

MARCH 2016



## Wiser by the Dozen

Investor perspectives on dividends and share buybacks

J.P.Morgan



## 1. Investor insights needed please

Last year, U.S.-listed firms returned over \$1 trillion to their shareholders in the form of dividends and buybacks.<sup>1</sup> Was this an appropriate amount? Did firms execute capital return programs in the most efficient manner?

Advising management teams and boards on these decisions on a daily basis, we continue to see a wide dispersion of approaches. Some feel capital returns shortchange future growth by limiting capex and R&D. Conversely, others staunchly believe that firms can over-invest, not earn their cost of capital, and should therefore return more capital to their shareholders.

Even when boards are in agreement about **how much** capital should be returned, there is often significant disagreement about **how** it should be returned. Some have the view that buybacks wrongly reward investors who are selling and leaving the firm. In addition, they say, firms are terrible at timing the market and often buy when shares are at, or close to, their peak. Others argue that buybacks are superior to dividends because they are more tax efficient to most investors, generate EPS accretion, and are inherently easier to modulate than dividends.

To incorporate the views of an important constituency, the public shareholders, we queried representatives of **more than three dozen of the largest asset managers, who collectively manage over \$5 trillion of assets**. We solicited their views on a dozen key issues related to capital allocation. Even among asset managers, there is a wide range of opinions on capital allocation. While firm-specific situations could refine viewpoints, key takeaways are:

- A **balanced capital return program that includes both dividends and buybacks** is likely appropriate for a majority of firms
- Most investors assert that **organic EPS growth is worth more** than repurchase-driven accretion
- A majority of investors believe that the buyback decision should be influenced by **management’s perspective on value**
- Investors view **token dividends and special dividends as generally less valuable**
- Investors generally **believe in a “dividend premium,”** i.e. a growth adjusted valuation premium for firms paying out strong dividends
- Many investors believe firms wait too long to cut their dividends when cash flow is constrained

### EXECUTIVE TAKEAWAY

J.P. Morgan surveyed investment professionals on a variety of issues regarding shareholder distributions. Respondents were clearly in agreement on several topics, but widely different on others. **This result is consistent with the backdrop against which firms need to make decisions every day—how to satisfy an often disparate set of interests.**

<sup>1</sup> For further details, please see our September 2015 report *2015 Distribution Policy: A trillion reasons to discuss dividends and buybacks* found at [https://www.jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_2015DistributionPolicy.pdf](https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_2015DistributionPolicy.pdf)

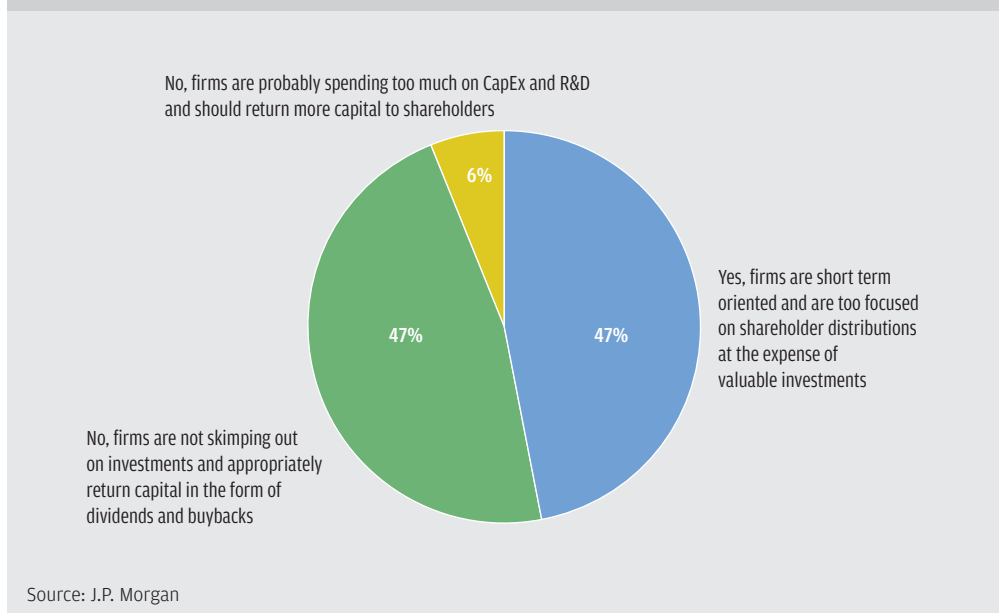
## 2. Wiser by the dozen: Insights from investors on twelve capital allocation questions

### 2.1 Are companies myopically returning capital to shareholders at the expense of investments and long-term growth?

Political and economic commentators suggest that the rise in shareholder distributions has come at the expense of corporate investments. In contrast, a number of prominent corporate executives and investors insist that robust shareholder distributions do not portray a short-horizon vision for the firm. Rather, they regard these shareholder distributions as the result of, and justified by, strong free cash flow generation and, potentially, a lack of attractive investment opportunities.

Figure 1

**Some prominent figures argue that firms are too short-term oriented and distribute capital at the expense of long-term investments. Do you believe firms are curtailing investments to favor shareholder distributions?**



As illustrated, institutional investors were **evenly divided between the notion that firms are too focused on shareholder distributions and the idea that firms appropriately balance dividends and buybacks with investments**. Interestingly, only a small fraction of responses indicated that firms have tilted too far toward investing too much. The range of replies suggests that firms need to strike a delicate balance between groups of investors that may be equal in strength but opposite in views. A well-thought out and well-defined capital structure and capital allocation strategy that is clearly communicated to investors can help with this dilemma.<sup>2</sup>

<sup>2</sup> For further details, please see our November 2014 report *To speak or not to speak: Learning from firms' capital structure communication* found at [https://www.jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_ToSpeakOrNotToSpeak.pdf](https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_ToSpeakOrNotToSpeak.pdf) and our September 2014 report *Bridging the Gap Between Interest Rates and Investments* found at [https://www.jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_InterestRatesAndInvestments.pdf](https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_InterestRatesAndInvestments.pdf)

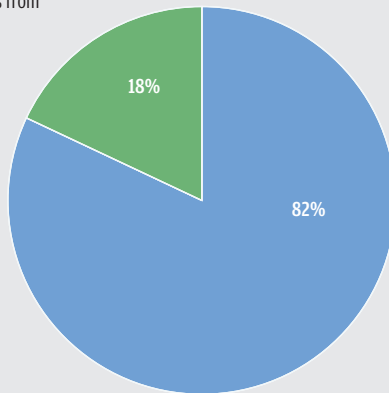
## 2.2 Is all EPS growth created equal?

Firms grow EPS in a number of ways: through top line growth, from cost cutting and efficiency gains, through M&A and associated synergies, or via buybacks (and associated share count reductions). Some argue that organically generated EPS accretion/growth is more beneficial than growth generated through share repurchases. Others consider that this is not necessarily the case, since share repurchases are themselves a sign of healthy cash flow generation from the underlying business or a view of management that the shares are undervalued.

Figure 2

**Some argue that EPS growth/accretion from different sources should be viewed and valued differently**

No, it doesn't matter where the EPS accretion comes from



Yes, EPS from organic growth is more valuable than EPS growth from share buybacks

Source: J.P. Morgan

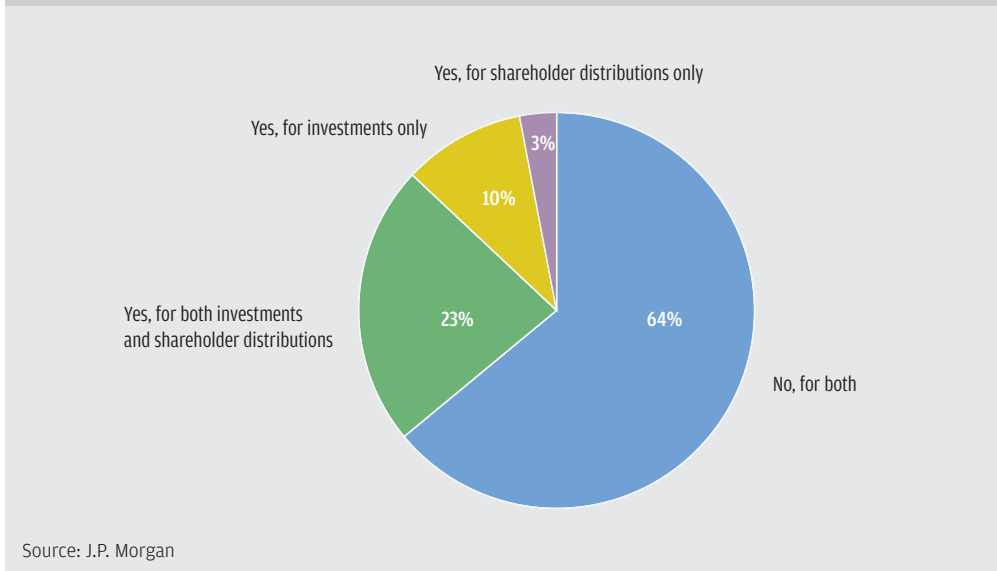
Our survey results suggest that **investors clearly prefer organically generated EPS growth** over accretion that is obtained through share repurchases. While this view is not surprising, it is critical that firms not prioritize projects that fail to earn their cost of capital for the sake of generating organic EPS growth. Share repurchases would be a wiser use of capital in such circumstances.

### 2.3 Should companies repatriate offshore cash?

The immediate tax cost of offshore cash repatriation and the hope for a tax holiday in the future have pushed many U.S. domiciled firms in recent years to instead tap the debt capital markets to finance domestic cash needs. However, these firms also face increasing investor pressures to repatriate some or all of their offshore cash balances. As a result, a few companies have already repatriated offshore cash, and an increasing number of firms are contemplating “biting the bullet” to repatriate offshore cash to finance domestic needs. The ultimate decision depends on a number of factors, including the ultimate use of proceeds.

Figure 3

**Many firms today keep cash offshore for tax reasons. Do you believe firms should pay the repatriation taxes and bring the cash back?**



About **two-thirds of the investors surveyed support most firms’ decision not to repatriate cash** for either investments or shareholder distributions. This sentiment is likely driven by the hope for a repatriation tax holiday and has contributed to the growing overseas cash stockpiles of U.S. firms.<sup>3</sup> Among the one-third of investors concluding that firms should repatriate offshore cash, two-thirds of this subset felt it should be deployed for both shareholder distributions and investments. Should offshore cash continue to rise and/or the hope for a tax holiday fades, firms and investors will increasingly evaluate the costs and benefits of repatriating cash for domestic use.

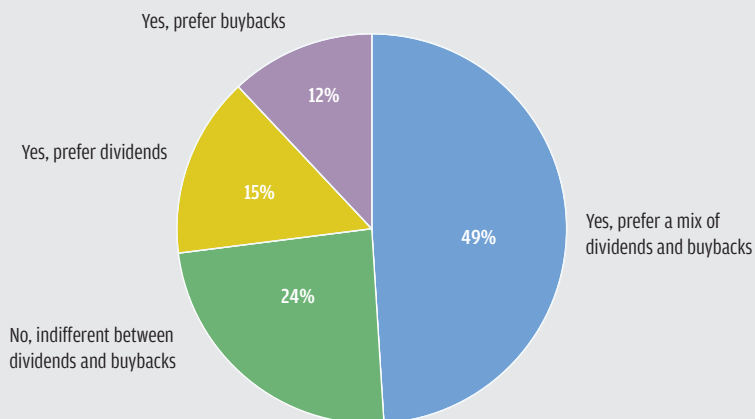
<sup>3</sup> For further details, please see our December 2015 report *The name is Cash, just Cash: Demystifying the “spectre” of record high corporate cash* found at [https://www.jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_TheNameIsCash.pdf](https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_TheNameIsCash.pdf)

## 2.4 Dividends or buybacks? Or both?

Both dividends and share buybacks have appeal, and their relative pros and cons are often hotly debated at senior management levels. As firms grapple with this decision, they carefully evaluate a number of factors, such as the stability of their cash flow, intrinsic valuation, growth profile, macroeconomic conditions, and, last but not least, investor sentiment. While some smaller firms do *either* dividends *or* buybacks, but not both, the vast majority of large firms return capital using *both* dividends and buybacks.

Figure 4

### Do you have a preference for how firms return capital?



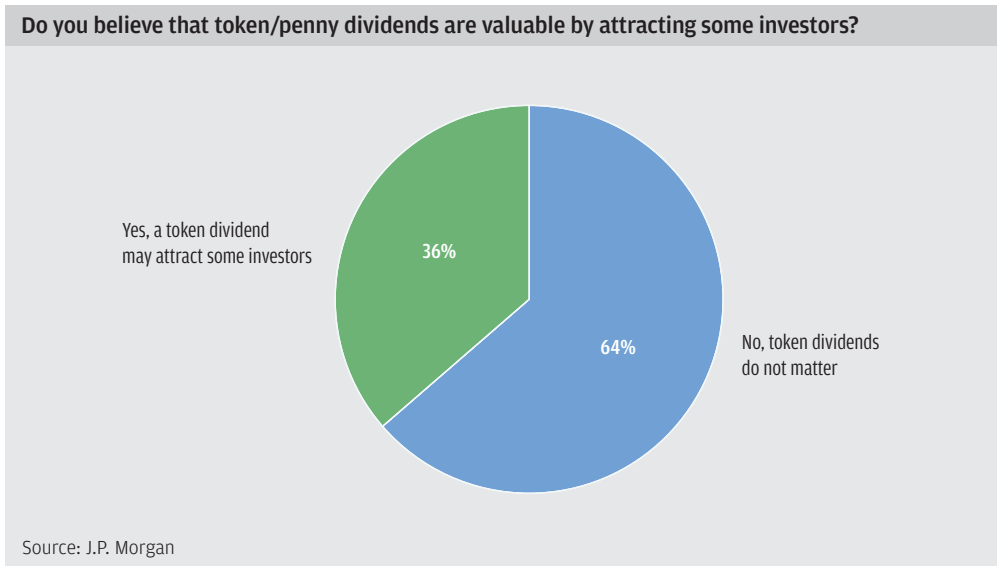
Source: J.P. Morgan

Approximately one-fourth of investors surveyed demonstrate strong preferences for dividends over buybacks or vice versa. In aggregate, however, investors did not demonstrate a preference for dividends over buybacks, or vice versa. Half the respondents indicated their desire for firms to employ both dividends and buybacks to return capital. That is very much in line with the preferred distribution method of most large U.S. firms. The results indicate that while firms often agonize over the dividend versus buyback decision, **for most firms the actual question should not be “which one?” but rather “how much of each?”**.

## 2.5 Does a token dividend make sense?

Because a regular dividend sends a signal of long-term financial stability, one could infer that a token dividend (such as a penny a quarter) would lack value. A number of firms, however, pay (or consider paying) a token dividend, hoping to qualify their stock for specific investor classes, such as yield funds.

Figure 5



**Two-thirds of investors surveyed felt that paying token dividends were not worthwhile,** while one-third felt that a token dividend may offer some value. These results are particularly topical for firms in two separate camps. The first camp comprises commodity-oriented firms grappling with whether to cut or eliminate their dividend as cash flow declines. While the majority of investors believe maintaining a token dividend does not matter, given more than one-third still see some benefit to it suggests that a dividend cut to a very low payout may offer incremental value over a complete elimination. The second group consists of those firms considering the initiation of a dividend to signal long-term stability. These results favor a meaningful dividend and the following question (2.6) addresses this topic further.

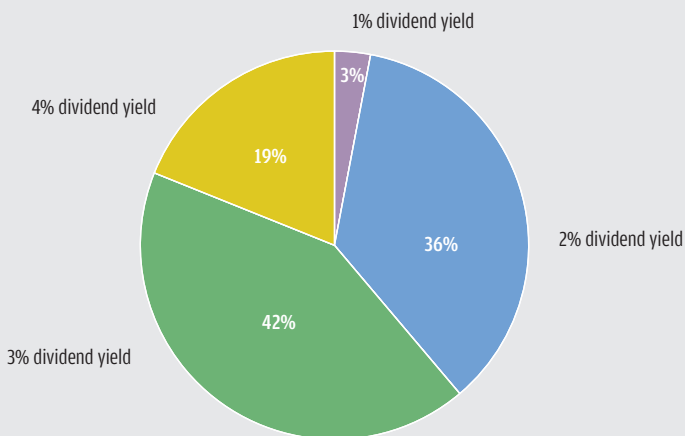


## 2.6 At what level is a dividend yield attractive?

Investors look at a number of metrics with respect to dividends including payout ratio and growth history, but perhaps none more so than dividend yield. The dividend yield is often compared to the yield on a number of other investment alternatives from Treasuries to real estate. A dividend yield cannot be studied in isolation, but rather in the context of the growth story, the payout policy, and the capital structure of the firm. Still, many do tend to look at the yield as a short-cut metric for comparison of a stock versus its peers or versus an index.<sup>4</sup>

Figure 6

At which dividend yield level does a firm become attractive from a dividend yield perspective?



Source: J.P. Morgan

The largest group of investors find a firm **attractive from a dividend yield perspective at a yield of 3% or higher**. There is, however, much dispersion over the “threshold” number. Over a third of respondents mentioned that a yield of 2% is also attractive while a fifth of respondents claim that the yield is not attractive unless it is above 4%. As firms size their dividends, they should **focus not just on their yield but also on payout ratio and regular, sustainable growth**, since the yield may be driven by stock price-related factors out of their control. Firms should also bear in mind that the attractiveness of relatively lower dividend yields may fade should interest rates or index yields rise. Similarly, the attractiveness of a relatively higher yield is relatively contextual, i.e., if the stock is down as a result of stress on liquidity, implying the risk of a future dividend cut.

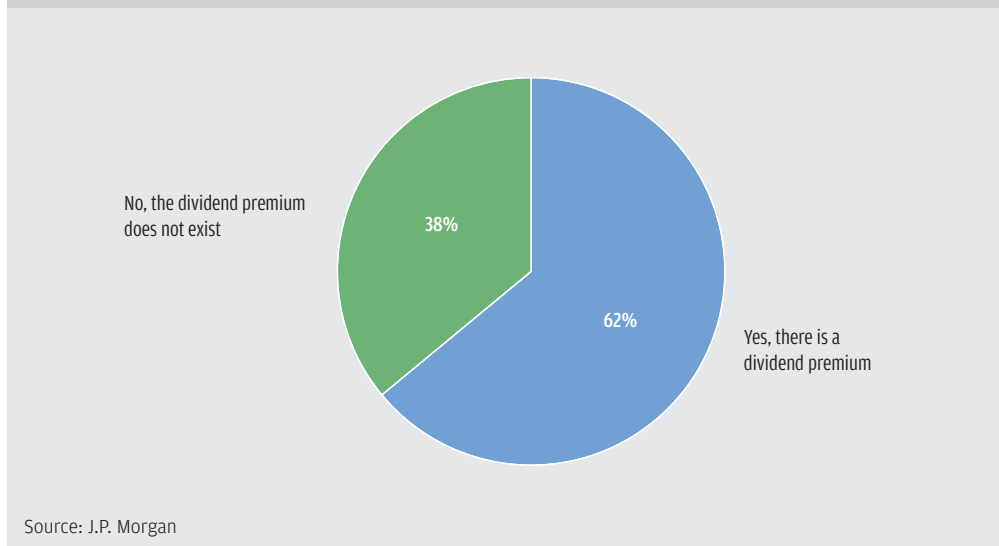
<sup>4</sup>For reference, the dividend yield of the S&P 500 is typically in the range of 2.0%-2.5%

## 2.7 Is there a dividend premium?

The benefits of paying a healthy dividend are well known, but the materiality of such benefits is often debated. In recent years, we have coined the term “dividend premium” to highlight that firms that are top dividend-payers often trade at a higher P/E ratio relative to their expected growth.<sup>5</sup> Many investors and corporate decision makers alike debate the value of a strong dividend not only in today’s environment of low interest rates, but also through the economic cycle. Is it just in today’s yield-starved environment that higher dividends provide a valuation pick-up? Or is the dividend premium a through-cycle phenomenon?

Figure 7

**Some argue that, all else equal, firms that pay higher dividends always trade at a premium (i.e., the dividend premium)**



Over 60% of investors avow the existence of a dividend premium. This corroborates the notion that for many investors, **dividends signal not only long-term cash flow generation potential to the market, but also capital discipline, despite their tax disadvantages to many.** Interestingly, those who believe in the dividend premium are not necessarily the respondents who favor firms choosing only dividends as their preferred mechanism to return capital to shareholders; in fact, 61% of this group favors firms adopting a mix of dividends and buybacks.

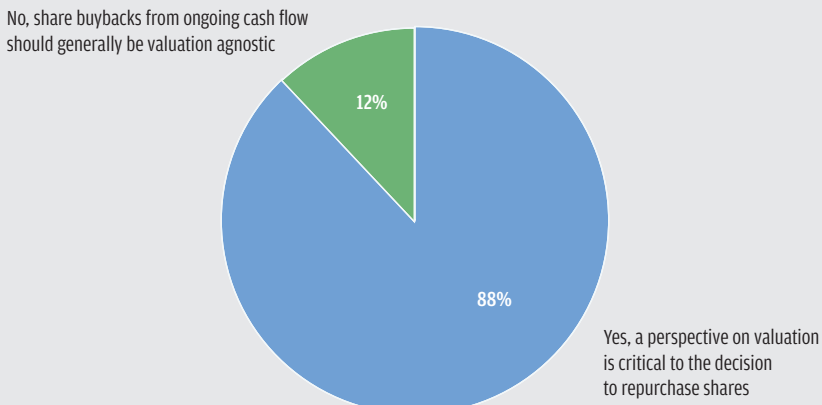
<sup>5</sup> For further details, please see our February 2012 report *2012 Distribution Policy: Dividend and share repurchase facts and trends* found at [https://www.jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_2012DistributionPolicy.pdf](https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_2012DistributionPolicy.pdf)

## 2.8 Should valuation influence share repurchases?

While firms tend to repurchase shares through the cycle, they often dial repurchases up or down, based on a variety of factors, including the availability of investment opportunities and liquidity. A key question in this context is whether senior management perspective on valuation should be added to this list. Some argue that firms generate stronger returns on repurchases in the long run when they take a valuation-agnostic approach and dollar cost average their repurchases. Others, however, opine that no one knows the value of the firm better than the managers themselves, implying that firms should take a valuation-driven approach to share repurchases.

Figure 8

**Should management's perspective on their stock valuation influence their decision to buy back shares?**



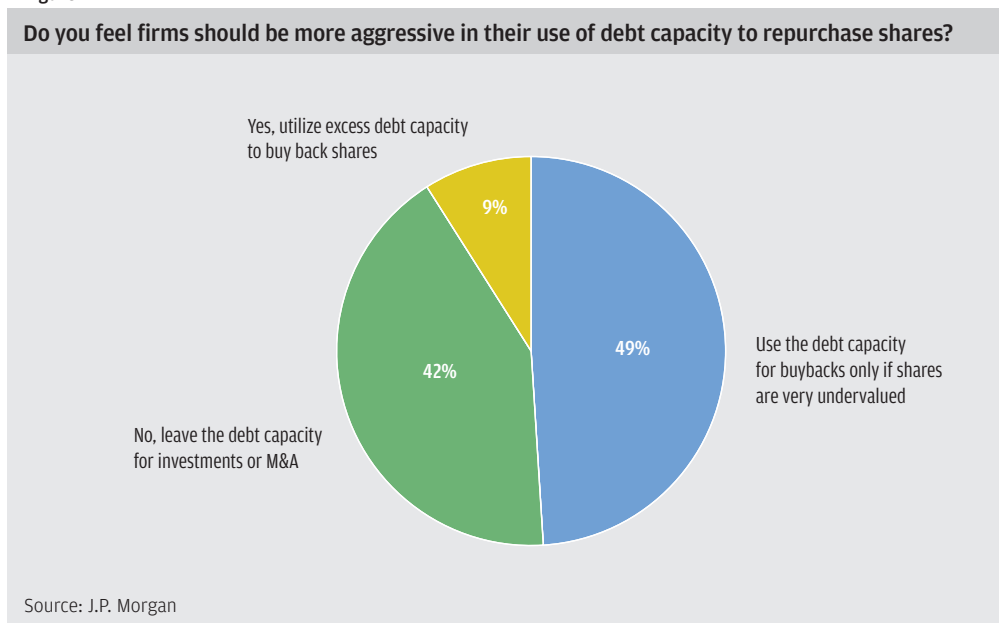
Source: J.P. Morgan

**The vast majority of investors we surveyed agree that a perspective on valuation is critical to the decision to repurchase shares. This does not mean, however, that valuation should be the only determinant of share repurchases.** Rather, this vote indicates that when firms dial their share repurchases up or down, based on current and expected cash flows, valuation should be one of the key factors they consider. It is perhaps not a surprise, however, that institutional investors feel strongly about this question. They are, after all, professionals regarding the selection of under- or over-valued stocks.

## 2.9 Should firms access debt capacity to repurchase shares?

The historical sentiment has often been that firms accessing their debt capacity to repurchase shares are signaling a potential lack of investment opportunities. The evidence shows, however, that most firms announcing a debt-financed buyback experience a positive market reaction. In recent years, the depth and breadth of the capital markets have been coupled with strong cash flow generation and rising debt capacity of firms. As a result, voices to use the debt markets to repurchase shares have been strong, at least until a few months ago. Despite the positive investor reaction to debt-financed buybacks, many firms still elect to repurchase shares only with ongoing free cash flow, preferring to retain debt capacity for growth investments and acquisitions.

Figure 9



Half of investors indicated a preference for the use of debt capacity for buybacks—but only if shares are very undervalued. Another 40% believe debt capacity should be preserved for investments or M&A. Not surprisingly, **100% of respondents who said to use debt capacity for buybacks when the firm was undervalued also indicated that the firm’s view on its valuation should influence the decision to buyback shares.** The results of the previous two questions are particularly relevant for those firms suffering stock price weakness today. A question for those firms with strong cash flow and liquidity, as well as management conviction regarding the long-run potential of their stock – is now an appropriate time to accelerate share repurchases?

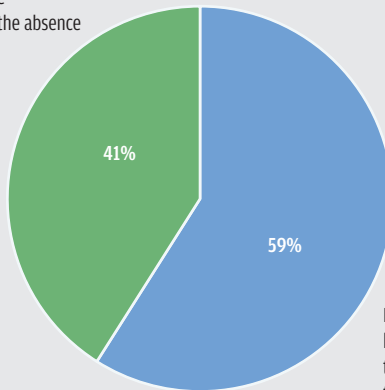
## 2.10 Do investors have confidence in buyback announcements?

When firms announce a share repurchase authorization, they do not always simultaneously announce a timing and execution plan, nor do they always complete the full amount announced in a timely fashion. As a result, some investors view buyback announcements skeptically. How can we place full faith in the announcements, these investors ask, when even the best laid plans go awry? Others, however, argue that share repurchase authorizations give firms optionality and flexibility and that firms appropriately postpone some buybacks when more attractive uses of cash emerge or when liquidity has become scarce.

Figure 10

### Do you have a lot of confidence in buyback announcements?

Yes, firms typically repurchase as much as they announce in the absence of unexpected events



No, firms generally tend to announce larger repurchase authorizations than what they actually intend to repurchase

Source: J.P. Morgan

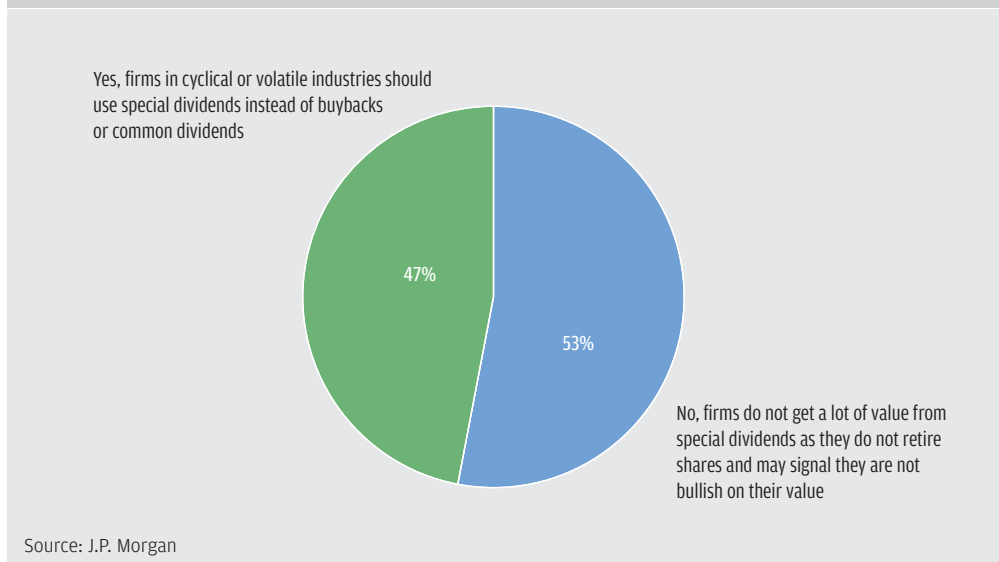
Approximately **60% of investors mentioned that they are skeptical of the repurchase plans firms announce.** The other 40% said they expected firms to carry through on their plans, absent unforeseen events. These results have significant implications for firms, particularly as they look to share repurchases as a way to capitalize on recent market weakness. Firms can boost the perceived credibility of their intentions by announcing concrete plans (in terms of timing and/or execution mechanism) to repurchase the shares. While this marginally impacts flexibility, these constraints may be outweighed by the benefits of stronger market signaling for most firms.

## 2.11 What is the value of special dividends?

While share buybacks are undoubtedly an efficient way for most firms to return capital to shareholders, an oft-repeated objection is that, in hindsight, firms often repurchase shares at elevated stock prices. Common dividends are valuation agnostic but they are expected to be progressive, that is, shareholders expect dividends to increase in line with earnings, but not to be cut when earnings decline. A third distribution method, special dividends, are valuation agnostic like common dividends, but are also widely expected, unlike common dividends, to increase and decrease with earnings. This raises the question of whether special dividends are a worthy alternative to share repurchases.

Figure 11

### Some firms believe that special dividends are a good way to avoid the buy high buyback phenomenon



Investors were **roughly split on the benefits of special dividends in cyclical industries**. This does not mean that every investor believes firms should be indifferent between special dividends and share buybacks. Depending on the composition of the firm's shareholder base, trading volume and liquidity, perspective on valuation, etc., a special dividend may make significantly more sense than a share repurchase. In fact, for some firms, a "recurring special dividend", or a variable dividend, is a better choice than share repurchases to return capital incremental to their common dividend.<sup>6</sup>

<sup>6</sup> For further details, please see our February 2012 report *2012 Distribution Policy: Dividend and share repurchase facts and trends* found at [https://www.jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_2012DistributionPolicy.pdf](https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_2012DistributionPolicy.pdf)

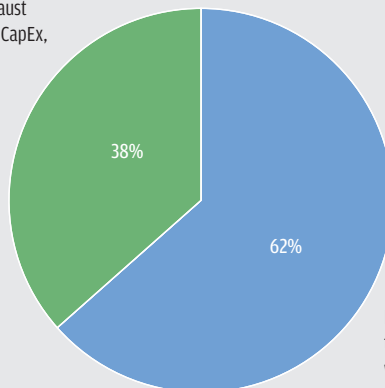
## 2.12 When should companies cut the common dividend?

Many firms view the common dividend as sacrosanct, and will go to great lengths to protect their dividends. But is it possible they may go too far? Is it worth cutting down on investments, downsizing, and raising equity to preserve the ability to pay a consistent dividend? This question is particularly relevant in 2016 when many commodity-oriented firms have already announced dividend cuts while many others are straining to keep their dividend. Should they consider deeper capex cuts before reducing the dividend?

Figure 12

### How or when should firms consider cutting their common dividend?

Firms should not cut the dividend quickly, but instead first exhaust all other options like cutting CapEx, G&A, and/or raise equity



Firms tend to wait too long to cut the common dividend when there is a downturn

Source: J.P. Morgan

**The majority of investors affirm that firms wait too long to cut their dividends in a downturn.** While they do appreciate the long-term signaling benefit of a dividend, they value downside protection and liquidity conservation to an even greater extent. As expected, investors preferring dividends to buybacks are more likely to state that firms should not cut their dividend quickly, while investors indifferent between dividends and buybacks are slightly more in favor of firms cutting their dividend. This indicates that while the firm's decision to cut its dividend is driven by available resources, the market reaction is additionally driven by the preferences of existing and potential investors. Firms should also maintain an active dialogue with their investors as this will be the most accurate way to identify the sentiment towards their payout policy.

### 3. 2016 Distribution Policy

Shareholder distributions have come under intense scrutiny in the last couple of months due to global macroeconomic headwinds and the associated financial market volatility.<sup>7</sup> During periods of elevated uncertainty, investors tend to be extra-sensitive to news and announcements. In a quest to unlock shareholder value, boardrooms are increasingly re-evaluating their financial policy decisions. Key questions in this decision matrix include “How much capital should I return to shareholders?” and “What is the best form of returning such capital?”.

We surveyed investors on a variety of topics related to shareholder distributions, to better assist firms with this complex and subtle decision making process. The results of the study are admittedly nuanced, but do provide interesting takeaways for firms in the current environment:

- A **perspective on valuation is necessary** for the share-buyback decision-making process. In fact, investors support even debt-financed share repurchases if management has strong conviction that their shares are undervalued. Firms with access to capital and anticipating a 2009-like recovery could find this an opportune time to repurchase shares
- Share buybacks can boost value, but cannot replace investing in growth initiatives, since **investors view organic EPS growth as more valuable** than non-organic EPS growth
- Overall, investors believe in a “dividend premium” for high dividend paying stocks. Therefore, firms with strong capital bases can capitalize on this by **maintaining, or even moderately increasing, their common dividend** to the extent possible
- A **majority of investors support most firms’ decision to keep cash offshore** for tax reasons. A sizable and potentially vocal minority of investors would, however, support repatriations for investments or shareholder distributions

#### EXECUTIVE TAKEAWAY

J.P. Morgan surveyed investors on their shareholder distributions preferences. On many issues, investors displayed conflicting opinions. This does not necessarily mean that a particular firm may be faced with investors with disparate views. Firms can gauge their shareholders’ sentiments through constant monitoring of, and active dialogue with, their shareholder base. Recent market dislocations provide an ideal opportunity for firms to enhance shareholder value through modifying or enhancing shareholder distributions.

<sup>7</sup>For further details, please see our February 2015 report *Here We Go Again... Financial Policies in Volatile Environments* found at [https://www.jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_FinancialPoliciesInVolatileEnvironments.pdf](https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_FinancialPoliciesInVolatileEnvironments.pdf) and our August 2015 brief *A bull or a bear in the China shop?* found at [https://www.jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_BullOrBearInChina.pdf](https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_BullOrBearInChina.pdf)





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