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Is the Market Understating the Dividend Outlook?

Our monthly view on Australian equities.

4 February 2021

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Questions on the Cusp of Reporting Season

On the cusp of February reporting season, we look at the outlook for dividends from the Australian market. With consumer discretionary and the materials sectors likely to be a source of dividend surprise during results season, this could raise a broader question around the profile of market dividends into FY22E and FY23E.

While intense focus has been given to the earnings recovery, with the 'lost' earnings from COVID-19 restored by FY23E market estimates, FY23E dividend estimates still lag pre-COVID-19 levels by almost 20%.

Read our Asset Allocation Strategy for our further thoughts on earnings.

Is the Market Underestimating the Outlook?

We think the market is potentially underestimating the dividend outlook. While market consensus implies a higher rate of dividend growth than earnings over the next 3 years, that is largely due to the one-time impact of large dividend cuts in FY20 in response to COVID-19.

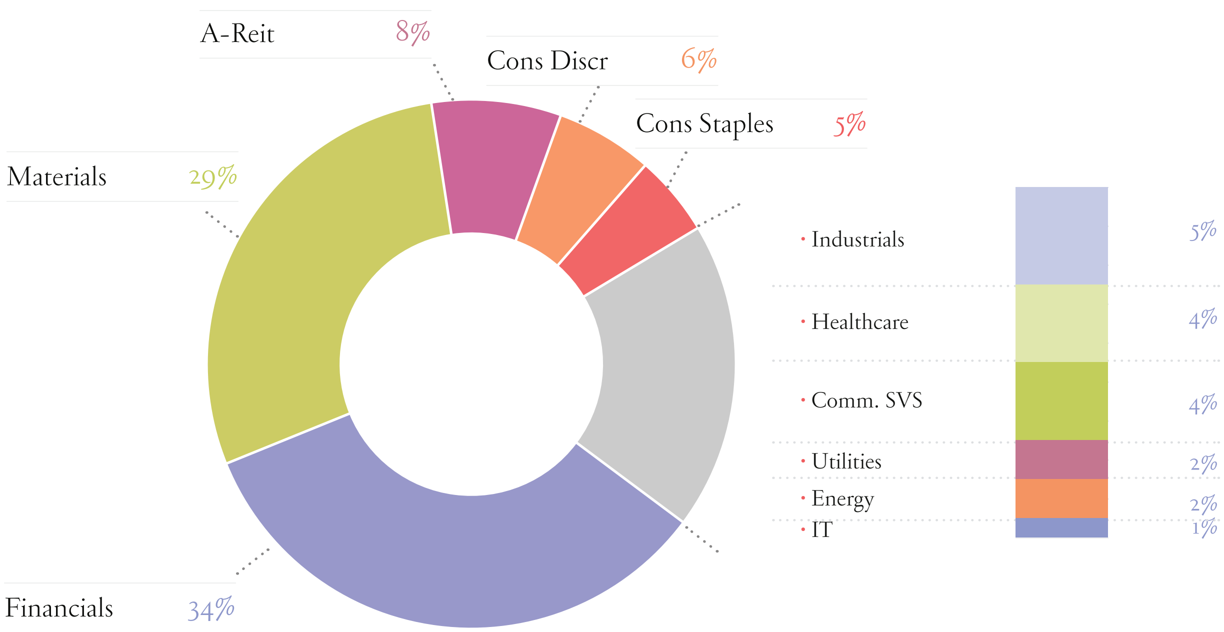
Corporate Australia quickly went into survival mode during 2020, with dividends being one of the key areas cut to preserve liquidity and capital. Dividends were cut against an outlook dominated by an abundance of caution ahead of the unknown.

At the same time, the banks had regulatory risks placed on dividend payments – capped at 50% payout (the regulator has now lifted this restriction). Financials are the most important sector from a dividend dollar of contribution perspective.

We estimate that COVID-19 reduced dividend payments in FY20E across the market by 35% relative to FY19A, while in contrast, earnings only fell 21%. For the market as a whole, the payout ratio fell from 84% to 65%, rivalling the GFC period both in terms of the speed and size of dividend cuts.

As a result of a lower payout ratio, corporates have retained a higher level of earnings. For most parts, this cash is now sitting on corporate balance sheets awaiting higher confidence around the outlook before deployment into growth initiatives, and or resumption of high dollar dividends.

Exhibit 1: S&P/ASX 100 dividend profile – banks and materials are key contributors to market dividends



Source: Refinitiv, Wilsons. Relative to a market cap based weighting, market dividends are more reliant on financials and materials, and less reliant on healthcare and energy.

The Outlook for Dividend Payout Ratios

The dividend payout ratio for the market has fluctuated over the past 15 years between 50% and 84%, with FY19 being at the upper end.

While there is an argument that the payout ratio pre-COVID-19 was too high relative to the incremental return on equity of the reinvestment of that cash flow, the elevated payout ratio reflected the operating environment and shareholder pressure for high payout ratios.

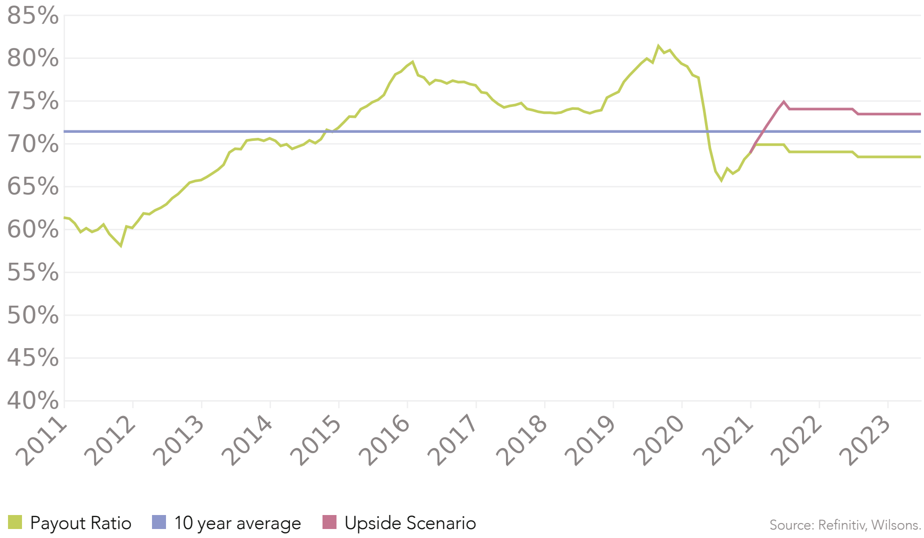
Rising dividend payout ratios leading into FY19 were systematic of:

1. The low interest rate environment
2. Disruption and future technology causing boards to hesitate on major CAPEX initiatives
3. The Federal Election in 2019, which maintained the status quo on franking credits – which kept both major institutional shareholders and retail investors pushing companies to lift dividend payouts

When looking at forward payout ratios, the market seems to be conservative with payout ratios of 68-69% being held flat through FY21-23E. This compares to a ~75% average payout ratio seen in the low dividend environment since 2013 (long-term average is 71%).

As a consequence, the recovery of total dividend dollars paid is still lagging the earnings recovery in FY23E by close to 20% on a per-share basis versus FY19.

Exhibit 2: S&P/ASX 100 dividend payout ratio – market estimates assume payout ratios do not return to FY19 levels



Source: Refinitiv, Wilsons.

Market Conservatism on Dividends

Market conservatism is being driven by:

1. Complacent forecasting by the market. Forecasts for dividend and payout ratios were set in mid-2020 when the worst of the COVID-19 crisis occurred. While earnings have been revised upwards with economic outcomes not as bad as feared, dividend estimates have lagged. Capital management initiatives are also typically poorly forecast – which offers an additional source of dividend payments.
2. Potentially underestimating the duration of buoyant commodity prices across both the materials and energy sectors.
3. Bank dividend recovery materially lagging the earnings recovery. While ordinary payout ratios for the banks are unlikely to reach the FY19 level of 84%, strong capital positions and potential for provision unwind are not captured in market estimates over FY21-23E. With banks typically making up around a third of the market's total dividend payments, this sector remains important for the overall index level of dividends.

We would not be surprised to see upward dividend revisions across the market this reporting season, driven by improved earnings estimates along with a lift in dividend payouts.

Potential Areas for Dividend Upside

The energy, financials and materials sectors all contain the potential for positive dividend surprise versus market estimates over the next 3 years. Notably, forward dividend estimates across all 3 sectors imply payout ratios well below FY19 levels. All other sectors should see a minimal lasting impact on payout ratios from COVID-19.

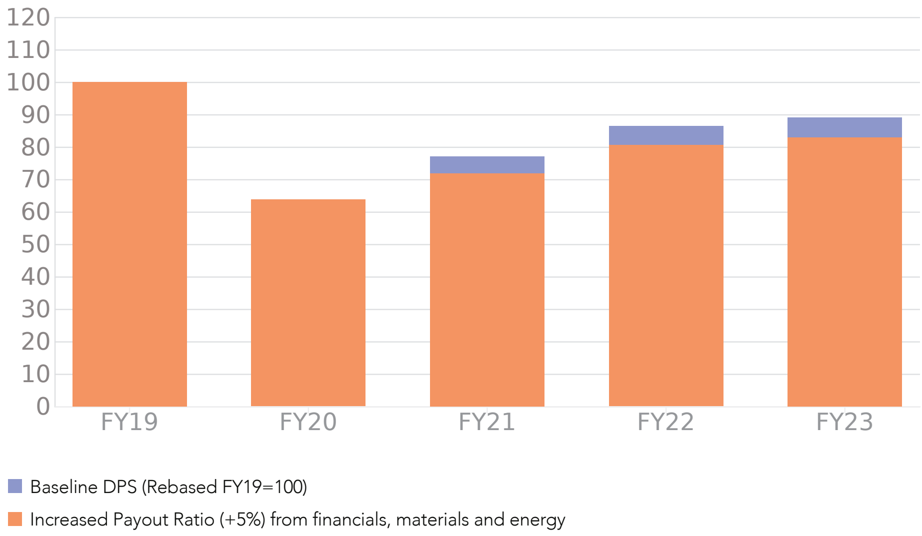
While we are not suggesting that the banks will return to peak payout ratios in the mid-80s, a 5% point lift in payout ratios from the mid-70s (versus low 70s), and a similar magnitude for both energy and materials would see market dividends lifted 7%. See Exhibit 2.

Extending this argument, if you were to assume FY23E bank payout ratios were to match FY19 levels, then the market's dividend would return to FY19 levels.

This raises an interesting prospect. If regulations are forcing the banks into highly capitalised, domestically-focused lending business - offering little in the way of non-system growth - then what is the argument for payout ratios in the mid-70s, particularly if capital requirements are expected to be stable? In the shorter term, we suspect the low payout ratios for the banks will be supplemented by capital management initiatives over the next 12-24 months.

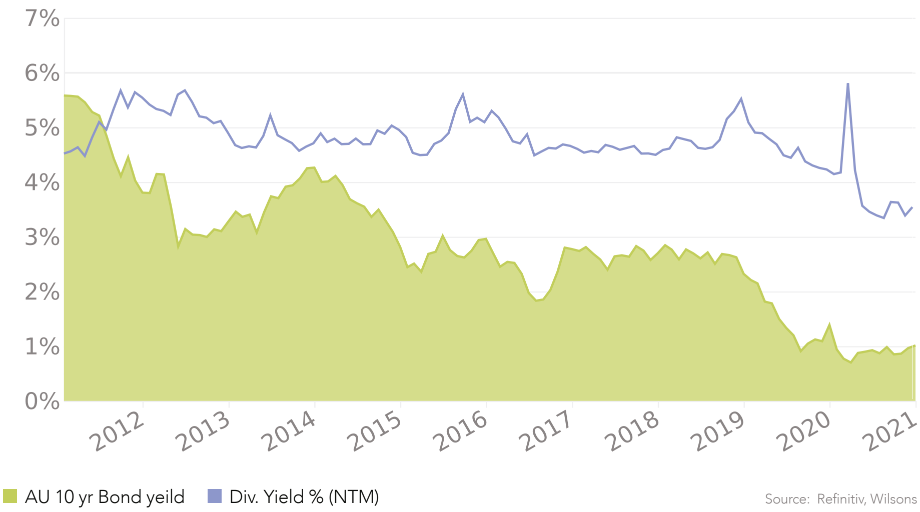
The other observation in terms of where dividend upside resides is that all 3 sectors - energy, financials and materials - are highly economically sensitive, and to some degree, all have higher than average risk of business model disruption. This suggests there is some risk around the dividend improvement scenario that we have projected, which should be considered.

Exhibit 3: Market dividends - partial normalisation of payout ratios in just 3 sectors would help close the gap



Source: Refinitiv, Wilsons. Market dividend payments rebased to 100 FY19

Exhibit 4: Markets 12-mth forward dividend yield of 3.6% potentially vulnerable to upward dividend revisions



Source: Refinitiv, Wilsons

Market Dividend Yield

The overall yield of the market is 3.6% on a 12-month forward basis, well below the 4.5-5.0% level we have been accustomed to for much of the last decade.

Using our upside scenario above on the payout ratios for energy, financials and materials, this would lift the yield to 3.8% 12-month forward. Taking this one step further, assuming a higher bank sector dividend payout ratio of 80% (close to peak level payout) would return market dividends to FY19 levels, and imply a market dividend yield of almost 5% on an FY23E basis.

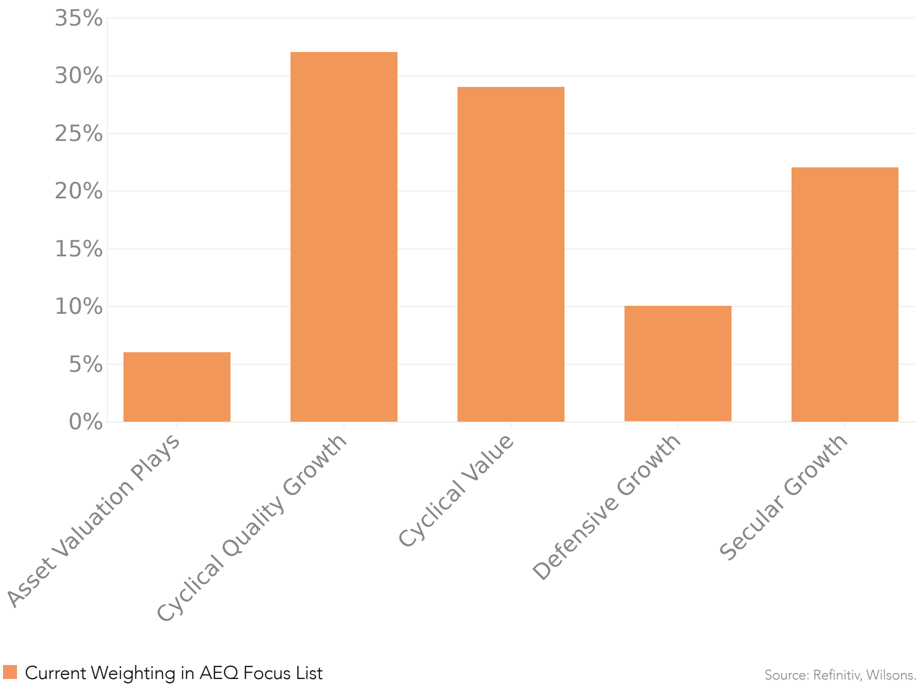
Equity Focus List and Dividends

Do dividends matter for our quality/ growth-biased Wilsons Australian Equity Focus List? The simple answer is yes, but not to the same degree as the broader market where dividends typically make up ~50% of the total return.

The quality/growth bias of the Focus List results in a much lower forward dividend yield of 2.9% versus the market at 3.6%. With the current overweight cyclical positioning, the Focus List has expected dividend growth of +44% in FY21E and +16% in FY22E. This is heavily influenced by companies like Aristocrat Leisure (ALL), James Hardie Industries (JHX), News Corporation (NWS), Super Retail Group (SUL) and the banks, where dividends are very low - and/or were substantially cancelled due to COVID-19 - and as consequence should bounce back quickly.

Ahead of the upcoming results season we have flagged the potential for upside dividend risk for banks, with Commonwealth Bank (CBA) providing 1H21 results and quarterly trading updates from both ANZ Bank (ANZ), National Australia Bank (NAB).

Exhibit 5: Focus List remains overweight cyclical exposures



Source: Refinitiv, Wilsons.

Materials with BHP Group (BHP), Northern Star Resources (NST), Oz Minerals (OZL) and James Hardie Industries (JHX) all contain potential for dividend surprise. In addition, domestically-focused Seven Group Holdings (SVW) and Super Retail Group (SUL) also offer potential dividend upside.

For more, read Can Australia's Earnings Reflect the Improving Outlook?

On a medium-term basis, strong dividend growth is likely to come from the banks and Transurban Group (TCL) as earnings are restored. Aventus Group (AVN) and James Hardie Industries (JHX) also offer strong medium-term distribution growth prospects.

Exhibit 6: Focus List Valuation Metrics

Ticker	Name	Sector	Focus List Weight	EPS CAGR (FY1-FY3)	PE (NTM)	Div Yield (NTM)	ROE (NTM)
Asset Valuation Plays							
AVN	Aventus	Real Estate	4.0%	5%	14.1	6.4%	7.9%
NWS	News Corporation	Communication Services	2.0%	41%	45.0	0.8%	3.4%
Cyclical Quality Growth							
ALL	Aristocrat Leisure	Consumer Discretionary	3.5%	26%	25.8	1.6%	22.1%
WOR	Worley	Energy	3.0%	23%	15.7	3.9%	4.9%
BHP	BHP Group	Materials	10.0%	-10%	12.8	4.1%	23.4%
CBA	CBA	Financials	7.0%	7%	19.2	3.9%	10.5%
JHX	James Hardie Industries	Materials	3.0%	15%	25.6	1.5%	30.2%
MQG	Macquarie Group	Financials	6.0%	22%	17.6	4.0%	12.9%
Cyclical Value							
ANZ	ANZ	Financials	7.0%	7%	13.6	4.9%	8.3%
OZL	OZ Minerals Limited	Materials	3.0%	36%	17.1	1.1%	10.6%
NAB	NAB	Financials	5.0%	8%	16.4	4.6%	8.6%
RWC	Reliance	Industrials	3.0%	5%	19.2	2.5%	11.4%
STO	Santos Limited	Energy	4.0%	48%	17.4	1.4%	7.9%
SUL	Super Retail	Consumer Discretionary	3.0%	-15%	11.1	5.6%	18.3%
SVW	Seven Group Holdings	Industrials	4.0%	11%	15.8	2.1%	14.9%
Defensive Growth							
AZJ	Aurizon Holdings	Industrials	3.0%	9%	13.6	7.4%	12.7%
NST	Northern Star Resources	Materials	3.0%	19%	15.8	1.7%	22.9%
TCL	Transurban Group	Industrials	4.0%	-	156.9	3.7%	4.0%
Secular Growth							
APX	Appen	Information Technology	3.0%	32%	33.8	0.6%	14.7%
CSL	CSL	Healthcare	7.0%	12%	40.7	0.8%	29.3%
GMG	Goodman Group	Real Estate	3.0%	10%	26.4	1.7%	10.8%
RMD	ResMed	Healthcare	2.0%	10%	37.3	0.6%	25.3%
TLX	Telix Pharmaceuticals	Healthcare	2.0%	-	-	0.0%	-26.5%
XRO	Xero Limited	Information Technology	3.5%	54%	24841.1	0.0%	14.5%
EML	EML Payments	Information Technology	2.0%	35%	32.3	0.0%	9.0%

Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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