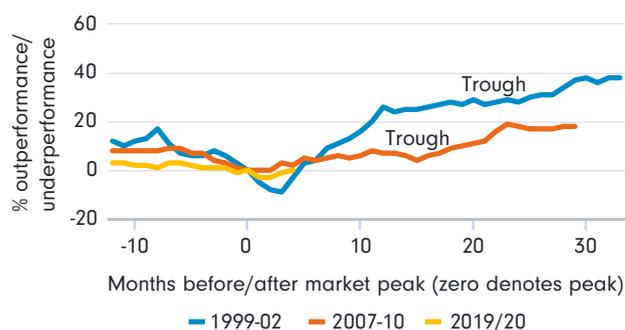
One factor here mitigating pressure to lower or postpone dividends is that companies paying dividends in Australia receive a franking credit that they can then allocate to their shareholders as a tax credit. These franking credits have no value to the company but a cash value to shareholders.

Under Australia's dividend imputation regime, which avoids the double taxation of dividends, there is an economic rationale to continuing to pay dividends so that they can be "fully franked" - meaning that tax already paid by the company is credited to shareholders and can be applied against their own tax liabilities. For companies, the value of any accumulated franking credits can only be paid out to shareholders at the prevailing tax rate. In the event a company has an unused balance of franking credits and the tax rate falls, the previous incremental tax paid at the higher level can never be recouped by shareholders.

While stopping short of outright directions, regulators in Australia have provided strong encouragement to the financial sector to trim or cancel dividends. Our view is that Australian companies are likely to trim their dividends, but we also expect that they will seek to pay out their franking credits, with the result being a trend toward smaller but fully franked dividends. They may shore up their capital positions by conducting Dividend Reinvestment Plans, and perhaps arranging to have these fully underwritten. In this way, shareholders receive the dividend and the franking credit but the company retains the cash, albeit with some dilution to share count.

Chart 2: Asia dividend stocks outperformed in previous market rebounds

Relative performance of MSCI Asia Pacific ex Japan High Dividend Yield Index vs. the MSCI Asia Pacific ex Japan Index



Source: Fidelity International, Bloomberg, April 2020.

Contrarian China

Asian dividend stocks have outperformed the broader region after previous selloffs (see Chart 2). And within greater China, many big companies were steady dividend payers through previous rounds of market turbulence, including firms like chipmaker TSMC (which paid out \$8.4 billion in dividends last year), CK Infrastructure, developer Sun Hung Kai Properties, or conglomerate Guangdong Investment.

There has been a particular focus among companies from mainland China, specifically those that count the state as a major investor, on increasing dividend payouts in recent years. This follows sustained calls by the government to increase shareholder returns.

Recent examples include telecom giant China Mobile; Shenhua Energy, the country's biggest coal producer; and state-backed property developer China Overseas Land and Investment, or COLI. All three companies recently announced dividend increases.

Despite a 9.5 per cent net profit decline, China Mobile slightly increased its full-year dividend payment for 2019 by 3.4 per cent, while assuring investors that it will maintain a stable dividend for the full year of 2020. The management cited shareholder returns as the reason for its decision to boost the payout from last year. Shenhua, sitting on a large

cash pile, bumped up its payout ratio to 60 per cent from 40 per cent, while pledging a floor of 50 per cent for 2020 and 2021. And developer COLI proposed a final dividend that lifted its payments for the full year by 13.3 per cent, slightly more than the annual increase in net profit.

China's securities regulator has repeatedly called for greater rewards for shareholders in the form of dividend payments, as the government seeks to encourage fundamental investing as part of a drive to reform the stock market.

We expect more near-term disruption, but this shouldn't alter the long-term outlook for what are otherwise solid businesses.

Generally, state-owned enterprises with strong cashflow are more likely to heed the call. Their cash distributions help to boost the coffers of various government units that hold SOE shares, especially in a slowing economy. Big dividend payers tend to include the largest SOEs, which are often financial firms, energy producers and real estate developers with cyclical profits. Many of them still have strong balance sheets this year that allow resilient distributions. Nevertheless, profit outlooks for Chinese companies in general remain challenging, with the Covid-19 outbreak hurting both exports and domestic consumption. Many other Chinese firms with weak cashflows are cutting or suspending dividends, just like their global peers.

It's not all about dividends

It's also worth remembering that dividend payments are only one of two main ways that companies return capital to shareholders. The other is through share buybacks.

This differs notably across global markets. In Europe the split can be as much as 80/20 in favour of dividends, while in the US it is closer to 40/60 in favour of share buybacks. Asia also favours dividends. In the US, many companies

have recently acted to cancel buybacks. The total amount of buybacks was down by around 60 per cent in the year to mid-March, according to a recent report by Jefferies, and there could be more to come.

This is important context when discussing companies in the US market, where payout ratios tend to be lower but dividends are regarded as more secure. Despite this, the total cash amounts returned to shareholders may well drop significantly once buybacks are factored in. For investors, this is particularly important to keep in mind when considering total returns, and not just dividend income received. And dividends are also likely to be at risk at those US companies that have levered up their balance sheets in order to do buybacks.

Takeaways for investors

Markets have been moving through an unprecedented crisis and still have some distance to go before the Covid-19 pandemic stabilises. For investors, especially those focused on investing for steady income, where dividends are a key part of many strategies, these are unsettling times. Many companies globally are reducing or delaying payouts. We expect more near-term disruption, but this shouldn't alter the long-term outlook for what are otherwise solid businesses.

There are a wide range of reasons why dividend payments come under pressure - and in many cases, cutting payouts is a perfectly prudent response to the current situation. But not all companies are responding to this pressure in the same way, and we're seeing some notable exceptions, for example in Asia or within certain more resilient sectors in Europe, where companies are leaning against the trend. The key differentiator for most company managements will be the resilience of their cash flows, strength of their balance sheets and sustainability of their dividend policies.

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ED20-124