



# Invesco Quantitative Strategies

## Dividend Sustainability in Australia - Past and Future

December 2020

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### Executive Summary

The following paper explores dividend sustainability in the Australian equity market, and the capture of sustainable dividend income through Factor Investing.

The paper identifies and explores:

- Trends in the ASX300 for Earnings Per Share, Dividends Per Share and Payout Ratio
  - Trends for these same measures for the key dividend delivering ASX300 sectors
  - Dividend changes over time in the ASX300
  - Dividends as a 'Factor' themselves
  - Using Factors to predict upward (or downward) dividend changes in the ASX300
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### Introduction

How sustainable is dividend income in Australia? Certainly COVID-19's impact on earnings across the ASX300 has been sharp and deep, but the impact is also likely temporary. Unlike the GFC, the COVID-19 shock has a clear path to recovery with a government-mandated opening-up as vaccines and tracing systems prevail. Though the GFC was a 'traditional' business and credit cycle downturn, it can still provide a useful guide to how dividends may recover from the current environment.

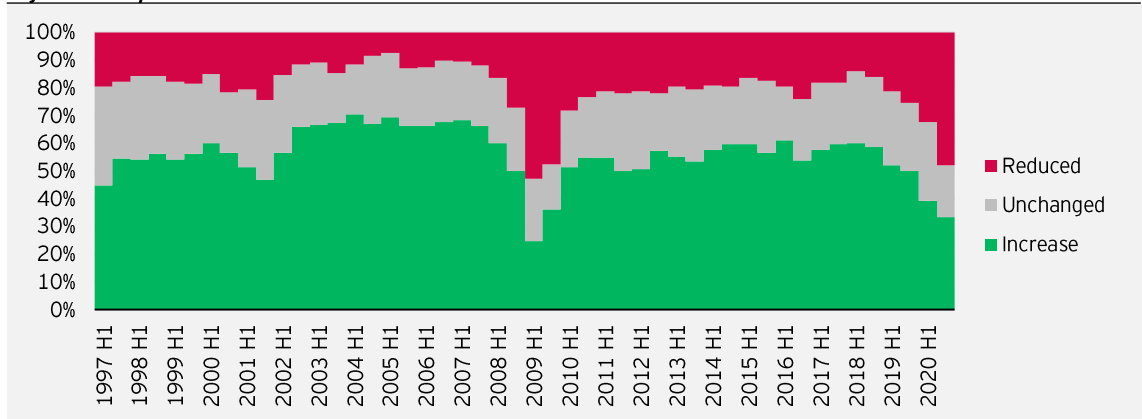
Much of the following paper is dedicated to examining key dividend producing sectors. This is because it's apparent that a sector rotation for income investors should presently be considered. The Australian income investor has been carried on the banks' broad shoulders for decades, with around a third of the dividends and franking credits paid out in the Australian market coming from the banks. This share is unlikely to continue in a low interest rate environment where banks cannot secure the margins they once did, and where regulators are tightening screws off the back of the Banking Royal Commission. Australian income investors can look to a handful of other dividend-paying sectors, namely resources, infrastructure and REITs, but can the earnings, dividends and payout ratios of these sectors be relied upon in the foreseeable future?

In the paper we analyse the last 20+ years of ASX300 data through our factors and their underlying signals, and we present our view of the key trends in earnings, dividends and payout ratios.

## Recent Developments in Dividends across the S&P/ASX300

Dividends have increased over time in the Australian market, with most half-year periods since 1997 seeing increases when dividends are announced [Figure 1]. COVID-19 ended a benign recent period since the GFC of steady increases, as issuers sought to preserve capital amid a combination of broad uncertainty and, in the case of travel and hospitality, very certain sudden stops in earnings.

**Figure 1: Daily Factor Returns - 1 Jan to 10 Nov 2020**



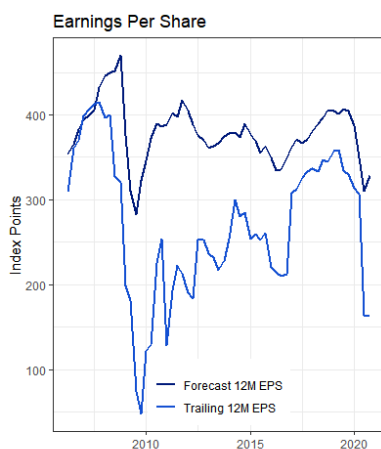
Source: Invesco, Bloomberg - Jan 1997 - Sep 2020. A measure of absolute dividend events, and therefore not weighted to dividends.

COVID-19 has severely depressed corporate earnings, and actual declines in Earnings Per Share (EPS) (trailing 12m) have exceeded forecast declines [Figure 2]. In the year to September 2020, 12-month EPS for the S&P/ASX300 Index fell more than 50% from the period ending September 2019.

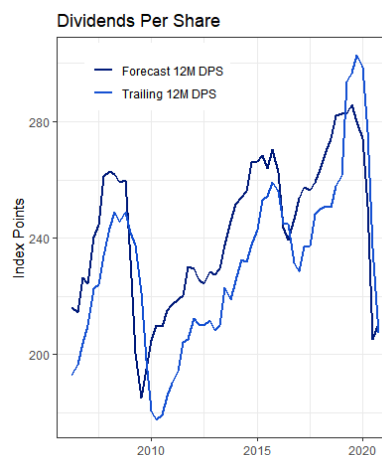
Where EPS goes, so too do Dividends Per Share (DPS). In fact DPS has been slashed more sharply and deeply during the COVID-19 period than during the GFC, and here the actual declines in DPS have been in lock-step with forecast declines [Figure 3], unlike EPS where 12-month forecasts have been fairly resilient. The current DPS 12-month forecasts point to zero aggregate growth.

The actual Payout Ratio (POR) has historically exceeded the forecast POR [Figure 4], but the present forecast is the lowest since 2013. When EPS collapses, such as during the GFC or the recent COVID-19 period, the actual PORs become unrealistic. Consensus forecasts indicate a rebound in earnings next year but not much of a recovery in dividends.

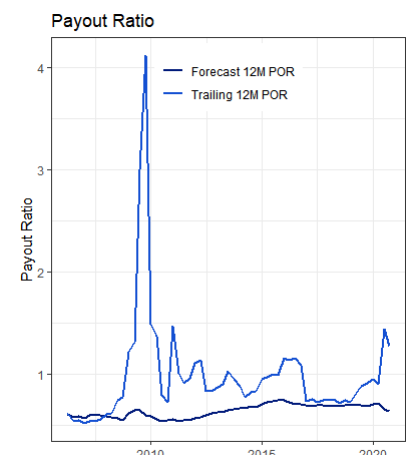
**Figure 2: ASX 300**



**Figure 3: ASX300**



**Figure 4: ASX300**



Source: Invesco, S&P ASX300, Jan 2006 - Sep 2020

## Recent developments in Dividends across the key dividend sectors

### Banks: The struggling atlas of Australian income

Banks are widely held by retail and institutional investors; by passive investors due to their sheer size in the index, and by active income investors for their generally high franked dividends. Bank profitability had weakened somewhat in the lead up to the pandemic as credit growth slowed due to a combination of macro-prudential monetary policy and measures taken to bolster capital. The onset of the GFC led banks to protect their balance sheets from expectations of deteriorating asset quality by raising capital and cutting dividends. Trailing 12 month DPS fell 21% from peak to trough through Dec-08 to Dec-09. A similar story has played out so far in the pandemic. Although bank dividends have been in steady decline since Dec-15, the 1-year decline to Sep-20 was 40% - a much sharper fall than observed during the GFC [Figure 6].

DPS forecasts [Figure 6] have fallen sharply in the pandemic. The year-ahead forecast for dividends at the end of September 2020 was 44% below the year-ahead forecast from September 2019. This forecast is still 11% below trailing bank dividends. Note that some banks (notably CBA with its Jun/Dec balance dates) paid dividends in the first half of 2020, reflecting events before the COVID-19 crisis, hence this is not surprising.

The POR [Figure 7] has tended to operate in a counter-cyclical manner as dividends tend to be smoother than fluctuations in earnings. Earnings forecasts generally display a degree of reversion from large swings, and hence forecast payout ratios tend to be much smoother than realised payout ratios. Based on Sep 2020 forecasts for earnings and dividends, the payout ratio for banks is expected to slip to just 60%, which would be lower than the lowest actual payout ratio following the GFC.

Figure 5: ASX300 - Banks

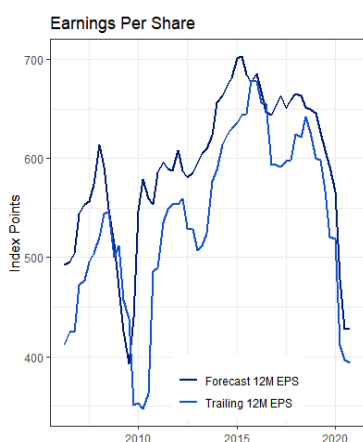


Figure 6: ASX300 - Banks

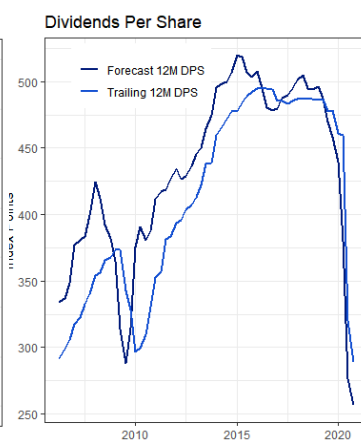
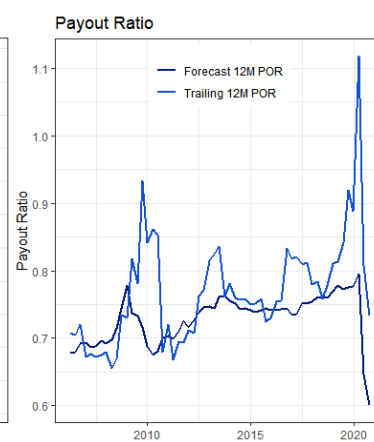


Figure 7: ASX300 - Banks



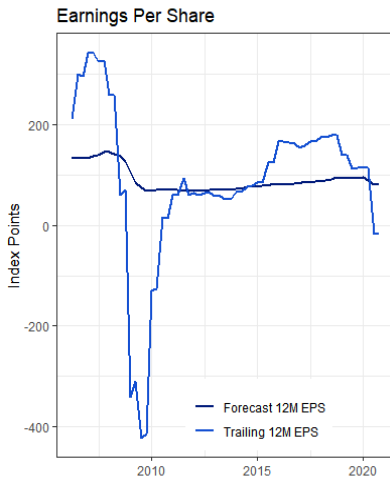
Source: Invesco, S&P ASX300, Sep 2006 - Sep 2020

### REITS: No friend in a crisis

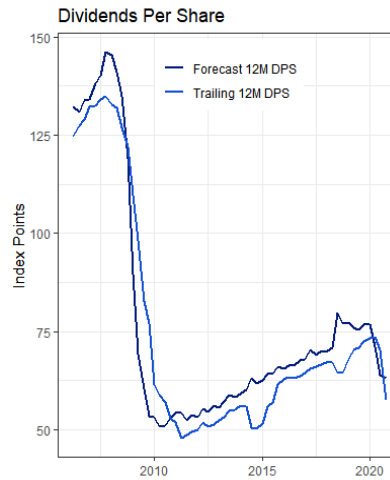
Property trusts have the desirable characteristic of generally smooth distributions which can be forecast with a high degree of accuracy - except, that is, when there's a crisis. In a crisis, REITs' EPS and DPS drop sharply [Figures 8, 9]. REITs are considered "defensive", perhaps because of their stability most of the time, but this defensiveness is illusory. REITs which survived the GFC (and some did not leading to survivorship bias in the below charts) cut distributions by more than half over the period of 2007 to mid-2011 [Figure 9]. It's notable that EPS and DPS were very high leading up to the GFC.

Following the GFC, as the recovery proceeded, boards tended to adopt a more conservative approach to capital management and allowed PORs to drift somewhat lower [Figure 10]. The drift lower turned into a plummet when COVID-19 hit, with a drop deeper than that of the GFC period. This points to the real estate specific nature of the COVID-19 impact; hitting rent collections and property valuations in a way that the GFC did not.

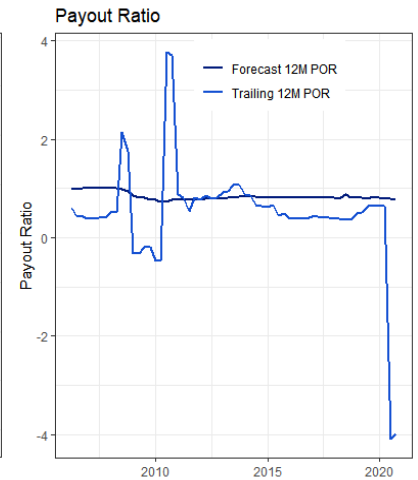
**Figure 8: ASX300 - REITs**



**Figure 9: ASX300- REITs**



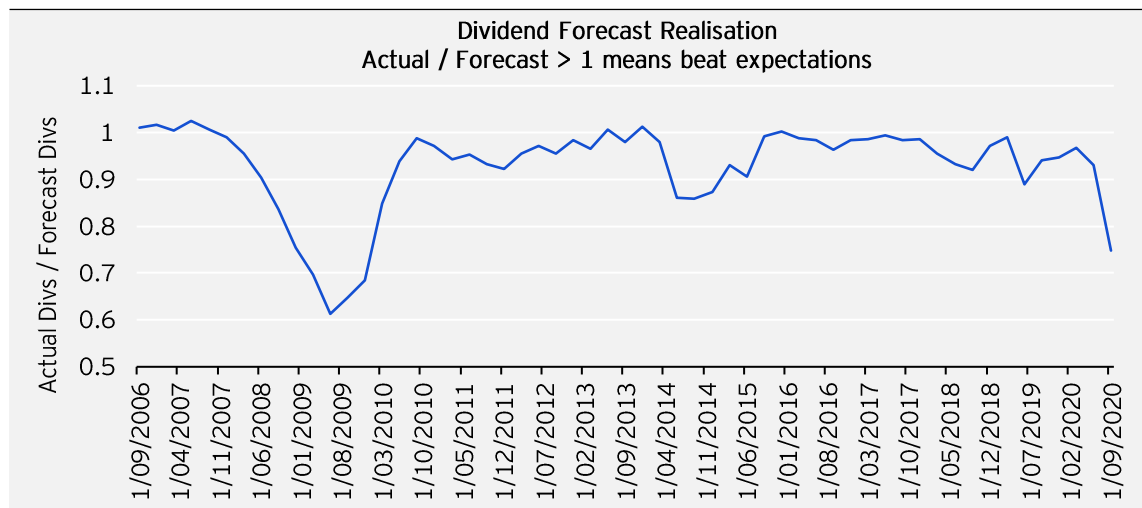
**Figure 10: ASX300 - REITs**



Source: Invesco, S&P ASX300, Jan 2006 - Sep 2020

Analysts have consistently over-forecast REIT dividends since the GFC, with the actual dividends rarely exceeding estimates, and by little when they do [Figure 11]. What does the future then have in store for Australian REITs income? How rapid and broad will reopening in Victoria be, and what will the valuation level be once the volume of commercial transactions increases from the current trickle? Recent history has told us to be conservative in our dividend expectations, and furthermore - since REIT statutory profits are sensitive to changes in property valuations - the earnings themselves of REITs are uncertain going forward.

**Figure 11: Actual 12 Month Dividends v 1yr Forward Dividend Estimates**



Source: Invesco, S&P ASX300, Jan 2006 - Sep 2020

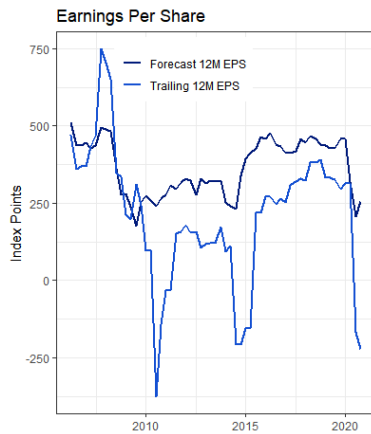
### Infrastructure / Transportation: Planes vs Power

The COVID-19 lockdowns saw travel related infrastructure hit much harder than power (energy) related infrastructure. This asymmetric impact differs significantly from that of the GFC<sup>1</sup>. Airlines are prone to cyclical downturns (i.e. the GFC) but also business shocks triggering write-downs (2014's carrier competition and US \$100+ barrel oil) as can be seen in the Payout Ratios turning negative at these points [Figure 14]. A dividend distribution recovery for travel infrastructure will depend on the speed at which travel restrictions are lifted. Infrastructure saw steady dividend

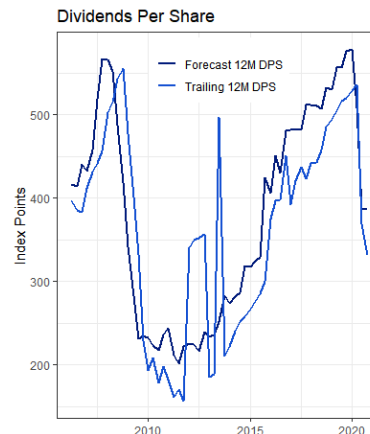
<sup>1</sup> Financial engineering and excessive leverage led to widespread declines in earnings of some infrastructure stocks during the GFC

growth post-GFC off the back of free cash flow which was less encumbered by leverage, but COVID-19 has cut free cash flow [Figure 12]. Nevertheless, analysts presently have the forecast POR above one [Figure 14] - in line with the historic Infrastructure POR. One could argue though that the POR becomes a technical footnote when earnings are negligible for shuttered travel companies.

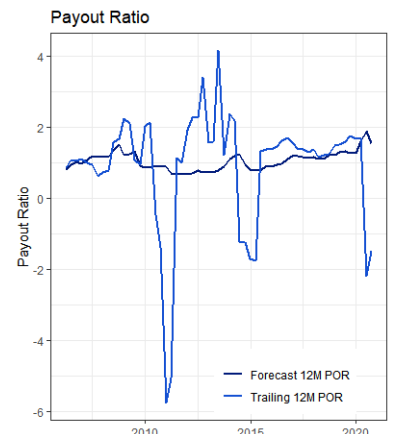
**Figure 12: ASX300 - Infra / Trans**



**Figure 13: ASX300 - Infra / Trans**



**Figure 14: ASX300 - Infra / Trans**



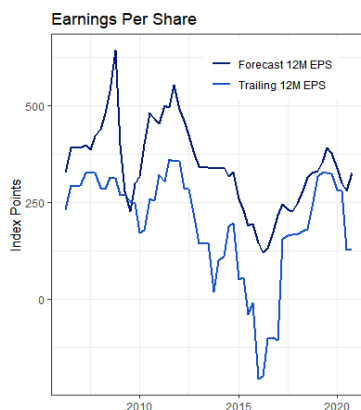
Source: Invesco, S&P ASX300, Jan 2006 - Sep 2020

### Resources: The income diversifier

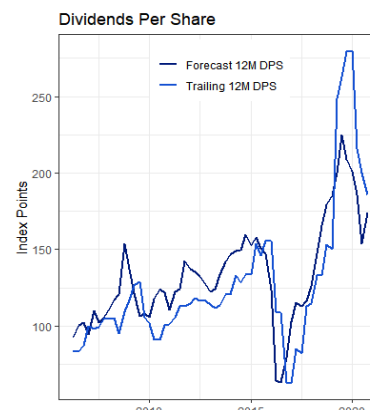
Resource company earnings depend on global prices for iron ore, coal, gold and oil (the commodity cycle) and on the capital cycle, which determines capacity in the industry; over-capacity or under-capacity to meet present demand. Resources therefore offer some diversification from the general business cycle sectors. 2015, the year of the slowest Chinese expansion in 25 years, was a sharply down period in Resources in terms of EPS, DPS and POR [Figures 15, 16, 17], but for Banks and REITs the 'China slowdown' barely registered.

Iron ore and gold have been the stronger commodities in recent years, and explain much of the recovery in EPS and DPS since 2015 - particularly iron ore producers which have effectively picked up the slack of the Bank's post-Royal Commission dividend retreat. Investors understand that commodity prices follow long and amplified cycles, so that the use of special dividends and other capital management tools are viewed as somewhat less sustainable than ordinary dividends. Companies are able to return excess income to shareholders during times of high prices and profitability, whilst preserving cash during leaner times.

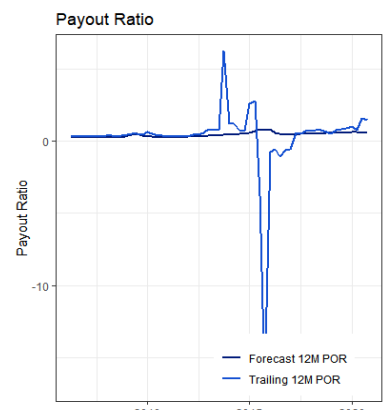
**Figure 15: ASX300 - Resources**



**Figure 16: ASX300 - Resources**



**Figure 17: ASX300 - Resources**



Source: Invesco, S&P ASX300, Jan 2006 - Sep 2020

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## Dividends as a 'Factor'

The Gordon Growth Model, also known as the dividend discount model (1962), presents a stock price as the present value of the stock's future dividends. It is a stylized model and misses key details such as considering non-dividend paying growth stocks. As a stylized model it over-emphasizes current or near term dividends as the key factor in the evaluation of stock prices.

Academic research has demonstrated empirical support for dividends as a signaling tool, where increases in dividends are predictive of future earnings increases, however the converse is not necessarily true - dividend cuts don't necessarily predict future earnings declines, rather, they reflect decreases in present earnings vs past earnings. Dividends are not a discrete factor in IQS' model, but the existing factors can predict dividend changes in a persistent manner.

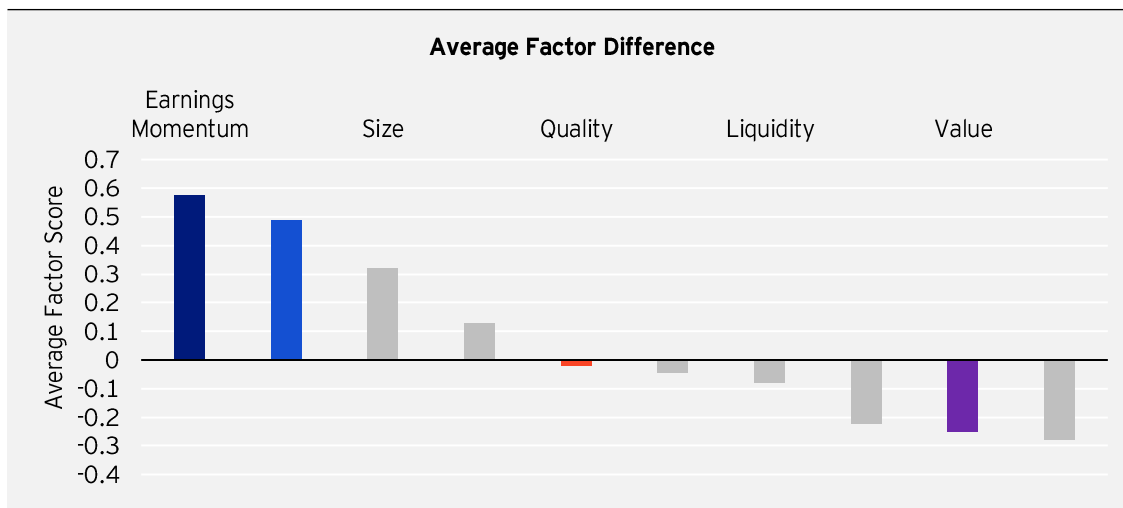
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## Predicting dividend changes with Factors

IQS' proprietary risk model measures return-generating factors such as Earnings Momentum, Price Momentum, Quality and Value, as well as style factors such as Size, Growth, Liquidity, Leverage and Volatility. Each company has a measurement for each factor (through underlying signals) at each point in time. We can therefore compare the factor scores of companies that raised dividends versus those that cut dividends.

Figure 19 shows the difference in the average factor scores from the IQS risk model for Australia for the month preceding a dividend declaration. That is, average Factor score preceding a dividend increase declaration *minus* average Factor score preceding a dividend decrease declaration. The factors have an average score of zero across the estimation universe and a standard deviation of one, meaning the majority of factor scores lie in the range of -1 to +1 (with a maximum of -3 to +3 at the tails).

**Figure 19: Factor prediction of dividend declarations - Coloured factors are proprietary IQS model factors, while grey factors are style factors which are not predictive of persistent excess return.**



Source: Invesco, Axioma risk model on S&P ASX300, Jan 1997 - Sep 2020. The factor scores are selected from the end of the month preceding the month of the Declared Date to avoid peak-ahead bias.

**Earnings Momentum** is the strongest predictor for differentiating between companies raising vs cutting dividends. Companies with stronger positive earnings momentum leading up to the announcement are more likely to increase dividends and those with negative earnings momentum more likely to decrease.

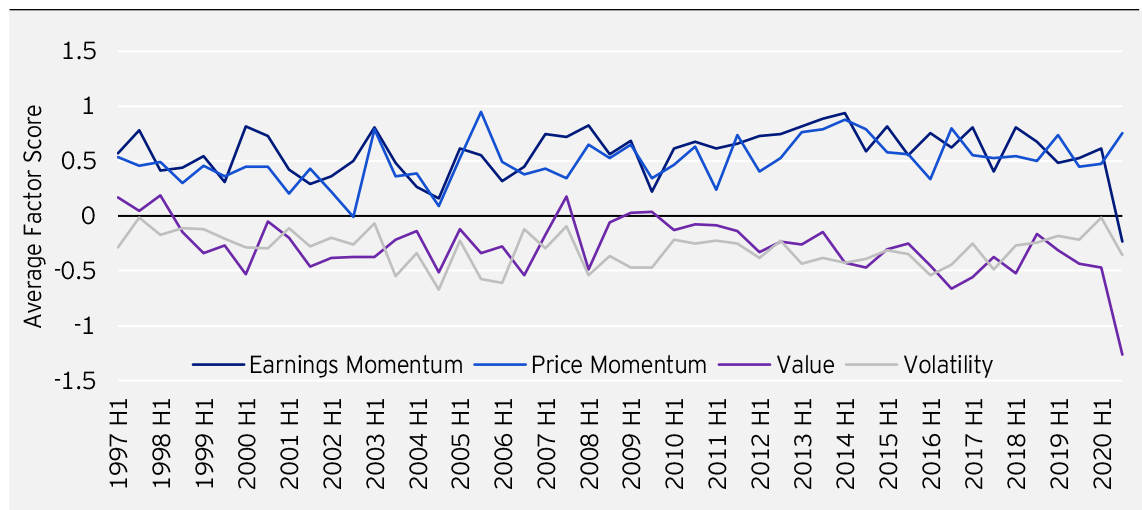
**Price Momentum** is the second most important factor. Companies with a stronger stock price and earnings performance are more likely to raise than cut dividends, and those with a weaker stock price and earnings performance are more likely to cut than raise dividends.

Higher **Volatility** and Higher **Leverage** is associated with dividend cuts, and Value also has a negative association; the better the Value score, the more likely a dividend cut will occur in the near future. The fact that cheapness on a relative value basis is associated with dividend cuts is related to the idea that distressed companies often appear cheap before cutting their dividends, so-called Value traps.

Finally, **Quality** is not a strong predictor in either direction.

Factor scores in relation to imminent dividend declarations are reasonably consistent through time [Figure 20]. Earnings and Price Momentum show a consistently positive relationship (i.e. improving earnings/price momentum is more likely to precede increases than decreases); while Value and Volatility have a consistently negative relationship (improving attractiveness on Valuation - that is, the stock price dropping - or increasing Volatility are more likely to precede dividend cuts).

**Figure 20: Factor prediction of dividends; consistent through time**



Source: Invesco, Axioma risk model on S&P ASX300, Jan 1997 - Sep 2020.

## Conclusion

As balanced investors across all sectors we do not pick sectors. We have a systematic approach to select the best companies in a given sector based on the company's relative factor scores. We've found that our Earnings Momentum and Price Momentum factors have been historically predictive of dividend increases. So too, we've found that our factors have been historically predictive of excess returns over time.

For those income investors who do wish to pick sectors, we've outlined the challenges that Banks are facing, and identified the problem in relying on REITs as a defensive sector (Consumer Staples, not explored in this paper, could supplement or replace REITs in this regard). We've also discriminated between sub-sectors - in Infrastructure for instance - with regards to the COVID-19 impact on income, and demonstrated the diversifying role of the Resources sector in smoothing the path of dividends for a portfolio.

It is difficult to form a strong view on the likely path of ASX300 dividends on the basis of the recovery from the GFC. EPS had a volatile recovery from the GFC, whereas the recovery of DPS was much smoother - perhaps we can expect a similar pattern for these two measures during the COVID-19 recovery? It would also appear that the sharp cuts to EPS and DPS due to COVID-19 have already occurred, but COVID-19 or lockdown second-order effects could yet surprise investors. The November bank reporting season performed in line with our views on dividend sustainability, but the December retail performance will be crucial to form stronger views for 2021 dividends.

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