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Q1 2011 Distributions: Facts & Trends

Resurgence in shareholder distributions

J.P.Morgan

1. Q1 2011 is nothing like Q1 2009

It has been well publicized that large U.S. corporations are more secure in their financial positions today than they have been in some time. S&P 500 firms have dramatically reduced leverage over the last ten years, with debt to EBITDA ratios dropping from about 3x to almost 2x, and coverage ratios increasing from under 7x to over 10x. Simultaneously, these same firms have increased cash holdings to a level not seen since the 1950s at 11.1% of assets, albeit a large fraction of this cash may be trapped offshore. As a result, many firms have built significant capacity and financial flexibility for investments, mergers and acquisitions, and shareholder distributions. This is in stark contrast to the situation they were facing just a few years ago when firms were almost solely focused on preserving and enhancing liquidity.

As more and more firms gain comfort with their leverage and liquidity profiles, as well as their expectations for future cash flow generation, shareholder distributions have become a higher priority for decision makers and Boards of Directors. We witnessed the beginning of this trend with the first-movers in 2010, and we have seen an acceleration of this trend since the beginning of this year. As distribution announcements are typically concentrated in the first quarter of the year, it is useful to evaluate Q1 announcements as a guideline for the remainder of the year.

Here are **10 key observations about Q1 2011's** distribution trends:

- (1) There were 413 Q1 dividend increases, a large jump from the 193 increases in Q1 2009, but still only about two-thirds of the number of increases in Q1 2006 and 2007¹
- (2) There were 15 Q1 dividend decreases, a large drop from the 222 decreases in Q1 of 2009, but still more than the decreases of 2006 and 2007
- (3) The average Russell 1000 dividend increase was 46.7%, and the median (typical) increase was 12.5%
- (4) The median and average dividend initiation was at a 1.2% yield
- (5) The S&P 500 pro forma 2011 payout ratio (relative to earnings) is 26%, lower than any year since 1988
- (6) As one would expect, dividend payments for large firms remained rather steady during the crisis, except for the financial sector (both banks and REITs), where cuts were prevalent
- (7) Also as expected, S&P 500 buybacks were cut significantly from a peak of \$172bn in Q3 of 2007 to a low of \$24bn in Q2 of 2009
- (8) Buybacks by S&P 500 firms have rebounded substantially more than dividends, with Q4 2010 levels at about \$86bn
- (9) The average Q1 buyback announcement was for 8.1% of the firm's market capitalization
- (10) Investors have responded well to dividend increases, dividend initiations, and buyback announcements (despite many of these announcements having been anticipated)

¹ Number of increases based on Standard & Poor's dividend analysis using common stocks (non-funds) listed on the American Stock Exchange, New York Stock Exchange, NASDAQ Global Market, and NASDAQ National Market

In Figure 1 we compare and contrast pro forma (annualized) 2011 distributions data to both pre-crisis and peak-of-the-crisis data. Interestingly, as buybacks were cut more aggressively during the crisis, dividends constituted a majority of the S&P 500 distributions during the crisis years. With a strong rebound in buybacks expected to continue, projected 2011 dividend payments are likely to be significantly below projected buybacks. Yet, dividends are only \$21bn below the pre-crisis level of \$245bn for S&P 500 firms, versus buybacks which are estimated to be approximately \$245bn below the peak level of \$589bn in 2007².

Figure 1

Distributions are on the rise, but substantial room for growth remains					
Distribution policy in today's environment					
Metric	Pre-crisis (2007)		Crisis period (2009)		Projected post-crisis (2011) ¹
Number of annual dividend increases ²	1,857	▶	699	▶	1,652
Number of annual dividend decreases ²	44	▶	527	▶	60
S&P 500 dividend % of earnings	42%	▶	44%	▶	26%
S&P 500 dividend % of distributions	30%	▶	59%	▶	39% ³
Annual S&P 500 dividends (\$bn)	\$245bn	▶	\$197bn	▶	\$224bn
Annual S&P 500 repurchases(\$bn)	\$589bn	▶	\$138bn	▶	\$345bn ³

¹ Based on annualized Q1 2011 data

² Based on Standard & Poor's dividend analysis using common stocks (non-funds) listed on the American Stock Exchange, New York Stock Exchange, NASDAQ Global Market, and NASDAQ National Market

³ Actual Q1 2011 repurchase data not yet available, thus repurchase figure based on annualized Q4 2010 data

² Based on annualized Q4 2010 data; Actual Q1 2011 S&P 500 repurchases not yet available

2. Distributions over time: steady dividends, unsteady buybacks

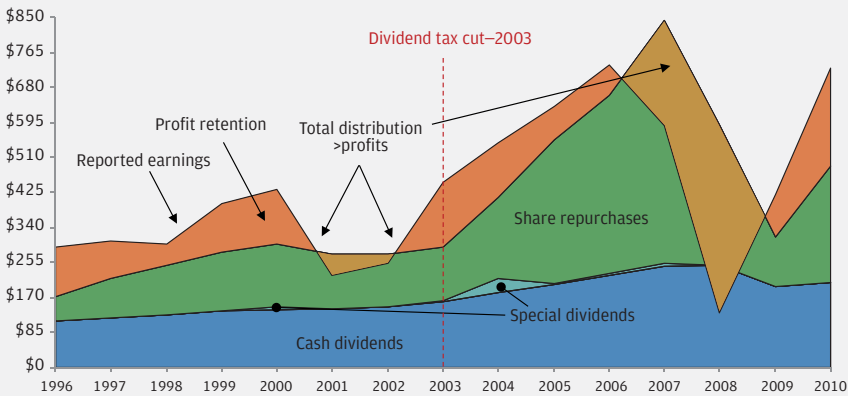
In Figure 2 below, we illustrate how common dividends by S&P 500 firms have steadily increased every year from \$113bn in 1996 to a peak of \$247bn in 2008, followed by a drop of about 20% to \$197bn in 2009. The drop in aggregate dividend dollars was largely driven by the financial sector, which was a significant dividend payer pre-crisis. This year, S&P 500 dividends are projected to be back at the 2006 level. This historical dividend pattern is consistent with investor expectations that dividends are a stable and predictable component of distributions that are only cut in extreme and unexpected circumstances.

The historical evolution in buybacks has, however, been much more volatile. As one would expect, many firms view buybacks as a flexible form of distribution that can, and should be, cut when needed. This need can arise for acquisitions, organic growth projects, to cover cash flow shortfalls, or to adapt to a changing economic environment (as has been recently experienced). The fact that buybacks tend to be EPS accretive and tax advantaged when compared to dividends were just some of the factors that fueled buyback growth from \$60bn, or 35% of total distributions in 1996, to \$589bn and 70% of total distributions in 2007.

Figure 2

Fifteen years of S&P 500 earnings, dividends and repurchases (\$ bn)

S&P 500 earnings, dividends and repurchases, 1996–2010 (\$ billions)



Reported earnings	293	306	300	397	433	223	254	450	545	634	734	587	130	449	700
Special dividends	0	0	0	0	7	0	0	1	34	2	4	6	2	1	0
Common dividends	113	120	129	138	141	142	148	161	181	202	224	245	247	197	206
Share repurchase	60	97	120	141	151	132	127	131	197	349	432	589	340	138	299
Total distribution	173	217	249	279	299	274	275	293	412	553	660	841	589	335	505
Distrib. % of earnings	59%	71%	83%	70%	69%	123%	108%	65%	76%	87%	90%	143%	452%	75%	72%
Dividends % of distribution	65%	55%	52%	49%	50%	52%	54%	55%	52%	37%	35%	30%	42%	59%	41%

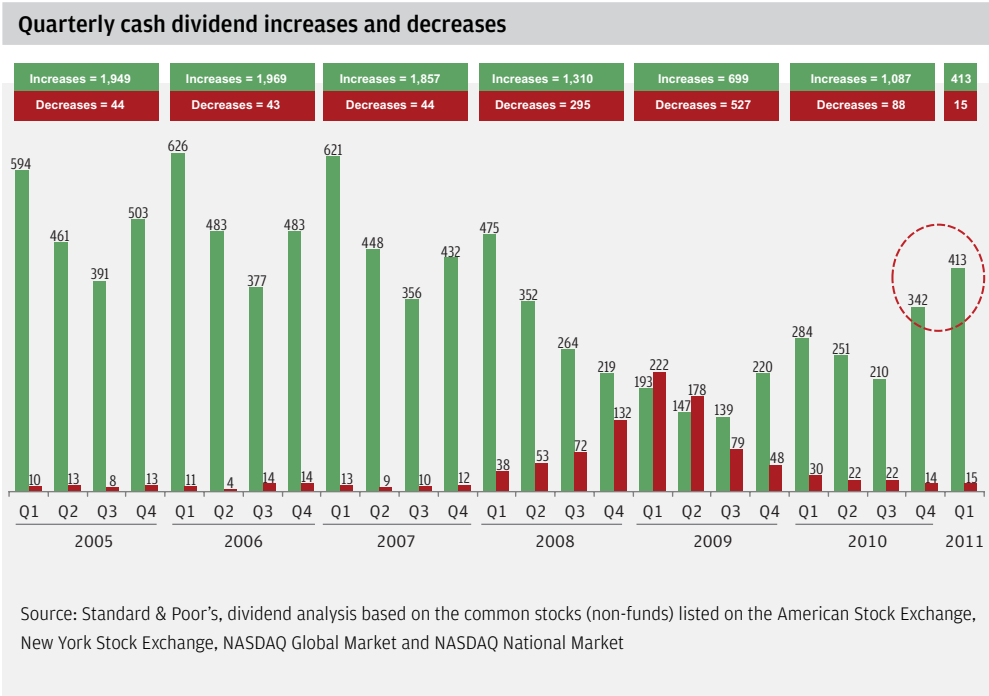
Source: J.P. Morgan, Standard & Poor's, Bloomberg

Note: Dividends % of earnings and dividends % of distributions includes special dividends

3. Dividends on the rise – but with room for further growth

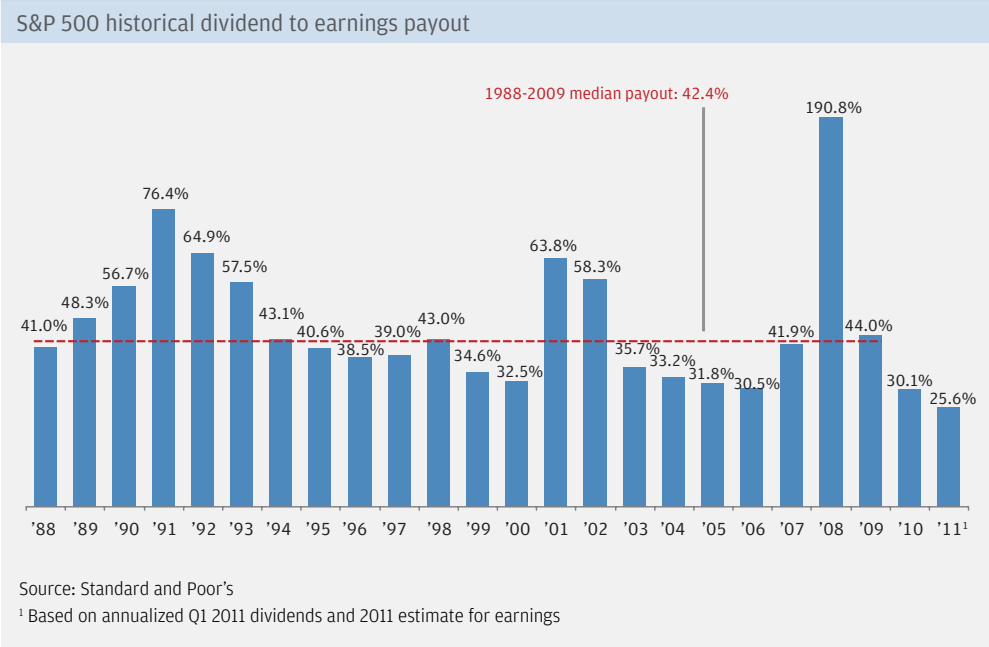
Following close to 1,900 dividend increases in 2007, firms announced only approximately 700 increases in 2009, a 62% decrease in just two years. Simultaneously, these firms announced a record number of dividend decreases, from just 44 in 2007 to over 500 in 2009. While there have been over 400 dividend increases in the first quarter of 2011, a number of factors indicate that there is still substantial room for dividend growth. First, while 400+ increases have the appearance of being in line with the historical quarterly pre-crisis average based on Figure 3, a large majority of firms evaluate the dividend decision in the first quarter, and thus Q1 has typically had more increases than any of the other quarters. When compared solely to first quarter increases, 2011 remains almost 30% below the 2005 to 2007 average of 579.

Figure 3



Second, and even more surprising, is the fact that the S&P 500 dividend to earnings payout ratio was lower in 2010 than it has been in the past two decades (Figure 4). While firms have been more aggressive in terms of their percentage dividend increases in Q1 2011 (with the typical increase at 12.5%), the 2011 expected dividend payout ratio is even lower than the record low 2010 level³. Thus, in the absence of major negative shifts in economic growth, the capital markets or geopolitical environment, we expect the strong trend in dividend increases to continue to gain momentum. In particular, with more baby boomers seeking a higher predictable yield component, and some Board concern over repurchasing shares at high levels, we expect decision-makers to continue to favorably consider dividends.

Figure 4
2010 S&P 500 dividend to earnings payout lowest in two decades



³ Based on annualized Q1 2011 dividends and 2011 estimate for earnings

4. Dollar distribution volumes up, repurchases leading the way

While a strong reduction in dividends was apparent over the course of the recent credit crisis, changes in repurchase activity were even more dramatic. S&P 500-executed repurchases plunged from over \$170bn in the third quarter of 2007 to just \$24bn in the second quarter of 2009. While this drop is staggering, it is also reasonably intuitive. The benefit of repurchases is that they are inherently more flexible than dividends, at least in today's U.S. corporate finance environment where the use of irregular special dividends is limited. Firms typically use repurchases as a means of distributing excess cash or excess cash flow that is less 'predictable'. In the same vein, one would expect repurchases to grow quicker than dividends in an economic rebound. But have they?

Since the recent quarterly low of just \$24bn in Q2 of 2009, repurchases executed by S&P 500 companies have grown over 250% to \$86bn in Q4 of 2010 (Figure 5). This represents a \$62bn increase in distributions through buybacks, relative to an increase in dividend volumes of just \$7bn over the same time period (Figure 6). Now, with banks and other large-cap firms back in the market for their shares, one might expect 2011 repurchases to approach pre-crisis levels.

Figure 5

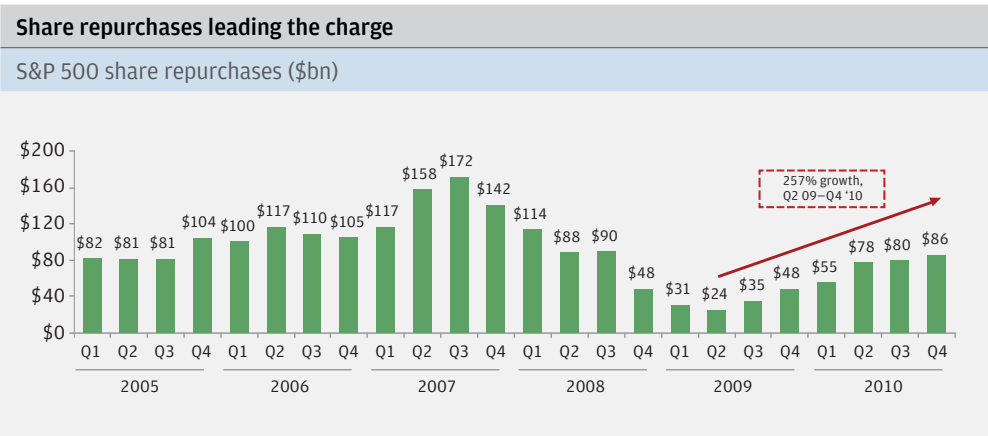


Figure 6



5. Investors continue to respond well

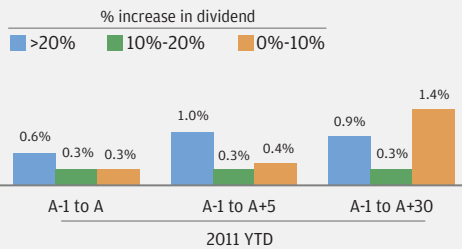
The strength of large-cap balance sheets has been highlighted many times before. Thus, it comes as no surprise to most investors that firms have considered larger distributions in Q1 of 2011 relative to the same period last year. For example, the recent bank dividend increases were widely expected as both senior decision makers and analysts had discussed the reinstatement of their distribution policies extensively. Likewise, for non-financial firms that cut back on repurchases and reduced dividend growth during the crisis, investors rightfully expected a catch-up phenomenon as the fears of a double dip recession abated, cost of debt capital reached historical lows, and cash on balance sheet continued to build. In some cases, investors have expected (and received) concurrent increases in both dividends and buybacks. Despite the market incorporating their expectations for these actions into stock valuations, investors have still responded positively to many of these announcements (Figure 7).

Investors are eager to see capital at work, and applaud the discipline associated with higher distributions. In the same vein, they have also applauded the recent use of capital for M&A and investments, as firms increasingly search for growth and synergies through strategic transactions.

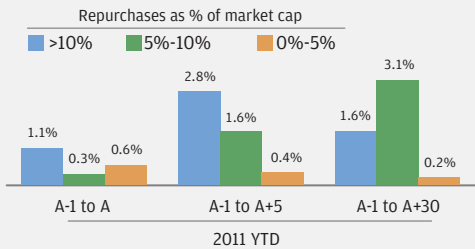
Figure 7

Market reaction to distribution announcements¹

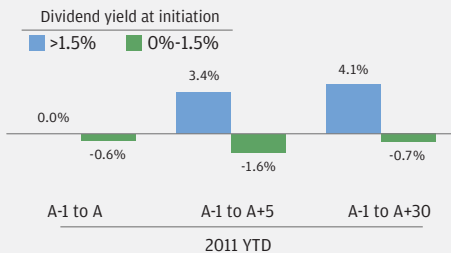
Median market reaction to dividend increases¹



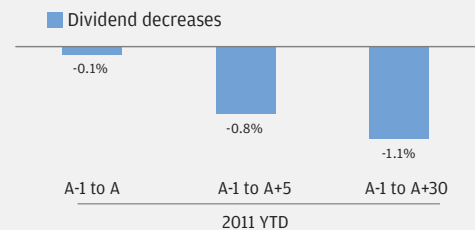
Median market reaction to repurchase announcements¹



Median market reaction to dividend initiations¹



Median market reaction to dividend decreases¹

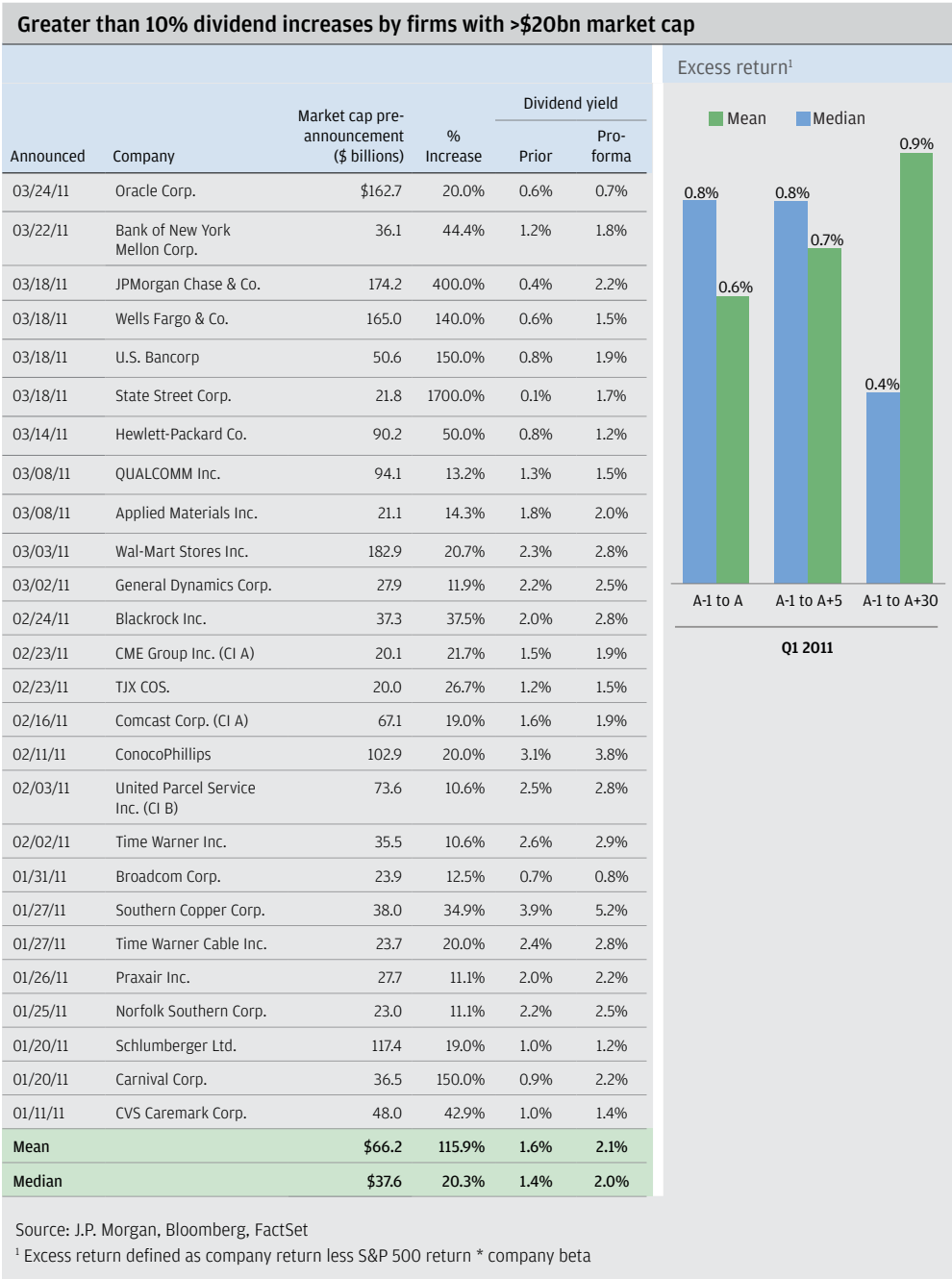


Source: Bloomberg as of 03/31/11

¹ Market adjusted performance defined as total return of company stock less total return of S&P 500 * beta

Large-cap firms traditionally pay the most substantial dividends. In a prior publication⁴, we mention that the 10 largest dividend payers in the S&P 500 constitute about 30% of the total dividends in the index (\$60bn of \$200bn total cash dividends paid in 2010). In Figure 8 below, we list the firms that have announced greater than 10% dividend increases with market capitalizations of over \$20bn. There are a few key lessons to be learned from this list: (1) large-cap firms have announced substantive dividend increases across a wide variety of sectors, including energy, technology, banking, retail, mining, media, and transportation; (2) the typical increase in this data set was just over 20%; (3) the typical yield increased from 1.4% to 2.0% on a pro forma basis; (4) the market has also reacted positively to these announcements.

Figure 8



⁴ Dividends: The 2011 guide to dividend policy trends and best practices, published January 2011

6. Appendix

Figure 9

Summary reaction to distribution announcements – Q1 2011

Market reaction to 2011 dividend increase announcements (163 observations)¹

	Market Cap (\$mm)	% Increase	Dividend yield		Excess return ²		
			Prior	Pro-forma	A-1 to A	A-1 to A+5	A-1 to A+30
Mean	20,266	46.7%	2.2%	2.5%	0.6%	0.6%	1.7%
Median	8,406	12.5%	1.9%	2.2%	0.4%	0.4%	0.8%

Market reaction to 2011 dividend decrease announcements (5 observations)¹

	Market Cap (\$mm)	% Decrease	Dividend yield		Excess return ²		
			Prior	Pro-forma	A-1 to A	A-1 to A+5	A-1 to A+30
Mean	7,110	(26.1%)	8.9%	7.2%	(0.3%)	(0.1%)	(1.1%)
Median	4,375	(26.2%)	5.8%	3.4%	(0.1%)	(0.8%)	(1.1%)

Market reaction to 2011 dividend initiation announcements (14 observations)¹

	Market Cap (\$mm)	Dividend		Excess return ²		
		Yield		A-1 to A	A-1 to A+5	A-1 to A+30
Mean	22,886	1.2%		(0.3%)	0.2%	2.2%
Median	5,764	1.2%		(0.6%)	0.2%	2.6%

Market reaction to 2011 repurchase announcements (118 observations)³

	Market Cap (\$mm)	Repurchase announcement		Excess return ²		
		Amount (\$mm)	% of market cap	A-1 to A	A-1 to A+5	A-1 to A+30
Mean	15,591	1,030	8.1%	1.0%	1.7%	2.7%
Median	4,043	300	6.2%	0.6%	1.2%	2.2%

Source: J.P. Morgan, Bloomberg, FactSet

Based on open market repurchase announcements greater than \$25mm

¹ Based on Russell 1000 firms

² Excess return defined as company return less S&P 500 return * company beta; A-1 defined as the last unaffected price before announcement

³ Based on open market repurchase announcements greater than \$25mm

Notes

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J.P.Morgan