Not All Dividend Cuts Are The Same

The global coronavirus pandemic and the resulting government restrictions on social interaction, which are unprecedented (at least in the modern era), have placed tremendous strains on wide sectors of the global economy. Many businesses have seen activity come to a sudden and full stop. Obviously, the abrupt decline in revenues, earnings and cash flows raises questions about the capacity for businesses to continue with shareholder distribution practices. It is important to note, however, that not all businesses face the same degree of stress. Many are experiencing strains but are still generating material cash flow or entered this period with ample liquidity and strong balance sheets. For the Shareholder Yield strategies, we are assessing risks in the portfolio on a company-by-company basis and have recently made some changes as a result (both sales and additions). We want you to know that we remain highly confident that we can continue to deliver attractive dividend income from a diversified portfolio of high-quality equities.

One factor that has recently emerged is heightened political pressure on companies to reduce or restrict shareholder distributions temporarily. In some cases, this explicitly applies to companies that take advantage of aid programs (like U.S. companies that tap emergency loans and grants established under the CARES Act). In some cases, the pressure is more along the lines of "moral suasion," and applies to companies even if they do not need to avail themselves of these emergency programs. For example, a number of large UK banks recently eliminated 2019 dividends following appeals from the head of the Bank of England to "think very carefully about the optics of capital distributions in the current environment."

We have seen companies in Europe (France, in particular) that declared dividends along with annual results earlier this year, but that have now canceled or reduced those dividends in response to public pressure—even though in many cases they continue to remain viable businesses with ongoing cash flow that would support dividend payments as announced. Michelin is a prominent example. While the originally declared dividend on 2019 results was easily covered by free cash flow, the company recently took the step of voluntarily reducing the dividend, stating in a press release: "In a commitment to optimally balance the interests of all its stakeholders, the Group has decided to reduce the amount of the proposed 2019 dividend to €2, compared with the initially announced €3.85." Before the reduction in the dividend there was a significant cushion to absorb a temporary decline in sales associated with the economic contraction caused by the pandemic.

It is also noteworthy that some of the recent dividend adjustments have been specifically characterized as being postponed rather than canceled. A good example, though not currently owned in the portfolio, is Svenska Handelsbanken, which made the following statement in its press release on 3/24/2020:

Handelsbanken's annual general meeting will take place as planned on 25 March 2020. There is no change to the Board's existing assessment of the dividend for 2019. A final decision regarding the dividend will be made, however, at an extraordinary general meeting, once the consequences of the coronavirus pandemic have become more clear.

Handelsbanken has a robust financial position in terms of both capital and liquidity. The Board has therefore arrived at the conclusion that the proposed dividend amount will in no way jeopardise the Bank's ability to support its customers through financing, in spite of the challenging circumstances.

In order to facilitate improved insight into the consequences of the pandemic, the Board does propose, however, that no resolution regarding the dividend be made at the annual general meeting, but instead be postponed until after the summer. Therefore, the Board intends to provide, in good time, notice of an extraordinary general meeting to be held in November 2020 at the latest, at which the matter will be addressed.

Traditionally, companies that cut or eliminate cash dividends are often considered poorly managed or facing structural decline. While some companies will continue to cut dividends for those reasons, we recognize that, in this unique environment, there are exogenous pressures that might lead companies to suspend dividend payments or reduce distributions to shareholders in the near term. We believe it is prudent to take into consideration the fact that not all dividend cuts are the same right now when making portfolio position-sizing decisions. Based on our conviction that the businesses remain fundamentally sound and that the suspension of or reduction in distributions is temporary and likely to be short-lived, we would prefer to not sell the positions simply because of a dividend cut or suspension. The decision to maintain these positions will be driven by the factor that led to the dividend cut – public pressure versus a need for financing or a change in the commitment to cash dividends going forward. The current environment is rapidly evolving as drastic measures are being taken to contain the coronavirus. We will continue to assess the breadth of opportunities we have to deliver a diversified portfolio of companies committed to returning attractive levels of free cash flow to shareholders.

To date, concerns about cutting the dividend as a result of public pressure appears to be limited to France. Today, France represents roughly 6% of our portfolio and just over 7% of our dividend yield. Our exposure within France is across a variety of sectors and having French holdings provides geographic diversification within the portfolio. Even if all of our French holdings elect to suspend their dividends this year and we maintained our current exposure, the resulting reduction to our dividend yield would only be roughly 40bps. The yield would go from 5.2% to 4.8% as of the beginning of April. This is a conservative estimate since we are confident that Michelin will pay the reduced dividend mentioned above. We recognize public pressure could spread beyond France. Using some simplifying assumptions, if an additional third of our portfolio were to cut their dividend in half, we believe this would amount to a further reduction of roughly 15% in our yield. We believe these assumptions are conservative based on the market environment today.

Cash dividends comprise a large portion of our long-term aspirational return and we do not expect this to change. We continue to believe we have a robust opportunity set to deliver the objectives of our portfolio~~s~~. We seek to invest in companies that have strong free-cash-flow profiles and cash cushions and/or balance sheet capacity to sustain the dividend during a temporary hit to demand. Within the portfolio construction process, we limit the reliance on any one company to deliver the income within the portfolio. To date, we have made a handful of changes within the portfolio where we felt the dividends were no longer sustainable given the rapid deterioration in demand, government intervention or the price war that has erupted in the oil markets. We do not anticipate that a meaningful number of companies within the portfolio will seek direct relief aid. We are making changes to the portfolio as we see appropriate to maintain an attractive and reliable stream of income.