European ex-UK Income – article for Swiss Funds Platform (May 2020)

HEADING: European Income: The Future of Dividends

Executive summary

- The great dividend reset – dividends are expected to recover quickly from the low 2020 and 2021 base
- Scarcity of yield has been a key factor in UK equity income problems; regional and global propositions offer much more diversified opportunity sets
- Lower but growing and sustainable dividend yields are more compelling than highest yielders
- ESG not going away – more stakeholders getting more of a say in payouts
- Attractive dividend yields in disrupted sectors should continue to be avoided

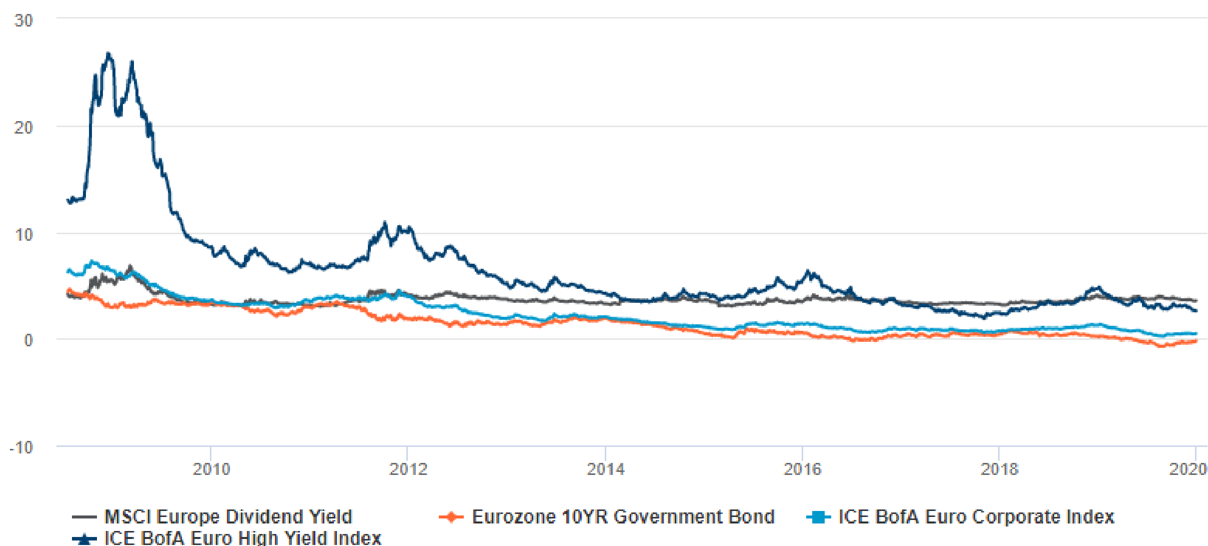
We have long argued that Europe is an attractive region for finding income stocks. It is a mature region with a diverse index by sector and country. The businesses we seek out have strong competitive positions in their respective disciplines, within industries that tend to have robust demand profiles. The resulting defensiveness leads to attractive and growing free cash flow, which funds the future growth of the company and its dividends to investors.

While the near-term dividend picture is clearly negatively impacted by the pandemic, we remain optimistic on the opportunity set and outlook for income stocks. The purpose of this note is to explain why Europe remains an attractive source for income and our broader thoughts on dividends as we continue to work through the consequences of the current crisis.

From a yield perspective, European equities have seen a strong relative derating against most conventional asset classes over the past decade. Government and corporate bonds have gone from yielding about the same as equities to almost nothing, while high yield bonds have seen their yield premium to equities disappear. From today's starting point, we see dividends rebounding, driven by some of the 2020-21 dividend rebase unwinding (some companies only cut for short-term political reasons, while we are sure some banks will restart dividends over the medium term) and the usual earnings recovery out of a crisis. Given inflation is a long-term driver of dividend growth, the increasing emphasis on fiscal policy once the initial deflationary wave passes indicates the potential for medium-term dividend growth. While the index yield is currently estimated to be only around 3%, we believe this should grow by high single digits post-2021.

We believe the long-term dividend growth potential for European equities is mid-single digits – lower in recessions and higher in recoveries. Nothing we have seen so far has changed our view that Europe still has plenty of resilient companies that should be able to continue to deliver this.

Yields have strongly rerated across other asset classes



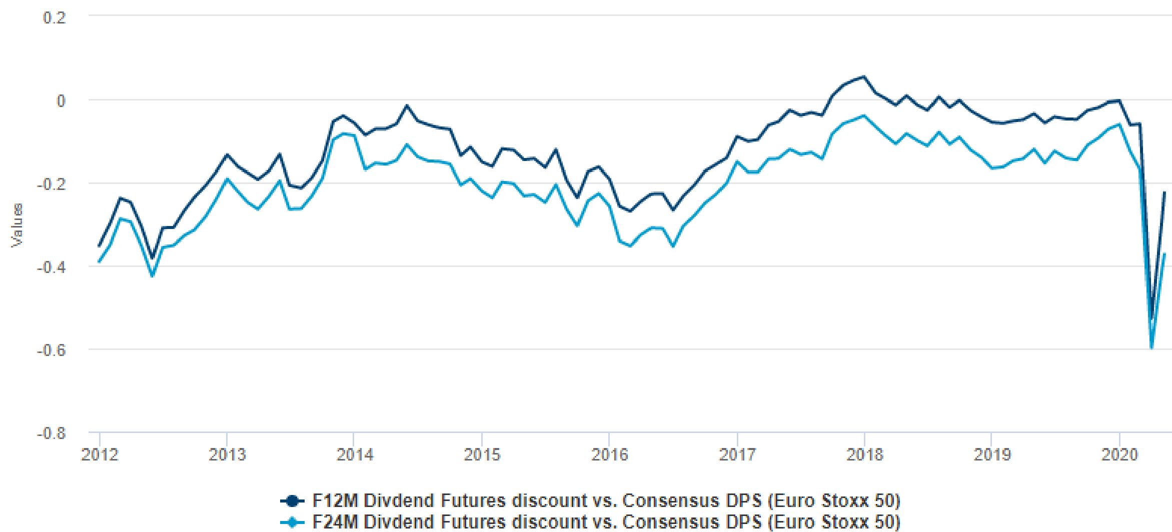
Source: *Bloomberg; Polar Capital, May 2020. Past performance is not indicative or a guarantee of future results.*

The great dividend reset

In the global financial crisis, oil producers and financial institutions made severe cuts to their dividends, but these were not matched in other sectors of the economy. The pandemic has resulted in a big rebasing of dividends globally, a number of lockdown victims (cinemas, restaurants, hotels, cruise companies, airlines, autos, retailers) have already cut their dividends, understandably as many of them have had their revenue streams completely cut off. The energy sector has been hit by a perfect storm of a lockdown demand hit and a weakening of OPEC supply discipline. While the UK has seen the most extreme income hit due to the concentration of dividends in a handful of challenged stocks (BT, oil majors, Imperial Tobacco etc), continental Europe has also suffered, particularly given the hit from Eurozone banks paying out nothing.

There are some regional differences that are worth noting. The payout by European companies is heavily skewed towards dividends, which comprises nearly three quarters of total cash returned to investors. On the other hand, US companies predominantly return cash in the form of buybacks, which constitutes nearly 60% of all payouts while the rest is in the form of dividends. This would also explain why we have seen far fewer dividend cuts in the US.

Dividend futures are predicting a much tougher near-term picture than bottom-up analyst estimates



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Companies have amended their shareholder cash return plans in a variety of ways, that we would plot within a broader range of capital outcomes from the pandemic as:

- **Suspend buybacks or special dividends:** Share buybacks and special dividends are typically the most discretionary forms of shareholder returns. As such, we have seen many companies choose to pause or delay such activities until visibility improves, while maintaining ordinary dividends.
- **Reduce ordinary dividends:** Ordinary dividends are conventionally thought of as more of a commitment to shareholders than buybacks and special dividends. The sheer scale of the crisis and the volume of companies cutting has reduced the usual taboo of cutting dividends. Some of the most controversial high dividend payers would have cut sooner or later.
- **No dividend in the near term:** Dividends being completely stopped in the near term. Some of these stocks will see income fund selling where there is low visibility on a return to dividends, but there should also be some good opportunities in this group.
- **Rights issue to recap business:** The increased share count dilution is a headwind to returning to previous dividend per share power, but there may be interesting income opportunities from depressed share prices and rebounding operations.
- **Government bailouts:** Where companies have taken government capital in formal bailouts, we expect these to include explicit constraints on dividends and buybacks and also implicit increased scrutiny on medium-term capital returns. At the least, we should expect these companies to run materially more conservative balance sheets going forward.
- **Bankruptcy:** We expect relatively few listed bankruptcies due to the scale of authority willingness to prevent this happening. Only if the situation were to deteriorate markedly do we think this could play out. An unwillingness to let excess capacity exit has been one of the structural factors that had hindered value since the global financial crisis.

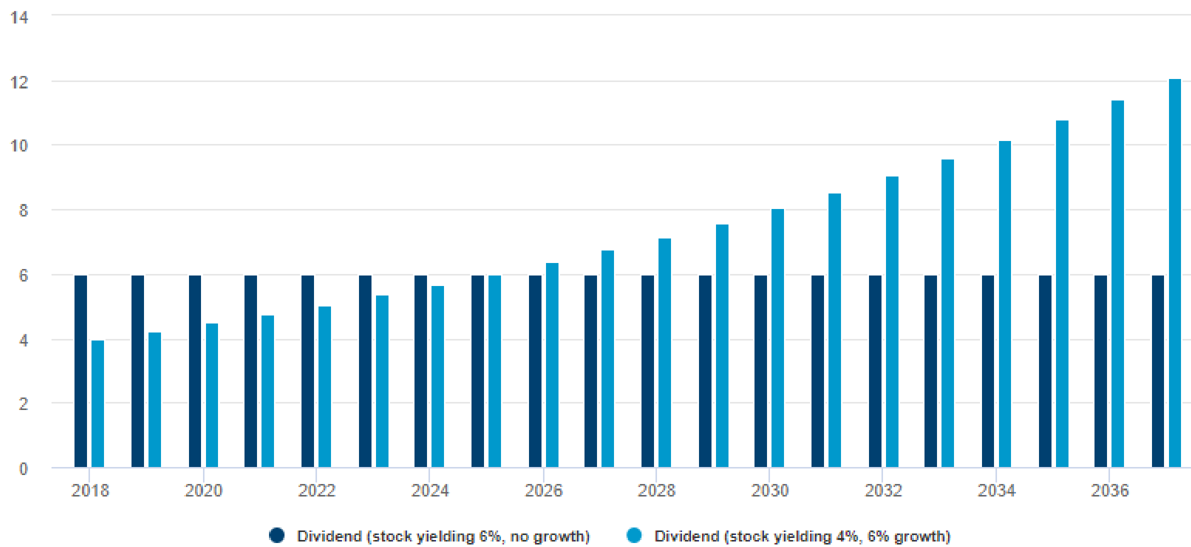
Prospects for dividends deteriorate as you move down the list above. Investors need to take a stock by stock view of dividend cuts because there is a great deal of nuance behind dividend

announcements. The moving parts behind decisions to reduce or end shareholder remuneration include one or more of:

- **Weak balance sheet and/or stretched payout ratios:** This is a more generic recession motivation for dividend cuts. Even companies with modest earnings hits are choosing to cut dividends that were already stretched and under pressure. These are in effect permanently impaired dividend streams given the previous payouts were not sustainable.
- **Political/regulatory:** Political and regulatory responses are highlighting both country and sector risks to payouts. Ultimately, we expect rationality to prevail given it is totally counterproductive to force up a company's cost of equity by messing around with dividends. However, near-term noise will remain elevated. Beyond 2021, there should be good selective dividend opportunities around these dividend cuts.
- **Tapping employee furlough schemes:** Companies choosing to tap furlough schemes are rightly not paying out dividends while they are using these schemes. We expect dividends to rebound relatively quickly for a lot of these companies.
- **Government capital injections (i.e. direct bailouts):** The need to take government capital is typically necessary where companies are unable to raise private capital. We expect it to take a long time for those taking bailouts to return to attractive dividend payout positions.
- **Existential exposure to lockdown:** For some companies (particularly restaurants etc), the social distancing policy response represents a unique and existential threat to their businesses. There is a huge amount of uncertainty around when things might normalise and how their business models need to adapt. We suspect there will be opportunities here for the brave, but painful dilutive recaps are likely.

To look at the resilience of dividends, we avoid companies that have extremely cyclical returns, require excessive capital, or allocate capital in ways that do not support the long-term success of the company. We have a rigorous checklist of dividend reliability that counts against such weaknesses. Being disciplined in recognising such risks and instead focusing on those companies with stable business models that generate cash will offer a significant boost for the longer-term income and capital growth.

Lower but growing dividend streams give better medium-term savings outcomes



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Regional and global opportunity sets more compelling for income funds

Many reasonably priced growth stocks (GARP) had rerated to high valuations, causing income funds to struggle to justify owning these stocks. As a result, many income funds are overweight sectors which are the worst positioned in the current environment, such as autos, banks and energy, that look ugly in terms of realisable dividend yields. Income funds are also underweight many of the sectors that have held up better so far.

Previously reasonably priced growth stocks have rerated strongly recently

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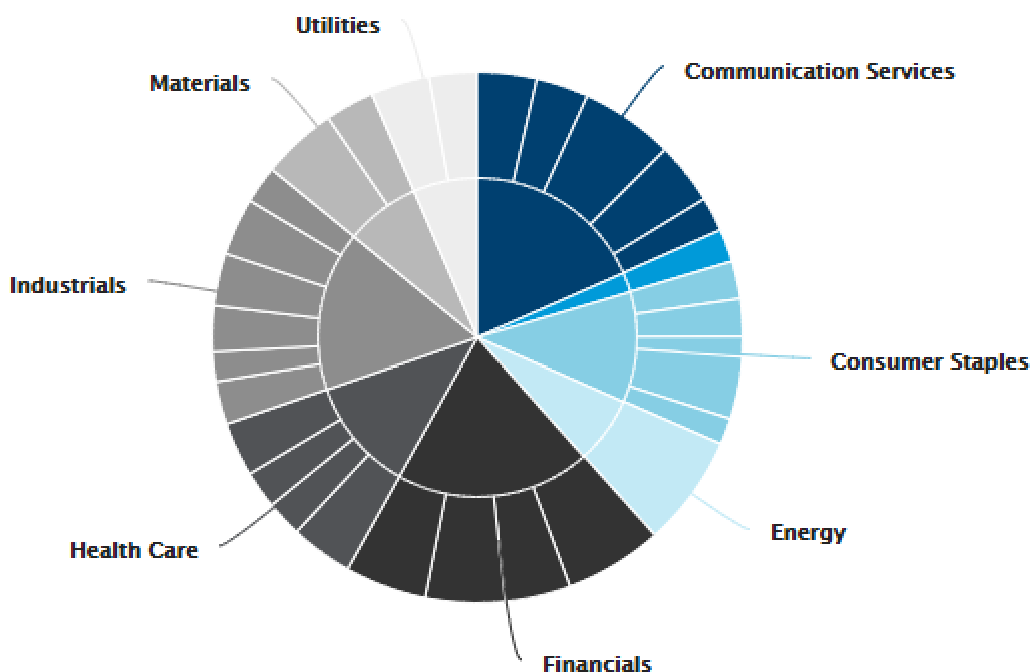
At a regional level, we see the UK as a particularly difficult index for income investing given the heavy concentration of dividend payments in the energy and bank sectors. This means a relatively lean pool of above index divided yielders, where many of these face notable structural challenges. Many of these companies are already paying unsustainable amounts in dividends instead of thinking about future investment. An example is Shell; the UK oil and gas giant announced a 66% dividend cut, its first since 1943 and a more significant cut than many expected. Data from Octopus Investments shows Shell as a top-ten holding for two-thirds of the IA UK Equity Income sector, while it represented c10% of the UK's total dividend distributions. Other big cuts or suspensions have included banks (Lloyds, RBS, Standard Chartered) and insurance companies (Direct Line, Admiral, RSA), as well as the large-cap telecoms company BT. This degree of concentration represents a meaningful hit to both active and passive investors.

Given the dividend concentration in the UK equity sector, we have often stressed the importance of our own income diversification; our sector mix (20% non-life and reinsurance, 18% telecoms, 11% staples, 12% healthcare, 7% utilities, 7% energy - as at 30 April 2020) and very low exposure to cyclical sectors bolsters our confidence in this challenging environment.

Our Fund dividend yield shows the good degree of industry diversification of Europe's opportunity set...



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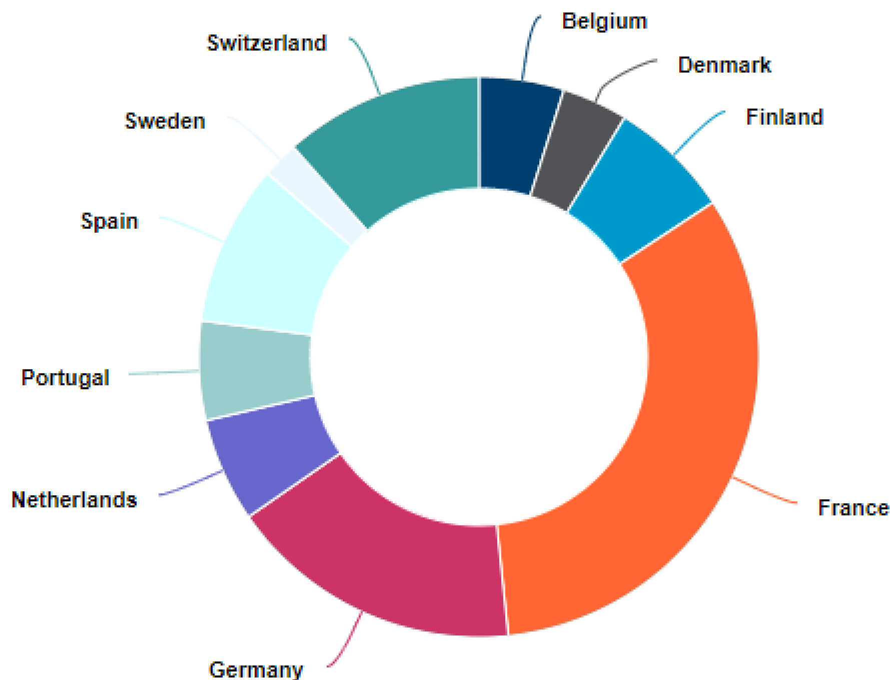
…with a similarly good diversification of dividends by country



Source: *Bloomberg; Polar Capital. 1 April 2020.*

ESG focus is not going away

Traditionally, we have considered dividend payout decisions being principally driven by three core stakeholders: company management, shareholders and credit agencies. We now see this broadening with more secondary stakeholders influencing decisions.

- **Supply chain considerations:** In the near term, we expect a variety of value chain considerations to affect a company's decisions around payouts. There will be negotiations with suppliers and customers around dealing with pandemic fallout. There will also be increased worry about counterparty credit risk where partners might expect stronger balance sheets to reassure them to transact.
- **Employees and unions:** The ability to cut costs and adapt business models will likely impact employees. Excessive dividend payouts are obviously challenging against the current backdrop.
- **Regulators:** While financials are the most explicit regulator-driven dividend sectors, there may emerge more pressure elsewhere to balance investment and other social priorities alongside dividends. We would argue that income investors are used to these issues given the income opportunity set is more exposed to regulated businesses than the broader index.
- **Politicians:** Beyond those companies that have directly held government stakes (where we expect extreme caution in dividend decisions), there will be clear political pressure on companies to cancel or justify dividend payments.
- **Wider society:** There will clearly be increased public scrutiny of high-profile dividend payers.

Disrupted sectors should continue to be avoided by income investors

We have previously stressed the importance of income investors avoiding companies being disrupted by entrants with new technologies or business models. Equity markets are very good at tempting investors to consider such stocks with attractive yields that ultimately prove too good to be true. Many of these disrupting trends have been accelerated in the near term by the consequences of lockdowns and social distancing. The sectors we consider seeing accelerated disruption include media (free-to-air broadcasters and ad agencies), physical retail and fintech companies targeting pockets of excessively profitable products. Income investors tend to have low exposure to the disruptors (start-ups are usually not listed, often based in the US and hardly ever pay dividends). In contrast, they do tend to own mature cash-generative businesses that are the targets of these disruptors. Fortunately, it is much easier to pick losers in the game of disruption than winners.

Our view is that the medium-term dividend prospects of continental Europe are attractive, especially relative to other asset classes. It seems perverse to us that the market wants to look through scary, near-term earnings hits, while in our view taking an excessively negative medium-term view of dividends.

Nick Davis
Fund Manager, European Income Team
28 May 2020

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