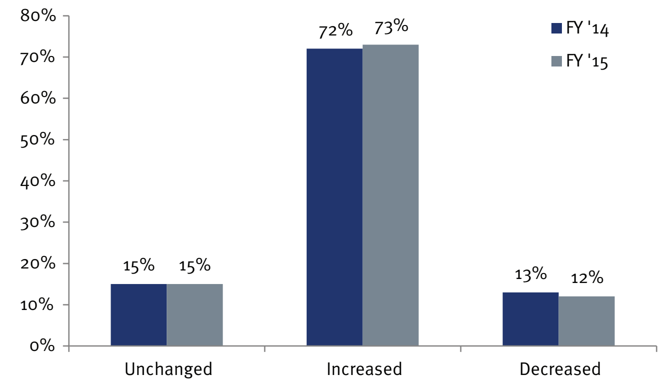
The Unexplored Power of Europe's Dividend Culture

In a market which has a long and strong culture of paying dividends, recent announcement of dividend cuts have not gone unnoticed. But with companies having to adapt to increasingly complex and challenging circumstances, one might expect these dividend cuts at a greater rate than we are seeing. After all, cycles appear to be shortening, the free market is ever more skewed by unprecedented policy intervention and change is accelerating across all areas of business.

In an attempt to substantiate this dividend observation and provide color on the payability forces at work, I will begin by examining these points in a European context, before presenting a point for point perspective on why the region remains the world's most compelling market for income investors.

Despite the sensational headlines which convey Armageddon for income investors, this evolution is not evident as yet. With full year 2015 European earnings season now complete, FactSet analysis shows that the direction of dividends is broadly unchanged (exhibit 1).

Exhibit 1 – Dividend changes for EuroStoxx 600

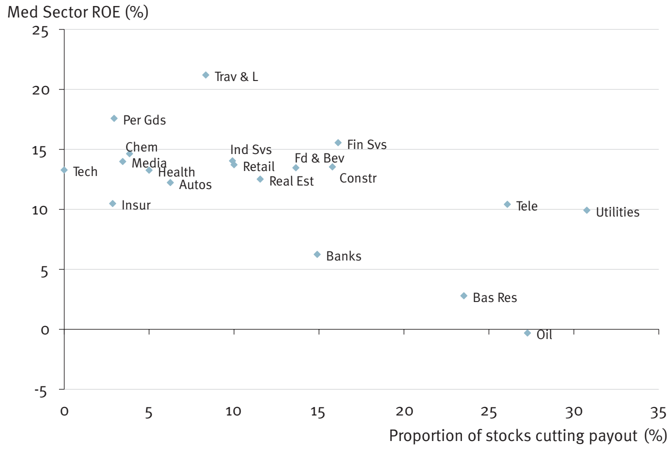


Source: FactSet, RBC GAM. March 2016.

The granularity reveals that the magnitude of decreases is greater than of the increases, and that the reductions are largely confined to certain areas of the market. Unsurprisingly these are Energy, Utilities, Financials and Materials; with the latter two heavily skewed to the Banking and Mining sub sectors respectively.

Generally speaking, the industries in reference generate little or no value above their cost of capital through a complete cycle. As evidenced in exhibit 2, this 'return' variable (proxied here by RoE) has a high inverse correlation with dividend cuts; in other words higher returns reduce the likelihood of dividend cuts.

Exhibit 2 – Sector distribution of dividend cuts



Source: ASR, March 2016.

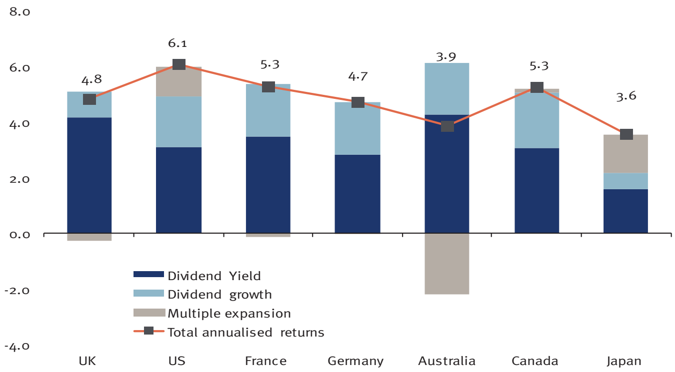
Commodities saw a period of supra-normal returns that were cyclical, not structural, in nature. Now the super cycle has ended, the underlying cost-of-capital dynamics have returned to the fore. In consequence, the companies are highly vulnerable to a negative outlook because they carry little headroom to manage their incumbent capital allocation policies that remain in situ from the boom years. Meanwhile Banks and Utilities are the victims of regulation but the point of little headroom is the same. Subsequently dividend cuts are the obvious means for these stressed businesses to alleviate pressure and shouldn't come as a surprise to investors.

While it's easy to get hung up on the negatives above, it's important to retain perspective and look at European equities in aggregate. In so doing, we are reminded that the vast majority of companies which operate in higher return areas of the market (and even anomalous companies within the aforementioned sectors) continue to deliver dividend increases (exhibit 1), despite the challenging environment alluded to at the start.

So why is this the case? Most obviously, managers avoid cutting dividends due to the negative share price reaction and as touched on, return profiles play a meaningful part. Less obviously and more enduringly, Europe possesses an entrenched dividend culture which has been developing since the 17th century. The numbers illustrate that this practice of sharing profits with investors in the form of dividends remains firmly intact. With tomorrow offering few definites, this is of great importance on a number of levels.

Firstly, certain investors will always require income and diversification; a factor which becomes even more important in the face of elevated uncertainty, such is the case today. Historically dividends have been the largest contributor to equity shareholder returns in most major geographies (exhibit 3). European dividends will continue to offer this visible risk-reducing revenue stream.

Exhibit 3 – Shareholder return breakdown (1970 – Q4 2015)

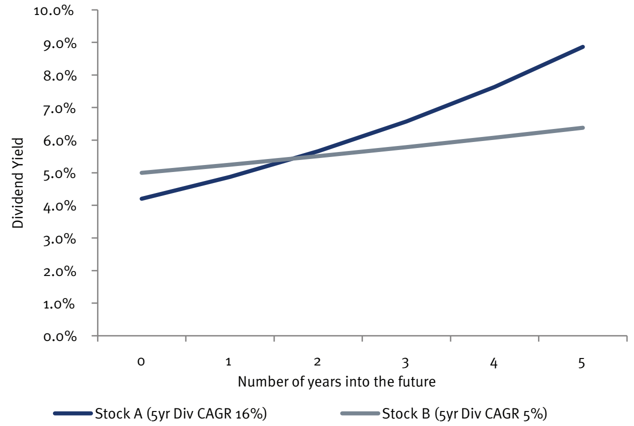


Source: SG Cross Asset Research/Equity Quant, MSCI, thomson Financial Datastream. April 2016.

Secondly, at a deeper level, the cultural norm for dividends, reciprocated by management and shareholders alike, perpetuates dividend growth which has been the second greatest component of total returns. Long term investors who buy and hold quickly realise the benefit of the compounding growing dividend, which culminates in an accelerating yield on initial investment (exhibit 4 shows this exponential relationship) and a hedge against inflation.

Thirdly, the long standing notion that dividends imply a stock must be 'ex growth' is a fallacy. The majority of European listed companies, especially those that are most investible (i.e. large, established and offer high levels of liquidity), generate ample cash flow to grow their asset bases (be it organically or inorganically) while simultaneously paying dividends which they can grow. The received market wisdom that there are unlimited investment opportunities for management teams to endlessly deploy all their cash flow into return accretive investments is both unrealistic and misguided.

Exhibit 4 – Compounding dividend growth



Source: Holt, RBC GAM. January 2016.

Fourthly, existing returns within the business can be amplified thanks to the capital discipline a dividend policy, be it explicit or implicit, imposes on management. For example: acquiring an asset heavy franchise in a non-core area where you have no proven record of execution, which will certainly see returns depress and cash flow diminish at the group level, appears less attractive to the executive committee and board when they know they have a commitment to pay and grow the dividend. So this less appreciated idea translates to operational efficiency, tighter allocation decisions and thus economic profit.

In conclusion, dividends, or more specifically growing dividends, are much more than ancillary to the investment proposition. They are an integral component of European corporate culture which, when coupled with sound analysis to identify the high return businesses that can support and grow the income stream, provides a powerful formula to generate value added total returns.

With uncertainty and volatility looking set to persist, companies that combine the above attributes are being celebrated and valued in a new way. Instead of being miscategorised as 'bond proxies' (a ludicrous parallel given that no equity sub group will ever resemble fixed income investments on any level; most notably the inability to grow the income stream), they should instead carry their own classification. One which is agnostic to temporary market factors and thus commands a lasting premium.

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