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2013 Distribution Policy:

How macro views shape the dividend vs. buyback dilemma

J.P.Morgan

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1. How macro views shape capital allocation decisions

In 2012, firms shifted their cash distributions into high gear. Despite the threat of increased shareholder-level taxes on dividends, firms increased payouts more aggressively than in years prior. Now that long-term capital gains and dividend taxes are known–at least until the next change–CEOs and CFOs are preparing for the upcoming Board meetings where capital allocation decisions will be made, often under greater public scrutiny by yield-hungry investors.

This investor frustration may not be entirely unwarranted. After a decade where equity underperformed most fixed income asset classes, shareholders are focused on record cash balances that continue to grow, debt costs that hover around historic lows and markets that reward more aggressive strategic actions, either via M&A or via return of capital (Figure 1).

Figure 1

Record times...what do you do?

Risk-free rate	Cost of equity	Dividend premium	High yield index
1.9% **U.S. 10-year treasury rate** 10-year treasury has only been lower 4.7% of the time since 1994	**7.5%** **Market risk premium[1]** Market risk premium has only been higher than current levels 12% of the time since 1994	**20%** **Premium dividend payers receive in their PEG ratio[2]** Highest dividend premium since 1998	**6.0%** **"High" yield** The high yield index[3] has been lower than current levels 0.5% of the time since 1994
VIX volatility index	**Coverage ratios**	**Cash balances**	**M&A market reaction**
15.5 VIX volatility index has only been lower 30% of the time since 1990	**13.3x EBITDA/ interest** **S&P 500 aggregate coverage ratio** Second highest coverage ratio since 1996	**$1,132 billion** **S&P 500 cash and cash equivalents[4]** Highest % of cash/ assets since 1950s	**2.0%** **Market reaction to 2012–2013 M&A deals[5]** For the first time in decades, investors are rewarding acquirers

Source: J.P. Morgan, Bloomberg, FactSet as of 2/28/2013

[1] J.P. Morgan estimate of market risk premium based on DDM approach

[2] Based on difference in median PEG ratio for dividend payers and non-dividend payers in S&P 500

[3] Based on J.P. Morgan High Yield Bond Index YTW

[4] S&P 500 ex-financials. Cash includes long term investments of firms with significant offshore cash

[5] Excess return over S&P 500 returns times acquirer's beta from unaffected date prior to announcement to five days following announcement; includes over 300 acquisitions by U.S. and Canadian buyers with minimum deal value of $500mm and target >10% of the size of the acquirer (excludes Reverse Morris Trusts)

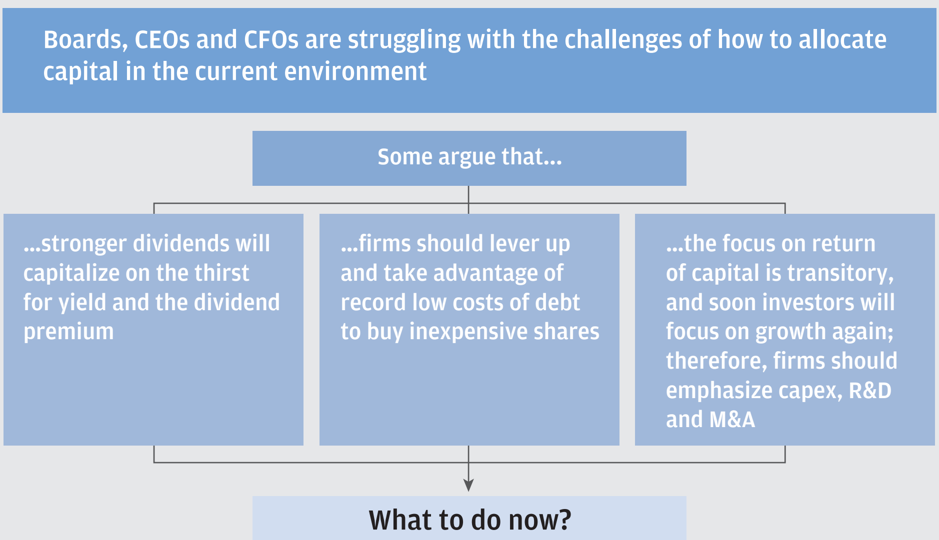
In this environment of contradictions, some Board members prefer to preserve liquidity for growth or potential M&A. Others are focused on preparing for new downside scenarios, and hence are loath to part with any cash. Even among those Board members who agree more cash should be returned to shareholders, **there is often vigorous disagreement between those supporting higher dividends and those advocating more stock buybacks.**

In response to these conflicting signals, optimal capital allocations are often dictated by a Board's macro views. If a Board believes that the low rate environment is likely to persist for a long time (referred to as the "**Japan scenario**"), then investors will continue to seek yield, and dividend stocks will continue to trade at a premium, suggesting that a more aggressive dividend policy will add value in both the short and long runs. Many firms have significant room to increase their dividends, since payout ratios are still below their historical average. Advancing a more aggresive dividend strategy also satisfies directors who are either reluctant to buy shares, are worried about buying at high valuations or are concerned about the trading liquidity of the stock.

On the other hand, if senior decision-makers believe that interest rates and inflation are likely to spike once central banks cease pumping liquidity into the markets (referred to as the "**distortive liquidity glut**"), then today would be a unique time to lock in historically cheap debt and buy shares (either the company's own shares or other firms' shares through M&A), so long as cash flows are sustainable and valuations are appropriate. Despite a recent run-up in equity valuations, shares in many sectors remain inexpensive when compared to historical valuations, the cost of debt and growth prospects.

Figure 2

The capital distribution conundrum



Source: J.P. Morgan

EXECUTIVE TAKEAWAY

The global economy is at a crossroad. Although rates may stay low for long ("Japan scenario"), some believe that once central banks wind down their unprecedented monetary easing, interest rates and inflation are likely to spike ("distortive liquidity glut"). More than ever before, capital allocation decisions are currently dictated by the macro view of senior decision-makers regarding these alternative scenarios. This report highlights the implications of the macro environment on the optimal shareholder distribution strategy.

2. Favoring dividends—The Japan scenario

Since the crisis-related drop in interest rates, which was part of the Fed's effort to jump start the economy, economists and business leaders have expected rates to increase. They have not, and the Fed remains committed to keeping rates low until the unemployment rate has dropped to more acceptable levels.

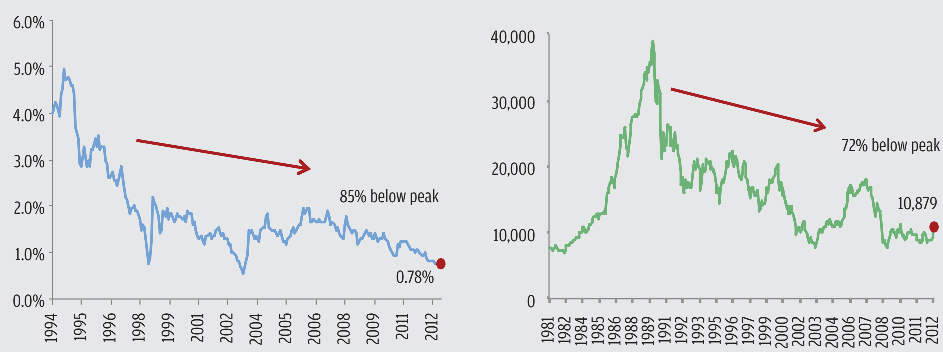
Japan's rates continued to drop for more than two decades after the collapse of both the Nikkei and the Japanese real estate market in the late 1980s/early 1990s (Figure 3). **What do low rates for a long time mean for distribution policy?**

Figure 3

The Japan scenario: "Low rates for long"

Japanese 10-year government bond rate since 1994

The Nikkei 225 index



Source: Bloomberg

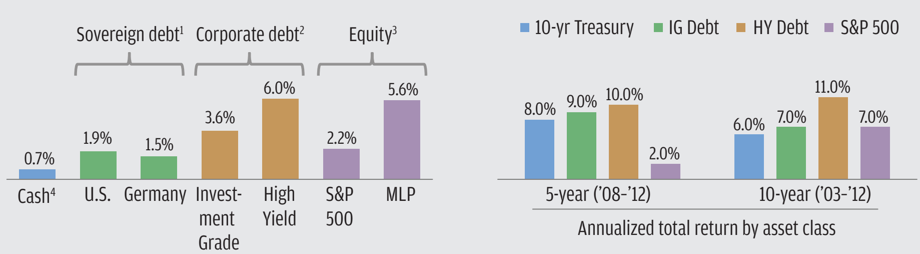
A meaningful portion of investors seek regular income. Traditionally, this type of investor would have focused on the fixed income asset class. Today, however, expected returns in most fixed income categories are at historic lows (Figure 4). Even the riskier segments of the fixed income markets, such as high yield corporate bonds, have cleared the market at sub-6% yields.

Figure 4

Fixed income has had a great run, but where is the yield now?

A low yield environment

Total return performance of various asset classes



Source: Bloomberg as of 2/28/2013

[1] Based on generic U.S. and Germany 10-year government bonds

[2] Investment grade debt based on JULI yield index; High yield based on J.P. Morgan High Yield Bond Index YTW

[3] S&P 500 dividend yield is market capitalization weighted; MLP dividend yield based on Alerian MLP index

[4] Bloomberg 12-month CD Index

Source: FactSet, Bloomberg, J.P. Morgan, Morningstar

The steady decline in rates has generated significant returns for fixed income investors relative to equity, a phenomenon that has not gone unnoticed by both the market and senior corporate decision-makers. The dividend premium, measured as the difference in the PEG (Price earnings ratio to growth expectations) of dividend payers vs. non-dividend payers, has reached new highs this past year. This premium can be found in both the U.S. and Europe (Figure 5). A directly related effect is that dividend funds have benefited from $17bn of annual inflows over the last two years, while broader equity classes experienced significant outflows of more than $80bn during each of these years. As a result, senior decision-makers have responded with a renewed commitment to a more aggressive dividend policy to capitalize on the pronounced dividend premium so evident today.

Figure 5

This dividend premium is observed both in the U.S. and in Europe

S&P 500—PEG ratio by dividend size

Europe—PEG ratio by dividend size —all index constituents[1]

S&P 500:

	No dividend	Lower dividend	Medium dividend	Higher dividend
Yield	0.0%	<1.3%	>1.3%;<3.2%	>3.2%
Div. payout (median)	0.0%	11.0%	30.8%	61.3%

Europe:

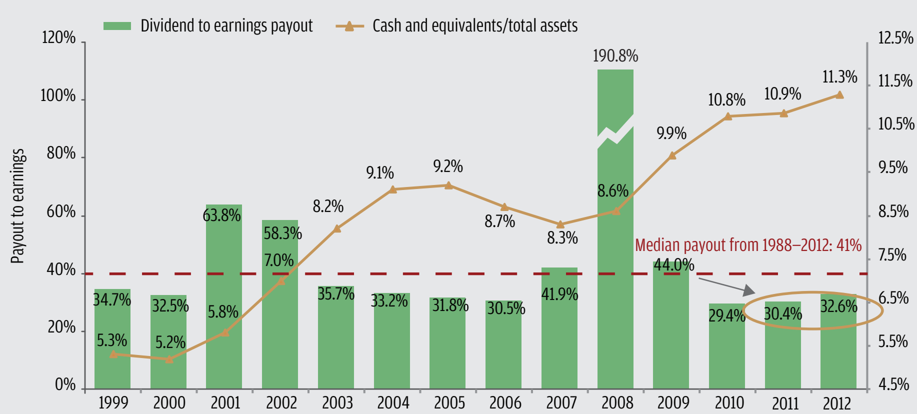
	No dividend	Lower dividend	Medium dividend	Higher dividend
Yield	0.0%	<2.0%	>2.0%;<4.2%	>4.2%
Div. payout (median)	0.0%	27.0%	41.7%	54.5%

Source: FactSet as of 12/31/2012
Note: Low dividend based on firms that represent the bottom 25% of the group in terms of dividend yield; high dividend based on firms with dividend yield that represent the top 25% of the group in terms of dividend yield. PEG defined as the median forward price earnings ratio to growth expectations for each subset of dividend payers
[1] European index comprised of constituents of the FTSE 100, German DAX and France CAC 40 excluding dividend aristocrats

Figure 6

Payout ratios remain low and cash balances remain high

Dividend payout for the S&P 500 is low...



Source: S&P, Bloomberg; data as of Q3 2012
Note: S&P 500 ex-financials. Cash includes long term investments of firms with significant offshore cash

Despite the increasing dividend premium, dividend payout ratios have been sticky at around 30%, 10 percentage points lower than the long-term median of 41% (Figure 6). Indeed, many firms still hesitate to commit to a stronger dividend. This situation may exist because a strong dividend policy serves to make equity more like fixed income. Although this helps value in today's low rate environment, management knows that once rates rise, equity classes that have fixed income attributes may suffer, like bonds, in contrast to their dividend-free or dividend-light cohorts.

Other firms are worried that a strong dividend may impact the market's perception of their growth orientation. This concern is mistaken: The existence of a dividend premium does not mean that growth is not a key valuation driver. Because high growth will be even harder to find in a slow growing economy, firms in high growth markets will also attract premium valuations regardless of their dividend policy. But in reality, few firms operate in such a high growth environment today. Many firms that are reluctant to give up their "growth-oriented with low-to-no dividend" policies generate lots of cash flow, have large cash balances and trade at depressed valuation multiples. Put another way, investors are not paying for these firms' "growth" prospects.

If the Japan scenario is our reality (as only future hindsight will tell), or even if rates stay low for the next 3–5 years, then investors will continue to flock to dividend-oriented equity, thereby boosting their relative value. As a consequence, pressure will increase on firms that resist dividend orientation. Their resulting weaker valuations may attract shareholder activists, or even a hostile acquirer. At the very least, the low valuation may make their cost of equity capital uncompetitive or make attracting and retaining employees more challenging.

EXECUTIVE TAKEAWAY

In the Japan scenario, rates will be low for long and yield-hungry investors will continue to flock to dividend-oriented equity. Mature firms that are unwilling to embrace this new environment with a stronger dividend policy may trade at a valuation discount and attract unwanted attention.

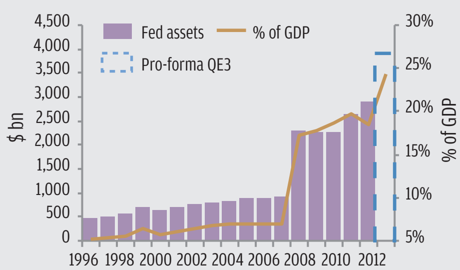
3. Favoring buybacks and acquisitions—The distortive liquidity glut

Over the last few years, we have witnessed unprecedented monetary intervention by central banks around the world (Figure 7). While it is not clear whether the resulting low rates drive investors to take on more risk, some market participants believe that this aggressive monetary policy disrupts traditional price signals. In other words, central banks' purchases are executed almost regardless of price, which may drive rates to an even lower level than the one that reflects the market inflation and growth expectations. In addition, pension funds, endowments and others are now also allocating greater fractions of their portfolios to fixed income.

Figure 7

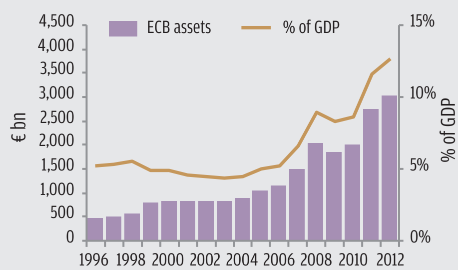
Unprecedented central bank intervention

Fed's balance sheet



Source: Federal Reserve Board of Governors, Bureau of Economic Analysts, Bloomberg

ECB's balance sheet



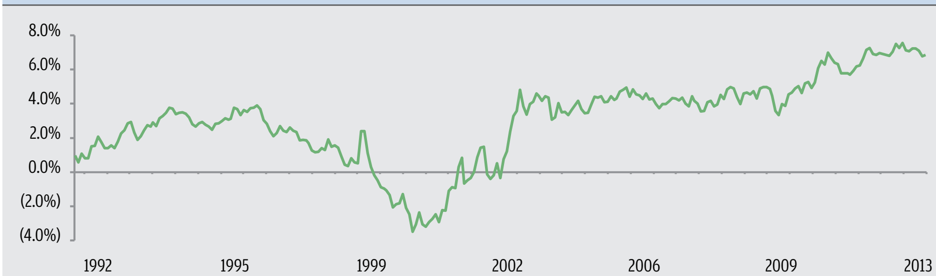
Source: ECB, Bloomberg

What happens when the music stops at the central bank dance halls? How can Boards factor this alternative scenario of a distortive liquidity glut into their distribution decisions? First, firms should not over-commit to dividends. Once rates rise, the fixed income attributes of equity will become less compelling. More importantly, however, this bond vs. equity disconnect is associated with a historic opportunity to issue debt and repurchase one's own or somebody else's equity. For the typical S&P 500 firm, a buyback of 10% of market capitalization was 3-4% dilutive in the late 1990s due to high rates and high PE multiples. Today, such a buyback is 7-8% accretive due to low rates and low PE multiples (Figure 8).

Figure 8

While the cost of debt and valuations have declined, EPS accretion of buybacks for S&P 500 companies has peaked

Illustrative EPS accretion of buybacks for S&P 500 companies[1]



Source: Bloomberg and FactSet as of 2/28/2013

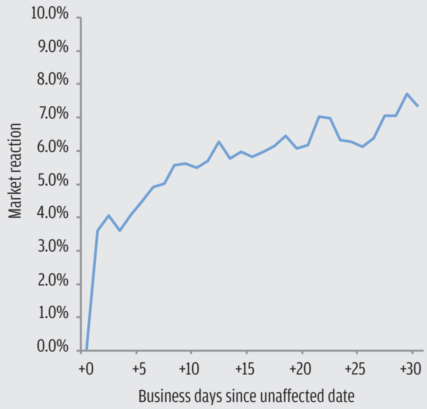
[1] Assumes buyback size of 10% of market capitalization, 5% repurchase premium, 35% marginal tax rate and Bloomberg fair market value index cost of debt for BBB rated issuer

Equity investors' reaction to recently announced debt financed share repurchases and cash acquisitions has reinforced the conclusion that the capital market is rewarding this "arbitrage." Companies that have issued debt with record low coupons and utilized the proceeds to repurchase shares have outperformed the market by more than 6% on average (Figure 9). Also, after decades of mute market reaction to acquisitions, investors now prize an acquisitive company with positive excess returns. In fact, 25% of the transactions lead to at least 10% positive market reactions for the acquirer.

Figure 9

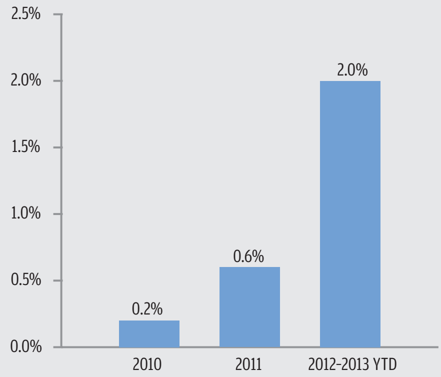
Investors are rewarding companies that take advantage of the disconnect between debt and equity markets

Average market reaction to debt-financed distributions[1]



Source: Bloomberg, FactSet as of 2/15/2013
Note: Includes debt-financed tenders offers and ASRs announced since 1/1/2011, where distribution was greater than $100mm and 5% of market cap
[1] Market reaction based on the total return in company stock less beta * total return on the S&P 500

5-day acquirer market reaction to cash M&A[1]



Source: Bloomberg, Dealogic, FactSet and company filings as of 2/15/2013
Note: Includes over 300 acquisitions by U.S. and Canadian buyers with minimum deal value of $500mm and target >10% of the size of the acquirer (excludes Reverse Morris Trusts)
[1] Excess return over S&P 500 returns times acquirer's beta from unaffected date prior to announcement to five days following announcement

For more information, please see "Uncorking M&A: The 2013 Vintage - Investors increasingly reward synergistic transactions" at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_MA.pdf

EXECUTIVE TAKEAWAY

Aggressive central bank interventions have kept rates low in recent years. This policy has led to disconnect between the pricing of debt and equity. As the economy continues to recover and the central banks tighten their monetary policies, rates may spike and this current "capital structure arbitrage" will vanish. With that in mind, firms can embrace an opportunistic approach and issue "cheap" debt to buy "undervalued" equity.

4. Concluding takeaways

Boards and senior decision makers should develop views on how potential future outcomes will impact not only their core business but also shareholder distributions. The “Japan scenario” and “distortive liquidity glut” are just two possible outcomes, but represent a full spectrum of possibilities. It is notable that both scenarios support M&A: In an environment where rates and growth expectations remain low for a long time, M&A can offer a path to growth via synergies and efficiency gains. Alternatively, in an environment where valuations are low today, but are likely to rise quickly, buying another firm’s equity (potentially financed with historically cheap debt) may be attractive. The recent pickup in M&A activity suggests many Boards are taking this approach–even if they hold different views on what the future may bring.

Equity market performance so far in 2013 suggests a robust recovery of valuations may be taking hold. Prevalent risk factors remain, however, and Boards are likely to remain divided on the appropriate course of action. It is of paramount importance that firms do take action. The recent number of high-profile activist campaigns over the last few months serve as a potent reminder of the costs of inaction.

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