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2015 Distribution Policy

A trillion reasons to discuss dividends and buybacks

J.P.Morgan

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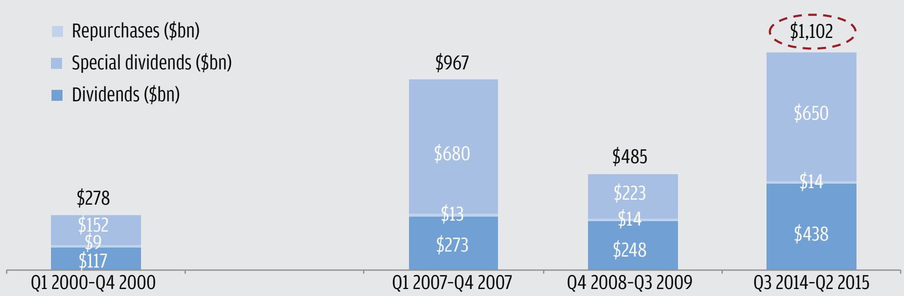
1. Shareholder distributions scale new peaks

Shareholder distributions have not just rebounded from post-crisis lows, but have reached new highs (Figure 1). **In fact, for the first time ever, distributions by Russell 1000 firms over the last twelve months surpassed one trillion dollars!** At $1,102 billion, these firms distributed 10% more than the previous twelve-month peak of $967 billion over the four quarters of 2007. To put this number in perspective, $1.1 trillion could purchase the equity of 143 S&P 500 firms today. This trend has been underpinned not only by a resurgence of share repurchases to near-pre-crisis levels, but also by a material increase in dividends as a percent of total distributions. This is particularly noteworthy considering the fact that most natural resource firms have cut buybacks and put dividend growth on hold, and that American firms with foreign operations are experiencing significant earnings pressure due to the strong U.S. Dollar.

Figure 1

A trillion reasons to discuss distributions



	Q1 2007-Q4 2007	Q4 2008-Q3 2009	Q3 2014-Q2 2015
Repurchases CAGR since 2000	25%	4%	11%
Dividends CAGR since 2000	13%	9%	10%

Source: J.P. Morgan, Bloomberg
Note: Shows cash dividends and repurchases of common stock each year for Russell 1000 firms; LTM data as of 8/31/2015; CAGR calculations use base year of 2000

Capital allocation to shareholder distributions continues to be one of the main topics companies discuss at the board level. These passionate debates are not surprising. Firms that allocate **"too little"** may be perceived as being either not shareholder friendly or undisciplined. Worse, they might even become a target of a public campaign by activist investors to demand more aggressive shareholder returns. On the other hand, firms that allocate **"too much"** to distributions may be vilified for buying stock at high prices or for chasing near-term gratification and forgoing investments in the future. Even worse, they may also find themselves short of liquidity in a downturn, compelling them to cut their dividend and possibly raise expensive equity to shore up their balance sheets.

In our previous annual reports on distributions, we discussed how the ongoing low interest rate environment, coupled with evolving investor preferences, has helped to shape the evolution of the corporate distribution policy landscape.[1] We showed that firms with strong distribution policies outperform through economic cycles, including in the current environment. We have also debated the "buy high-sell low" phenomenon extensively.[2]

[1] For further details, please visit previous reports such as "2014 Distribution Policy: Challenging conventional wisdom about dividends and buybacks" and "2013 Distribution Policy: How macro views shape the dividend vs. buyback dilemma" at https://www.jpmorgan.com/pages/cib/investment-banking/corporate-finance-advisory/archive

[2] For further details, please visit previous reports such as "2012 Distribution Policy: Dividend and share repurchase facts and trends" and "Buy High, Sell Low: Evaluating pre-crisis buybacks with perfect hindsight" at https://www.jpmorgan.com/pages/cib/investment-banking/corporate-finance-advisory/archive

In this report, we highlight key aspects of the current distribution policy landscape with a **focus on company guidance, payout ratios, and how offshore cash is likely to affect the future distribution policy debate.** Together with previous reports, we hope this report provides an evolving, yet robust, framework for firms to develop and articulate their policies going forward.

Key statistics about today's distribution landscape include:

- **$1.1 trillion:** Russell 1000 distributions over the last 12 months
- **>100%:** The total payout ratios for S&P 100 firms
- **1/3 vs. 2/3:** The dividend vs. buyback allocation for S&P 500 firms
- **86%:** Percent of the largest firms providing distribution policy guidance
- **10–11%:** Annual growth rates for dividends and buybacks since 2000
- **15%:** Returns for Dividend Aristocrats when rates rose from May 2013 to December 2013
- **15% vs. 3%:** Growth rate in offshore vs. onshore cash for S&P 100 firms
- **$1 trillion:** Estimated funding needs for S&P 100 firms for the next four years based on the offshore/onshore split and current payout levels
- **50%:** Increase in S&P 500 dividend cuts over the last 12 months vs. 2013

Market uncertainty, regarding a number of factors such as long-term interest rates, global growth rates, and exchange rates, is currently at elevated levels. This makes considerations around distribution policy and communication strategy paramount for maximizing shareholder value.

EXECUTIVE TAKEAWAY

Russell 1000 firms returned more than $1.1 trillion of capital to their shareholders over the last twelve months, surpassing the pre-crisis 2007 record by over 10%. Boards now debate the appropriate level of capital returns more than ever before. Firms that allocate **"too little"** are portrayed as not shareholder friendly and/or not disciplined. Or worse, they become the target of activist investors clamoring for more aggressive shareholder returns. Firms that allocate **"too much"** are vilified for buying stock at high prices or for forgoing investments in the future. Or worse, they find themselves short of liquidity in a downturn, having to cut the dividend and possibly raise equity. While many firms with robust payout policies have been rewarded by the market, recent elevated levels of uncertainty make today an ideal time to revisit distribution policy strategy and communications.

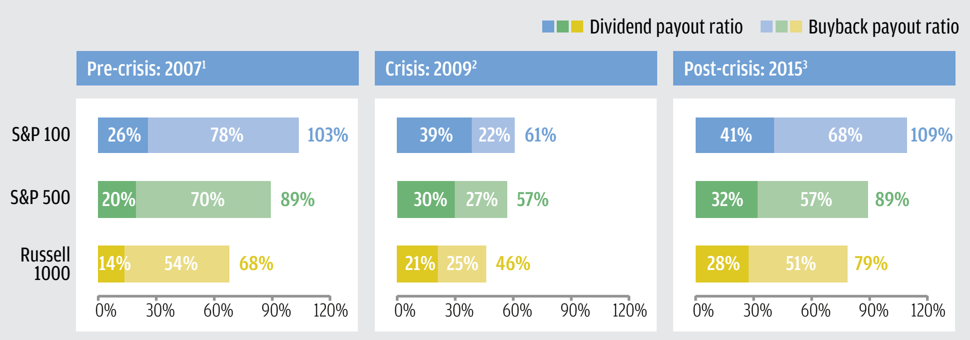
2. Post-crisis, dividends emerge stronger than ever

Dollar amounts distributed have unquestionably reached new peaks. Strong income and cash flow growth has, however, tempered the rise in payout ratios. **Total shareholder payout ratios have also rebounded and are now in line with pre-crisis levels, approximately double their crisis lows.** S&P 100 firms have total payout ratios of over 100% (whether measured by net income or free cash flow). Earnings payout ratios are around 90% for S&P 500 firms, and nearly 80% for Russell 1000 firms (Figure 2). As we will discuss later, many global firms realize less than half their cash flow domestically. These firms therefore borrow incrementally each year to achieve these distribution payouts even as their overseas cash balances continue to grow rapidly.

Despite the sometimes critical media and political attention on share buybacks, we note that while buybacks constitute a larger fraction of returns relative to dividends for all firm sizes, **firms return a greater fraction of their capital to shareholders through dividends today than they did before the crisis.** With regard to buybacks, firms continue to appreciate their flexibility and tax efficiency, their positive impact on EPS, and their bullish signal of value. On the other hand, the signal of long-term growth, confidence, and stability that dividends provide is especially relevant against a backdrop of sluggish growth globally. Further, many firms today realize that investors appreciate total shareholder return predictability, afforded by a reasonable and sustainable yield, particularly in a low rate environment.

Figure 2

Today's payout ratios are near pre-crisis peaks, but with a stronger focus on dividends



Source: J.P. Morgan, Bloomberg
Note: Payout ratios computed relative to net income; excludes firms with negative net income, financial firms, and firms with payout ratios over 300% as outliers; financials accounted for 26% of dividends in 2007 vs. 17% LTM Q2 2015

[1] Q1 2007-Q4 2007
[2] Q4 2008-Q3 2009
[3] LTM figures as of 8/31/2015

EXECUTIVE TAKEAWAY

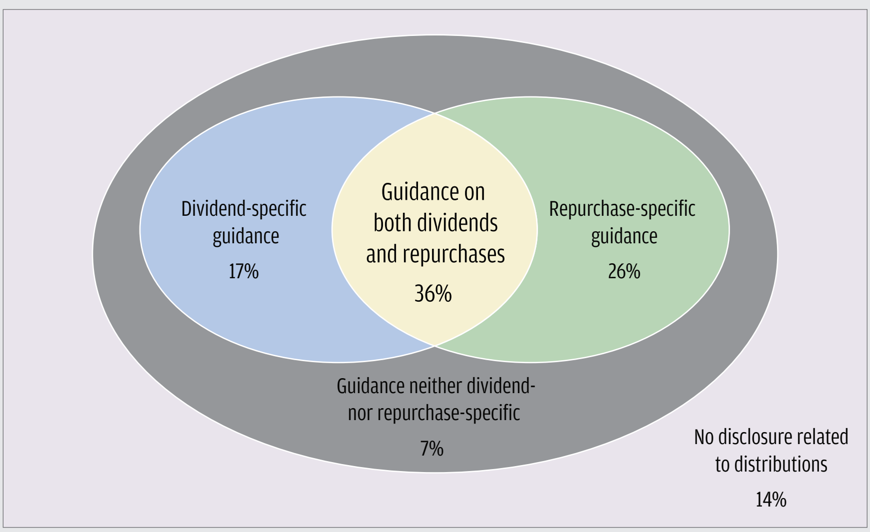
Shareholder payout statistics have rebounded not just in dollar terms but also in relative payout metrics. The largest firms commit all their free cash flow to shareholder distributions, with an increasing amount to dividends.

3. What to communicate publicly?

Given strong cash flow generation, rising cash buildup, and analyst and activist focus on capital allocation, firms are increasingly revisiting their capital allocation policies. **Nearly 90% of the largest firms provide some form of distribution-related guidance,** compared to only about half of that for communication related to capital structure (Figure 3).[3] Close to 40% of firms provide guidance on both dividends and repurchases, with a slight tilt towards communicating repurchases over dividends. This tilt toward buyback guidance appears counterintuitive at first glance, but likely arises from the fact that the dividend process is inherently more predictable. Many of the largest firms have increased their dividend in line with earnings growth, keeping the payout ratios at roughly the same level. This approach reduces the need for explicit dividend guidance beyond the earnings guidance that they already provide.

Figure 3

Shareholder distribution communication policies of large firms



Source: J.P. Morgan, company filings over the last two years for S&P 100 firms

Firms provide guidance on a variety of metrics, but the focus is on dividend growth, payout ratios, and buyback dollar amounts (Figure 4). **Slightly over a quarter of all mega cap firms analyzed provide guidance on dividend growth rates and nearly half of all firms provide guidance on the dollar amounts of share repurchases.**

The focus on communicating dividend growth is particularly evident in more dividend-oriented sectors not represented in the S&P 100, such as MLPs, REITs, YieldCos, where dividend growth guidance is critical to valuations. The lesser focus on payout ratios, whether for dividends or share repurchases, is not surprising, since underlying cash flows and income can vary significantly. This may limit the flexibility of management teams who like to grow the dividends and, at the very least, do not intend to make downward adjustments when income

[3] For further details on financial policy communication, please refer to our November 2014 report "To Speak or Not to Speak: Learning from firms' capital structure communication" located at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_ToSpeakOrNotToSpeak.pdf

temporarily drops. For firms in more stable sectors, dividend payout ratios and growth rates have been rather stable and in line with earnings growth rates. This stability of payout makes incremental disclosure less informative.

Figure 4

Public dividend and buyback guidance varies significantly

	Percentage of S&P 100 firms providing guidance		Sample shareholder distribution communication
Dividends	Dividend growth guidance	28%	"The dividend is important to us and we'll continue to grow it and perhaps it will grow a little faster than earnings as we have in the last few years." - Consumer firm
	Payout ratio guidance	21%	"We intend to continue to pay... according to our annual dividend policy, which remains at approximately 50% of the prior year's cash earnings." - Technology firm
Repurchases	Buyback dollar amount guidance	45%	"Share repurchases for the five-year range, 2013 to 2017, we're expecting to buy back shares between $20 billion and $22 billion." - Industrials firm
	Share count-related guidance	8%	"This ongoing repurchase program enables us to progress on our related goal of reducing total outstanding share count to below 300 million shares by the end of 2017." - Industrials firm

Source: J.P. Morgan, company filings over the last two years for S&P 100 firms

EXECUTIVE TAKEAWAY

A significant majority of large firms provide guidance on their shareholder distribution policy. Many firms provide enhanced visibility into dividend growth, payout, and intended buyback sizing in dollar terms. The stability of dividend growth rates and payout ratios in certain sectors diminishes the incremental value of explicit dividend payout information. In general, management teams prefer less explicit payout communication to preserve strategic flexibility.

4. Distributions do not necessarily hurt if rates rise...and dividends may lower volatility during market disruptions

The low-rate environment has served as a catalyst for the recent rise in shareholder distributions. With Fed tightening expected later this year, there is understandably a concern among executives about the impact of rising rates on firms with strong dividend and buyback policies. **Rising rates are, however, typically accompanied by a strengthening economic environment.**[4] **Firms able to leverage the growth in the economy will, therefore, likely see stock price performance in line with the overall market** (Figure 5). In recent periods of rising rates, firms that have a consistent history of raising shareholder distributions in line with growth have not underperformed the market (for example, the Dividend Aristocrats in Figure 5). On the other hand, firms less tied to the economy, such as utilities, which often have "sticky" regulatory constructs, tended to significantly underperform the broader market in such periods.

Figure 5

Yield-oriented sectors leveraged to the economy may be protected during rate hikes

	June 2003–September 2003	December 2008–June 2009	October 2010–February 2011	May 2013–December 2013
10-year UST yield	+149 bps	+189 bps	+135 bps	+140 bps
Total returns by index				
S&P 500	4%	7%	15%	17%
Buyback Achievers[1]	8%	10%	17%	24%
Dividend Aristocrats[2]	3%	6%	7%	15%
MLP Index[3]	3%	39%	10%	7%
REIT Index[4]	n/a	(4%)	9%	(11%)
Utility Index[5]	(3%)	(5%)	2%	(6%)

Source: J.P. Morgan, Bloomberg, S&P
Note: Shows total return of each index and assumes reinvested dividends
[1] NASDAQ US Buyback Achievers Index is comprised of NASDAQ or New York Stock Exchange listed securities issued by corporations that have effected a net reduction in shares outstanding of 5% or more in the trailing 12 months, rebalanced quarterly
[2] S&P 500 Dividend Aristocrats Index is comprised of companies within the S&P 500 that have followed a policy of consistently increasing dividends every year for at least the last 25 years
[3] MLP (Master Limited Partnership) index based on the Alerian MLP Index
[4] REIT (Real Estate Investment Trust) index based on the MSCI US REIT Index
[5] Utility index based on the Philadelphia Stock Exchange Utility Index

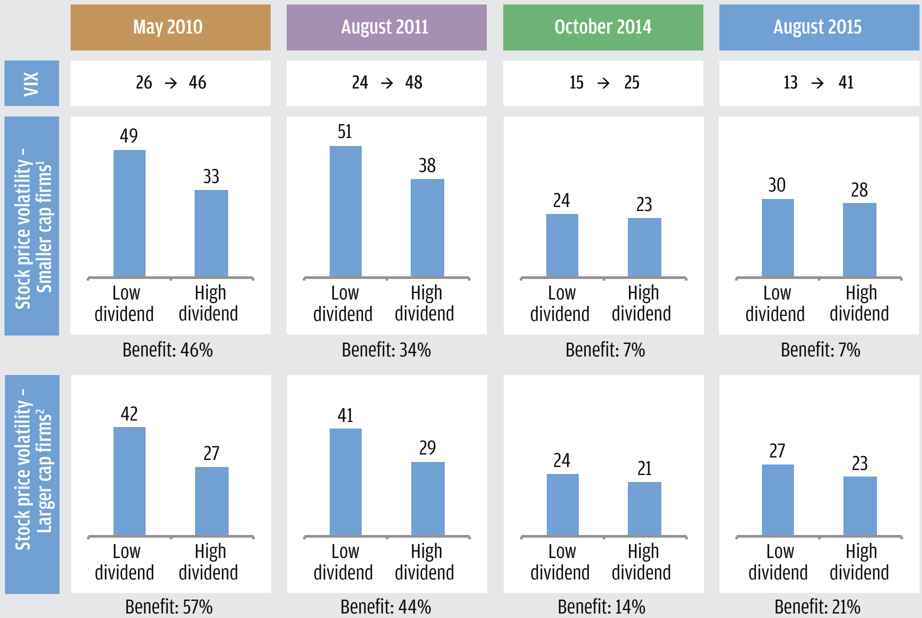
The impact of the Fed raising its benchmark rate on long-term rates is unclear. While the expectation is for long-term rates to increase, there is no consensus regarding the timing and pace at which this will evolve. This uncertainty could lead to marked volatility in financial markets in general, around Fed announcements or around economic news that may change interest rate expectations. **During periods of heightened market volatility, robust dividend policies could mitigate the impact of this uncertainty on such firms.**

[4] For further details on rising rates, please refer to our May 2013 report "When Rates Take Off: Corporate finance implications of rapidly rising interest rates" located at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_WhenRatesTakeOff.pdf

As Figure 6 shows, firms with high dividend yields tend to have lower stock price volatility, even after controlling for firm size, during market disruptions. The most recently observed period of elevated market volatility also illustrates the potential benefits of a strong distribution policy. Of course, many firms have also used recent price weakness as a buying opportunity for their share repurchase plans.

Figure 6

Strong dividend policies mitigate the impact of market disruptions



Source: J.P. Morgan, Bloomberg
Note: Shows 20-day equity volatility on day of VIX peak (May 20, 2010; August 8, 2011; October 15, 2014; and August 24, 2015); volatility peaks defined as a 50% or greater spike in VIX within one week with no peaks in the preceding 90 days; "Low dividend" firms defined as those having a dividend yield in the lowest third of the S&P 500, and "High dividend" firms defined as those having a dividend yield in the highest third of the S&P 500
[1] S&P 500 in the lowest third of the index by market capitalization
[2] S&P 500 in the highest third of the index by market capitalization

EXECUTIVE TAKEAWAY

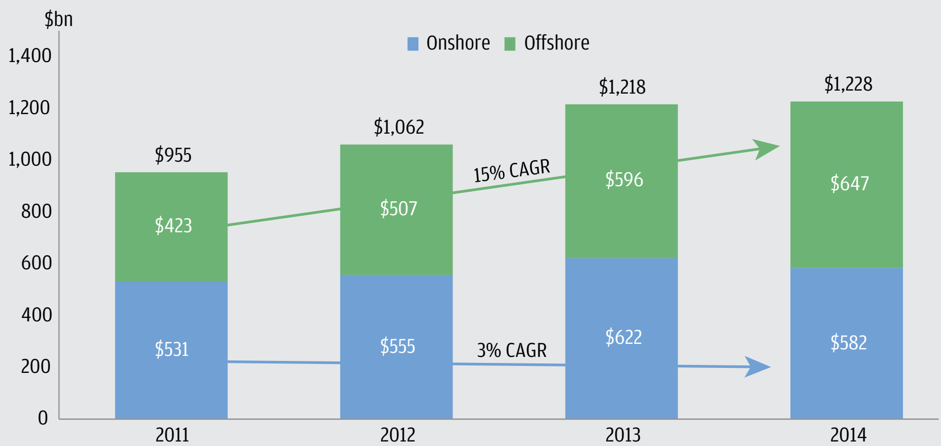
Higher interest rates may put pressure on the valuations of strong dividend payers. This pressure is, however, more likely a reflection of the potential sensitivity of strong-dividend-paying firms to broader economic growth—which typically accompanies rate increases. Strong dividend payers with leverage to the economy perform in line with the market during rate rises. Despite this potential valuation uncertainty, dividends appear to help mute stock price volatility during market disruptions.

5. The offshore cash challenge

The tax cost of offshore cash repatriation has pushed many firms to dip into their domestic cash balances to finance shareholder distributions. Consequently, **despite strong domestic cash flow generation, onshore cash levels have been flat in recent years for many large firms** (Figure 7). Driven by relatively higher overseas growth, offshore cash has grown at 15% annually over the last three years for the S&P 100 versus 3% annually for onshore cash. After years of steady increases, domestic cash balances dipped in 2014. This reversal is driven by growing offshore cash generation vs. increasing domestic cash flow needs (for capex, R&D, debt payments, distributions and M&A).

Figure 7

For the S&P 100, domestic cash balances are stagnating while offshore cash continues to build

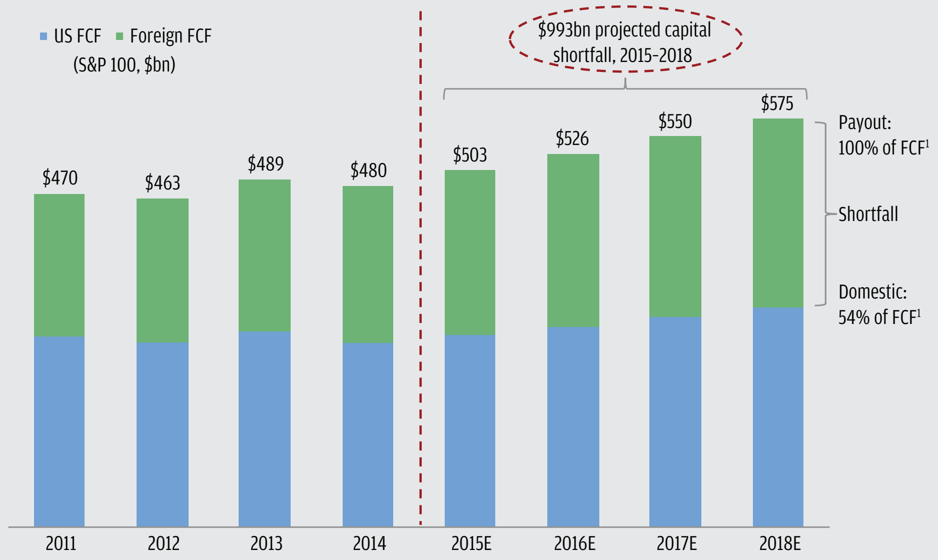


Source: J.P. Morgan, Bloomberg, company filings
Note: Shows onshore and offshore cash balances for S&P 100 non-financials as of each year

Ready access to capital markets in recent years has allowed firms to raise debt capital quickly and inexpensively, limiting the impact of the pressures on domestic cash balances. While this cooperative environment is generally expected to continue in the near-to-medium term for most firms, the long-term consequences are unclear. **Assuming payout ratios remain constant, and the split between domestic and international cash flow remains static, firms may need to raise nearly $1 trillion of debt capital in the next four years to finance shareholder distributions and all other domestic cash outlays** (Figure 8). Most large cap firms have strong ratings and S&P has recently given credit for trapped cash in computing credit metrics. Regardless, the long-term consequences of these ballooning balance sheets are not fully understood.

Figure 8

Firms may need to raise capital to fund distributions at current payout ratios



Source: J.P. Morgan, Bloomberg, company filings
Note: Excludes financials
[1] Free Cash Flow ("FCF") computed as operating cash flow less capex, and projects 2015-2018 FCF based on 2011-2014 annualized growth rates; applies 2014 geographic sales split to FCF projections; assumes 100% payout ratio and cash payouts made with US FCF with remainder funded by debt

EXECUTIVE TAKEAWAY

Rising offshore cash generation creates a tension between investor expectations for large capital return and the need to fund domestically if trapped cash is not repatriated. In the absence of a change in corporate behavior or tax legislation, S&P 100 firms are likely to need nearly $1 trillion in financing to close the funding gap through 2018.

6. Summary takeaways

At over $1.1 trillion, shareholder distributions have hit at an all-time high in the U.S. Recent market volatility is, however, potentially challenging some firms' financial policies. Here are key questions that surface in this environment:

What should I communicate publicly?

Most firms provide guidance on their distributions. Investors always prefer greater guidance as it provides them with more clarity. Despite this, management teams may hold back on communicating dividend payout or growth as this may hamper their flexibility.

What happens when rates rise?

Firms leveraged to the economy will likely be buffered against changing investor preferences in a rising rate environment. On the other hand, firms that have benefited from the dividend premium despite limited leverage to the economy may temporary suffer as investors adjust to a new yield environment.

How should my shareholder distribution plan adapt to periods of elevated market volatility?

Strong dividend policies can help mute equity volatility. Furthermore, a share repurchase policy that incorporates sufficient flexibility to accelerate repurchases opportunistically may offer additional upside. To the extent enhanced volatility signifies an economic downturn to come, liquidity may come at a higher premium and distributions may need to be reduced.

How do offshore cash flows affect distributions?

Favorable capital markets have allowed firms to issue debt to fund their domestic cash needs, including distributions. This approach may, however, be challenged when funding costs increase and/or balance sheets balloon.

Notes

Notes

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