# Sustainability of Dividends

There has been a lot of discussion about the sustainability of UK dividends in the media recently and we too have been carefully monitoring the situation. It is important to realise that the picture is nuanced, with the situation for the market as a whole being very different to the positioning of our favoured funds.

The FTSE 100 dividend yield has become increasingly concentrated in relatively few companies. This has been a cause for concern, especially as some of these companies are in the mining and oil sectors which have performed poorly due to commodity price declines. Analysis by Capita indicates that 33% of all UK dividends paid in 2015 were paid by 5 companies namely BP, Royal Dutch Shell, HSBC, GlaxoSmithKline and Vodafone. Moreover, 55% of total UK dividends were concentrated in the largest 15 payers, including BHP Biliton and Glencore.

At the market level the outlook for dividend growth is quite subdued with the latest Dividend Monitor report from Capita forecasting a 0.9% fall in underlying dividend growth and a 1.3% fall in headline growth (which includes special dividends) in 2016. This has been influenced by deteriorating prospects for resources and food retailing stocks. The managers we invest with are focused on individual company cash flow, secure dividends and the potential for dividend growth. We have discussed the outlook for dividends during our regular meetings with UK and global equity income managers in the last few months and several have adjusted their portfolios to remove any holdings where dividends could be vulnerable and to rotate into stocks which have good long term dividend growth potential.

Many companies have declining dividend cover, a metric that is used to assess the sustainability of dividends by dividing profits with the amount of money returned to shareholders. A score close to 1 suggests that dividends are unsustainable; a figure of 2 or above is viewed as “comfortable”. Declining dividend cover (and in some cases its total absence) for a number of leading companies is revealed by Morningstar data and this is shown in the table below.

**Dividend Cover for Selected Top UK Dividend Payers**

| | FY[1] 2011 | FY 2012 | FY 2013 | FY 2014 | FY 2015 |
|---|---|---|---|---|---|
| Vodafone | 2.50 | 2.41 | 4.52 | 6.52 | 2.01 |
| Imperial Brands | 2.12 | 2.04 | 1.65 | 1.60 | 1.67 |
| British American Tobacco | 1.64 | 1.58 | 1.58 | 1.35 | Tbc |
| HSBC | 4.27 | 0.68 | 1.33 | 1.50 | 1.30 |
| GlaxoSmithKline | 1.40 | 1.07 | 1.38 | 0.88 | Tbc |
| AstraZeneca | 2.78 | 1.01 | 1.47 | 0.74 | 0.87 |
| Royal Dutch Shell | 2.80 | 2.22 | 1.79 | 1.64 | 0.59 |
| Rio Tinto | 7.02 | 3.80 | 3.01 | 2.16 | 0.50 |
| BP | 4.80 | 1.75 | 2.04 | 2.07 | -0.51 |

Vodafone is one of the few top dividend payers to have been consistently in a comfortable position. On the other hand mining and resources stocks are under particular pressure following commodity price declines. For instance, BP has no dividend cover, with the actual figure working out at minus 0.51% and is funding dividends from debt. It is also interesting to see that the tobacco companies which feature in so many equity income portfolios have consistently had dividend cover below 2 in the last few years. Major

[1] FY means “fiscal year” and reflects the fact that companies report their financial data at different points in the year. Tbc means “to be confirmed” following the release of company results.

pharmaceutical stocks AstraZeneca and GlaxoSmithKline also look stretched. We have had frequent discussions regarding these stocks with fund managers and the consensus is that AstraZeneca has a positive outlook due to the innovative cancer treatments it is developing. Conversely, we have heard a range of views on GlaxoSmithKline. Mark Barnett has sold the company from the Invesco Perpetual High Income fund. Other managers including Neil Woodford (Woodford Equity Income), Adrian Frost (Artemis Income) and Richard Colwell (Threadneedle UK Equity Income) are aware that the dividend could be under threat but see good potential for GlaxoSmithKline possibly through a demerger of the consumer business.

Some companies have had to cut dividends due to declining dividend cover and because earnings growth and profitability have faltered. Examples include Barclays, Standard Chartered, Rolls Royce, Tesco, Morrisons, BHP Biliton and Glencore. Dividends for many other companies may also be vulnerable.

The equity income funds we invest in have a focus on sustainable dividends, which automatically excludes a number of companies, especially in the resources sectors. They also take a very selective view on other cyclical businesses such as banking and in some cases exclude the banking sector altogether. One of the attractions of active fund management is that the best managers are able to use their judgement to anticipate this kind of problem. For example, Neil Woodford sold Rolls Royce prior to the dividend cut.

The level of Sterling will also influence UK dividends in the coming year. Several large multinational firms such as British American Tobacco, Diageo and Vodafone rely heavily on their overseas earnings and the fact that Sterling has weakened as markets ruminate over the possibility of a UK exit from the European Union will assist their earnings once they are translated back into Sterling.
It is also important to remember that some firms have increased dividends despite the prevailing market conditions and our favoured UK equity income funds have exposure to some of these stocks including BT, Imperial Tobacco, Provident Financial and Legal & General.

Falling dividend cover is mainly a UK issue and some of our favoured UK equity income funds also allocate up to 20% of their portfolio to high quality international stocks such as Roche, Reynolds American and Abbvie. Our portfolios also typically include an allocation to global equity income funds which have exposure to some very high quality, cash generative global stocks with secure dividends.

To sum up, we acknowledge that UK dividends are under pressure at the market level but we believe that the managers of our favoured UK equity income funds have taken steps to position their portfolios to withstand any difficulties that may arise. It is important to keep in mind that dividend growth in individual funds may be subdued in the coming year because the managers have positioned themselves for longer term growth opportunities.

**Georgina Ogilvie-Jones**

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