2014 Distribution Policy

Challenging conventional wisdom about dividends and buybacks

J.P.Morgan

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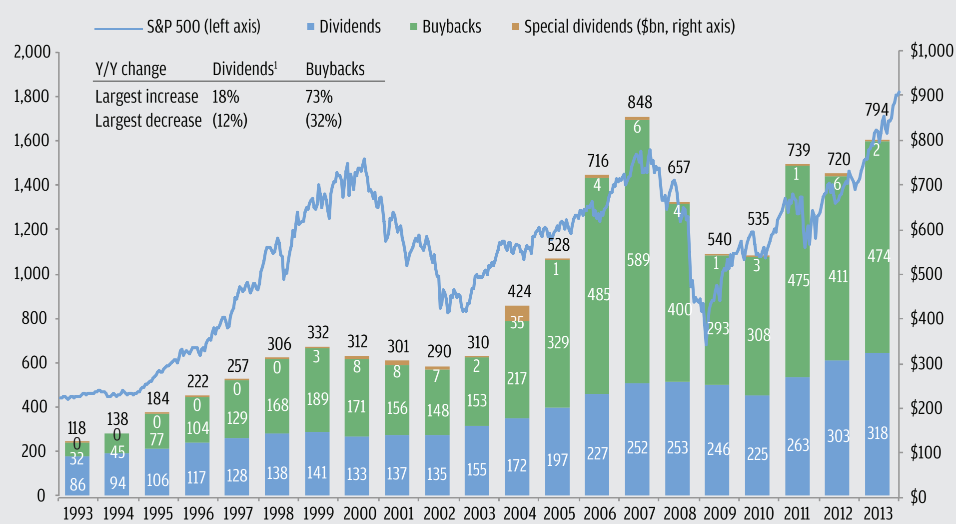
1. Shareholder distributions continue to rise

Shareholder distributions continued to increase in 2013, driven by both rising dividends and buybacks (Figure 1). Total common dividend payments by S&P 500 firms have scaled new peaks, rising by $15 billion to $318 billion over the past year. Aggregate share repurchases have surged from a recent low of $293 billion in 2009 to $474 billion. While this rise in buybacks is significant, the buyback total remains $115 billion shy of the all-time high of $589 billion, achieved in 2007.

Figure 1

S&P 500 distributions vs. S&P 500 index, 1993–2013



Source: Bloomberg, FactSet, S&P Index Services
[1] Excluding special dividends

These trends have not been limited to the U.S. In all but one of the major markets analyzed, growth rates for dividends have been materially higher over the last 10 years than over the preceding decade. In particular, dividend-growth rates in Germany, Japan and Canada were multiples of their respective growth rates in the preceding decade (Figures 2A and 2B). When analyzing this data, it should be noted that this growth is especially noteworthy because it includes the drop during the financial crisis. As part of this trend, yields have also risen meaningfully over the past decade, though they have dipped over the last couple of years on the back of strong equity market performance.

Figure 2A

Dividend yields, 1993–2013

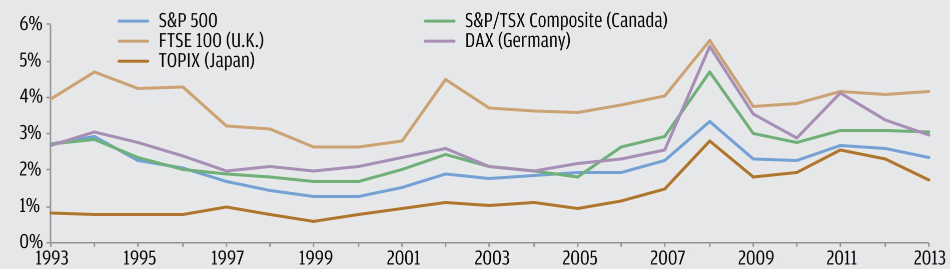


Figure 2B

Dividends paid, 1993–2013

	CAGR	
	1993-2003	2003-2013
S&P 500	6%	7%
S&P/TSX Composite (Canada)	4%	12%
FTSE 100 (U.K.)	4%	5%
DAX (Germany)	4%	14%
TOPIX (Japan)	(1%)	8%

Source: FactSet
Note: Analysis done in local currency and based on aggregate dividends

Distributions have displayed unexpected patterns as they bounced back from crisis lows. In this report, we answer five questions regarding distributions in today's environment. In each case, our answers challenge conventional wisdom.

1. Do growth firms pay dividends?
2. Are technology firms participating in the dividend trend?
3. How high are payout ratios?
4. Will rising rates hurt dividend paying stocks?
5. Do firms overpay during share repurchases?

EXECUTIVE TAKEAWAY

Shareholder distributions have rebounded from their crisis lows and have been embraced by a wide range of firms. Of the entire S&P 500, 84% pay dividends and more than half repurchased shares this past year. Less than 10% did not distribute any cash whatsoever to shareholders. Does the focus on distributions encourage capital discipline or does it starve our economy of needed growth capital?

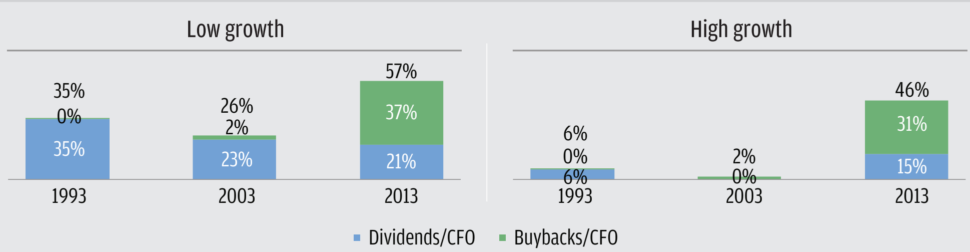
2. Challenging conventional wisdom

2.1 Do growth firms pay dividends?

Conventional wisdom has been that growth firms do not make distributions—and definitely do not pay dividends. Boards often delay dividend initiations for fear that announcing such a strategy would signal the lack of suitable investments. In today's environment of strong cash flows and favorable financing markets, that notion is not as relevant. Rather, distributions, both in the form of dividends and share repurchases, are being viewed by investors as a signal of management discipline. As a result, **firms of all growth profiles are now embracing shareholder distributions as a value-enhancing mechanism.** Low-growth firms continue to lead the pack, returning over half their operating cash flow to shareholders in 2013 versus one third two decades ago (Figure 3, left side). More interestingly, high-growth firms, which did not always have excess cash flow to distribute, return almost half (46%) today, versus hardly anything a decade ago (Figure 3, right side). Interestingly, the distributions are approximately split between one- third in dividends and two-thirds in buybacks for both low- and high-growth firms.

Figure 3

Growth and shareholder distributions are not mutually exclusive



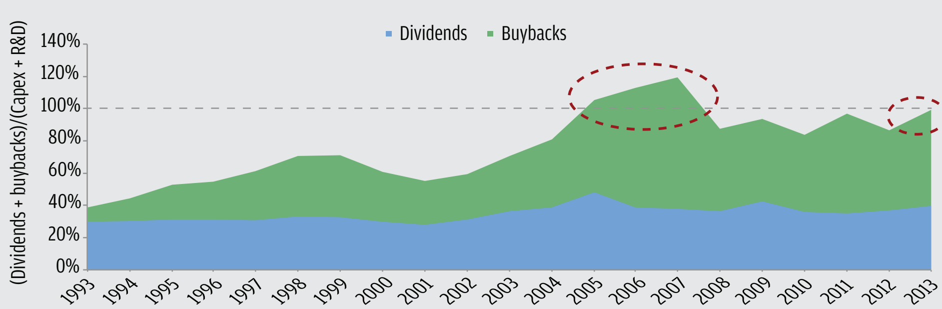
Source: Bloomberg, FactSet
Note: Median of S&P 500 firms with I/B/E/S consensus long-term EPS growth estimates less than 5%

Source: Bloomberg, FactSet
Note: Median of S&P 500 firms with I/B/E/S consensus long-term EPS growth estimates greater than or equal to 15%

In the current low-growth environment, shareholder distributions have been receiving unprecedented attention. In fact, an equal amount of capital is now allocated to shareholder distributions as is to organic investments. As Figure 4 illustrates, **dividends and buybacks in 2013 were almost as high as the combined amount of capex and R&D.** The ratio of shareholder distributions to organic investments has held steady in the post-financial crisis period at close to 100%. This ratio was less than 40% two decades ago.

Figure 4

Ratio of dividends and buybacks to capex and R&D for S&P 500 firms



Source: Bloomberg, S&P Index Services

EXECUTIVE TAKEAWAY

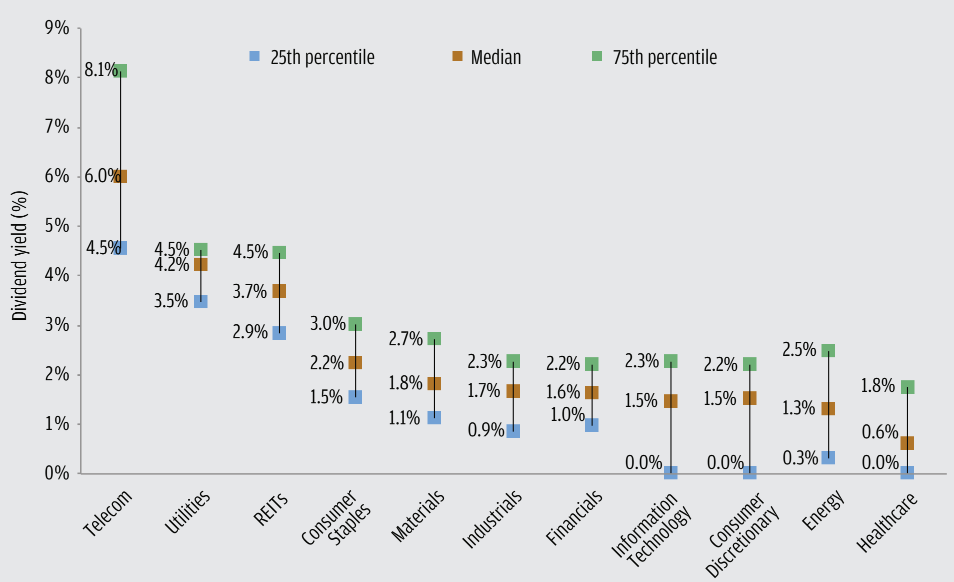
Do growth firms pay dividends? Yes.
In today's environment of strong cash flows and favorable financing markets, firms of all profiles pay meaningful dividends.

2.2 Are technology firms participating in the dividend trend?

Historically, strong dividend-paying firms were concentrated in certain sectors. This trend has changed significantly in recent years. The evolving payout policies of growth-oriented firms and the **trend of tech firms embracing dividends** have changed the distribution landscape. Tech firms are now grabbing a significant share of the attention and capital of yield-seeking investors. As Figure 5 illustrates, telecoms, REITs and utilities still have the highest median dividend yields. However, for tech firms, which were historically among the lowest dividend payers, the median dividend yield (1.5%) is now comparable to that of firms in more traditional dividend-paying sectors such as consumer discretionary (1.5%), financials (1.6%) and industrials (1.7%).

Figure 5

Most sectors now have a preponderance of dividend payers in the S&P 500

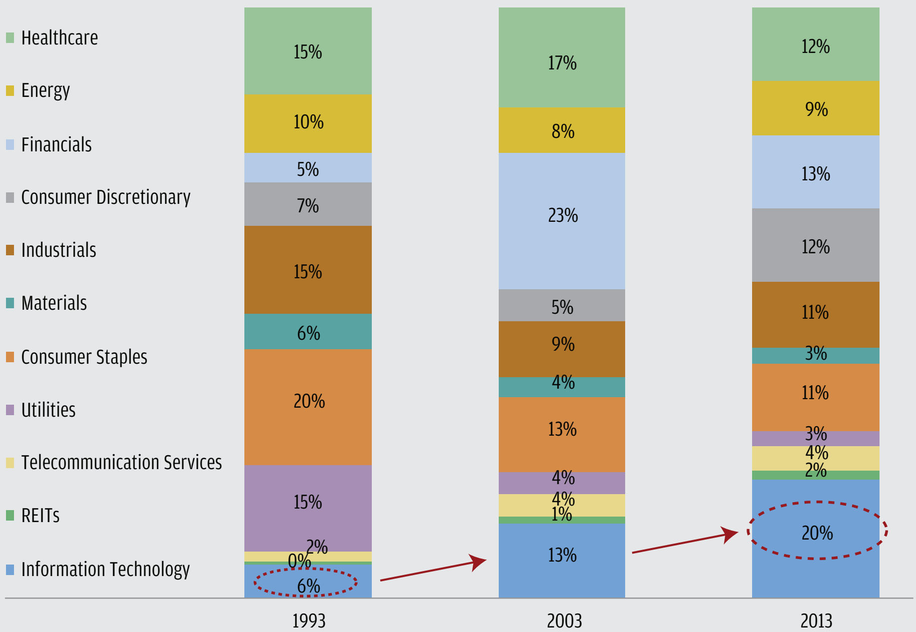


Source: FactSet
Note: Dividend yield based on share price as of 12/31/13 and latest annualized dividend

As tech firms have grown in size and economic relevance, so has their contribution to overall shareholder distributions. **The tech industry's share of the total distributions by S&P 500 firms has more than tripled in the last 20 years** from 6% to 20% and is now higher than that of any other sector (Figure 6). In fact, four of the top 25 dividend payers in the S&P 500 are from the tech sector, and some of the largest tech firms are yet to pay dividends. This trend of rising tech dividends has been at the expense of more traditionally dividend-oriented sectors, such as utilities and consumer staples, whose share of the dividend pie has declined.

Figure 6

S&P 500 total payout by sector as a % of total repurchases and dividends, 1993–2013



Source: FactSet, Bloomberg; data based on all S&P 500 firms
Note: Total payout refers to the sum of dividends and share buybacks

EXECUTIVE TAKEAWAY

Are tech firms participating in the dividend trend? Absolutely.

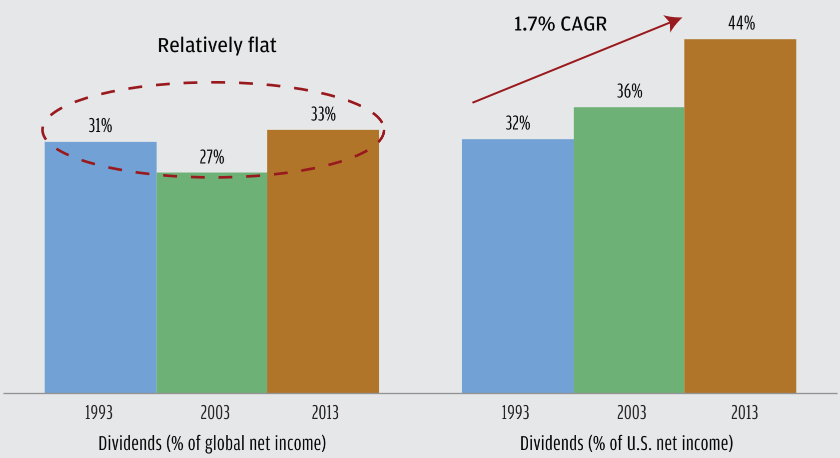
Tech firms now pay 15% of all S&P 500 dividends and 20% of all S&P 500 distributions, triple their level of 10 years ago.

2.3 How high are payout ratios?

Traditional analysis suggests that dividend and total payout ratios have been relatively flat to down over the last two decades[1] (Figure 7, left side). For U.S. multinationals, however, distributions are typically paid only with domestic cash. This restriction **increases effective payout ratios and may strain U.S. firms as global growth recovers** and their overseas cash balances rise. Firms are already seeing the signs of this: The ratio of dividends paid to domestic net income has risen by more than one-third from 32% to 44% over the past 20 years (Figure 7, right side). Absent a change in tax rules, many U.S. multinationals will increasingly be forced to contemplate alternative sources of capital to support their payout policies, up to and including the issuance of debt in the U.S. to support investor expectations that almost all free cash flow—both foreign and domestic—be distributed.

Figure 7

Rising non-U.S. income places upward pressure on U.S. payout ratios



Source: FactSet
Note: Medians based on S&P 500 constituents as of 12/31 for each year; excludes firms that do not break down sales by geography; assumes same profit margin for U.S. operations as non-U.S. operations

EXECUTIVE TAKEAWAY

How high are payout ratios?
Higher than you think.
Payouts are almost half of distributable, domestic income creating an issue for global firms with trapped cash.

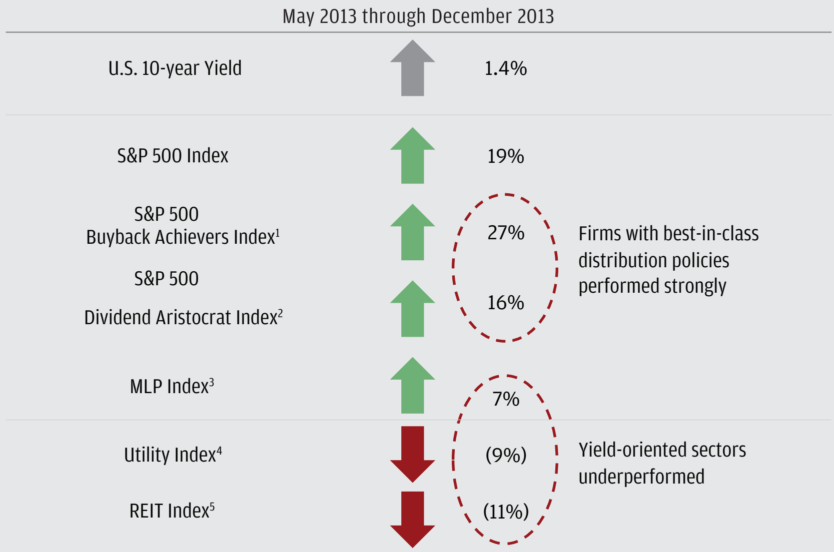
[1] For instance, please see our March 2013 report: "2013 Distribution policy: How macro views shape the dividend vs. buyback dilemma"

2.4 Will rising rates hurt dividend paying stocks?

Investor demand for yield in the current low-rate environment has led to a dividend premium and has helped to fuel the growth in dividend distributions. As interest rates rose from May 2013 through the end of the year, investor appetite for bond-like equities declined. This reduction in demand was most felt by firms in yield-oriented sectors, like REITs and utilities (Figure 8). **Firms that have a history of generating strong cash flow growth as the economy grows have, however, not been affected by rising rates.** Thus, dividend-oriented sectors with limited leverage to a growing economy and rising rates will suffer when rates rise. Conversely, firms that will be able to offset higher rates with accelerated dividend growth should be able to avoid valuation pressure.

Figure 8

Valuation impact of surging treasury rates in the spring and summer 2013



Source: Bloomberg
Note: Total return from 5/1/2013 to 12/31/2013 assuming dividends reinvested

[1] S&P 500 Buyback Achievers Index is comprised of the top 100 S&P 500 firms that have the highest buyback ratio in the last 12 months (SPBUYUP)

[2] S&P 500 Dividend Aristocrats Index is comprised of S&P 500 firms that have increased dividends for the past 25-plus consecutive years (SPDAUDP)

[3] Alerian MLP Index (AMZ)

[4] PHLX Utility Sector Index (UTY)

[5] MSCI US REIT Index (RMZ)

EXECUTIVE TAKEAWAY

Will rising rates hurt dividend paying stocks? Not necessarily.

Dividend paying firms that are levered to the economy may be able to grow dividends in an accelerated fashion, offsetting rising rates.

2.5 Do firms overpay during share repurchases?

Firms are thought to ramp-up share repurchases when cash flows are strong and dial them back during periods of weak cash flows and/or unfavorable capital markets environments, leading to low returns from share repurchases. **Firms have, however, generally earned returns in excess of their cost of equity.** In particular, stock buybacks by S&P 500 firms have almost doubled since their recent trough immediately following the financial crisis (Figure 1), leading to a significant cumulative return of 12% since 2005 for S&P 500 firms.

Our analysis indicates, however, that if firms had dollar cost averaged their repurchases through the period, they could have generated even higher returns (Figure 9). This result indicates that **a consistently strong share repurchase program may help firms enhance shareholder value.** This notion is particularly applicable in today's environment of significant cash flow generation, high cash balances, low leverage and limited growth opportunities. Furthermore, despite major indices currently trading near all-time highs, investors continue to reward firms that raise debt to return capital to shareholders.

Figure 9

Share repurchases have generated significant returns

S&P 500 returns on repurchases executed during a given quarter

Source: J.P. Morgan, Standard & Poor's and FactSet as of 2/15/2014; data based on all S&P 500 firms
Note: Returns include dividend savings. Returns for last four quarters not annualized; distribution data for 2013 Q4 not yet available

EXECUTIVE TAKEAWAY

Do firms overpay during share repurchases? Not really.

Firms have generated high returns and investors continue to respond well to firms that use debt or excess cash to fund buybacks.

[2] For further reading, please see our recent brief: "Leveraged recaps: Unlocking hidden balance sheet value"

3. Summary of takeaways

Firms have ramped-up shareholder distributions in the post-crisis period, encouraged by a variety of factors from investor demand for yield to favorable capital markets and minimal investment opportunities. While these factors remain important today, firms should understand the evolving distribution landscape. Firms and senior decision makers should challenge conventional wisdom as they seek to continue their value-enhancing distribution policies.

Figure 10

The new "conventional wisdom" about dividends and buybacks

Do growth firms pay dividends?	Yes	In today's environment of strong cash flows and favorable financing markets, firms of all profiles pay meaningful dividends.
Are tech firms participating in the dividend trend?	Absolutely	Tech firms now pay 15% of all S&P 500 dividends and 20% of all S&P 500 distributions, triple their level of 10 years ago.
How high are payout ratios?	Higher than you think	Payouts are approaching half of distributable, domestic income creating an issue for global firms with trapped cash.
Will rising rates hurt dividend paying stocks?	Not necessarily	Dividend paying firms that are levered to the economy may be able to grow dividends in an accelerated fashion, offsetting rising rates.
Do firms overpay during share repurchases?	Not really	Firms have generated high returns on share buybacks and investors continue to respond well to firms that use debt or excess cash to fund buybacks.

Notes

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