MLC IncomeBuilder – Outlook for dividends

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With economic uncertainty remaining high, many Australian companies have slashed their dividends, affecting MLC IncomeBuilder's ability to grow its income stream.

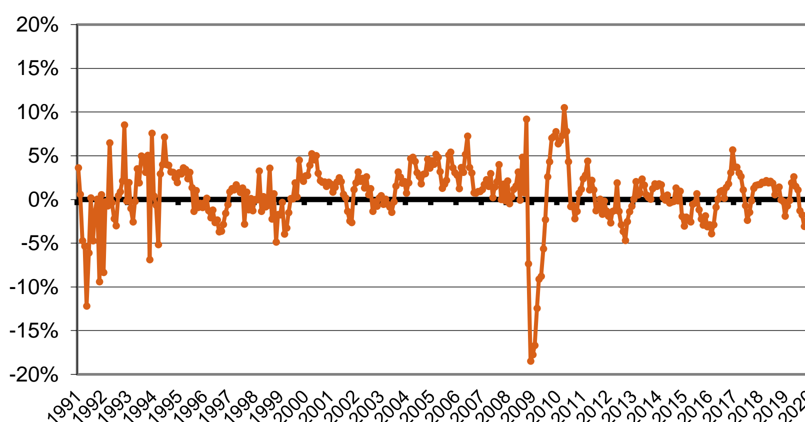
COVID-19 has caused a dramatic drop in economic activity

Measures implemented by the Australian and state governments to combat the spread of COVID-19 have led to a dramatic drop in economic activity. The speed and magnitude of the decline that has occurred so far is unprecedented. Some industries (travel, gaming, hospitality) have effectively shut down overnight, while companies operating in sectors normally considered to have defensive characteristics have experienced a sudden fall in demand for their products.

At this stage, the outlook is very uncertain because, in the absence of a vaccine, we cannot be sure how the spread of the virus may evolve from here. This means the economic consequences of the measures taken so far to slow the spread of the virus, the length of the economic downturn, and the effectiveness of the support provided by the Reserve Bank of Australia, Federal and state governments cannot be assessed with much accuracy.

As a result of the economic decline so far and uncertain outlook, a significant number of companies listed on the Australian share market have withdrawn their earnings guidance for fear of misleading investors. Chart 1 shows the downward revisions to earnings so far is nearly as bad as we saw in the GFC.

Chart 1: Australian listed company earnings revisions



Source: MLC Asset Management Services Limited.

Many companies have chosen to cut dividends

Companies with the flexibility to do so have responded to the dramatically worse trading environment and uncertain outlook by reducing their operating costs (usually by cutting their workforce, evident in the worsening unemployment rate), accessing government support programs, and in some cases raising additional equity to underpin their financial position.

In addition to these measures, many companies have chosen to preserve capital by cutting dividends, deferring them or cancelling them altogether. This was evident from the recent half year profit announcements by the banks:

- **ANZ** has advised shareholders it was deferring a decision on the payment of an interim dividend "until the economic outlook is clearer". It's promised to provide an update in August. ANZ's interim dividend in 2019 was 80 cents per share (cps).
- **Westpac** has also deferred its interim dividend decision and committed to review dividend options over the course of this year. Westpac's interim dividend in 2019 was 94 cps.
- **NAB** paid a 30 cps dividend but this was 64% lower than the previous year's corresponding dividend.
- **CBA** is on a different half year reporting cycle. In its recent March quarter trading update, CBA announced it was making a $1.5 billion provision for potential impacts of COVID-19. It made no comment on its dividend intentions for the full year.

These four companies accounted for 22% of MLC IncomeBuilder's portfolio as at 21 May 2020.

The Australian Prudential Regulatory Authority (APRA) recently advised banks and insurance companies to maintain capital buffers by reviewing dividend policies. As a result of this direction, and also due to profit pressures caused by the summer bushfires and subsequent storm damage, insurance company IAG warned "there is presently limited scope to pay a final dividend in September 2020".

Aside from the bank holdings, other stocks in the portfolio have also reappraised their dividend policies:

- **Star Entertainment Group** (3% portfolio weighting) has had to indefinitely close its casinos in Sydney, Gold Coast and Brisbane. Effectively the company has no revenue. As a result, the company said it will not pay a final dividend for the year ending 30 June 2020. Last year, Star's final dividend was 10 cps.
- Betting and gaming company **Tabcorp** (3% portfolio weighting) has also cancelled its full year dividend to shareholders, which was 11 cps last year. Earnings have been adversely impacted by the postponement of professional sport and the closure of pubs, clubs and betting venues.
- The retail sector has clearly been badly affected by the measures to restrict community movement and social distancing. Shopping centre owner and manager **Scentre Group** (2% portfolio weighting) has announced it won't pay an interim distribution for the half year to 30 June (11.3 cps last year). **Mirvac** (1%) and **Stockland** (2%) have withdrawn earnings and distribution guidance due to the uncertain outlook. Retailer **Harvey Norman** (2%) cancelled its 12 cps dividend due to be paid on 4 May, in order to preserve capital. **Coca-Cola Amatil** (3%) has decided to defer the decision on a dividend until the second half of 2020. It also withdrew previous guidance on its dividend payout ratio (the % of earnings paid to shareholders as a dividend) and expected dividend franking levels in 2021.

Despite the seriousness of COVID-19's impact on the economy, some companies will be less effected:

- Supermarkets of **Woolworths** (3%), **Coles Group** (5%), and **Metcash** (1%) enjoyed strong sales growth in the March quarter as customers stock-piled food and household essentials.
- Businesses operated by **Wesfarmers** (2%) such as Bunnings and Officeworks have experienced significant demand growth as people who are spending more time at home undertake maintenance and put in place working-from-home office infrastructure.
- Despite the challenging market conditions, **Medibank Private** (2%) hasn't changed its 2020 fiscal year financial outlook.
- **BHP Group** (3%) continues to enjoy strong operational performance, particularly its iron ore division where record production volumes were achieved in the nine months to 31 March 2020.
- **Telstra** (7%) and **AGL Energy** (2%) should be largely unaffected due to the essential services they provide.

With an eye to the future, the fund has participated in discounted capital raisings including **Incitec Pivot**, **Orica** and **QBE Insurance Group**.

Clearly the outlook for corporate earnings, and the fund's ability to generate a growing income stream, has deteriorated. While there are a small number of companies that aren't negatively affected and are likely to maintain their dividends, the majority of companies can be expected to declare materially lower dividends or none at all for at least the current half of the year or, for some companies, until the crisis is over. These changes are necessary to

preserve their balance sheet strength in an extremely uncertain business trading environment, and includes large dividend-payers like the banks, property trusts and infrastructure companies.

Investors can expect this financial year's distribution to be lower than in 2019

As a result, investors can reasonably expect 2020 financial year's distribution to be lower than in 2019. However, the fund will be distributing to investors as it has already distributed income for three quarters of the financial year, and realised capital gains will be distributed in the final quarter. Beyond the 2020 financial year we expect the fund's distributions to be cut materially in the short term, but it's still too early to estimate the extent of dividend cuts to be made by most companies and how long it will be for company earnings and dividends to recover.

Our experience during the GFC, which is probably the most serious market dislocation, prior to COVID-19, that we have seen in Australia in the last thirty years, where company earnings declined significantly in a very short timeframe, resulting in the fund not growing its income for two financial years.

However, we believe the experience and research skills of the two investment managers we've appointed to manage IncomeBuilder, Maple-Brown Abbott and Antares Equities, will allow us to again meet the fund's objective in future years. The active investment style of both managers will help position the fund's investments appropriately through the challenging period ahead and when company earnings eventually recover. Our managers continue to research and engage with companies on a regular basis, and many companies continue to provide stock market updates, as relevant information about their business's trading conditions becomes available.

While we're closely monitoring company dividend reduction and deferment announcements, our investment managers have been looking through to the other side of this economic downturn in determining the companies they believe will provide income growth in the future. We're cognisant that leading dividend-paying companies in the Australian market will change as a result of COVID-19. Some of the portfolio changes our managers have undertaken in recent months are outlined below.

Portfolio activity

Holdings have been maintained where our investment managers have assessed companies to have:

- strong balance sheets
- management proactively and constructively managing costs, and
- sufficient funding through debt or capital raisings.

We have confidence the companies with these features will continue to operate throughout this period and when the economy recovers they will return to paying dividends in the future.

Our investment managers have made some adjustments, including trimming positions where company earnings are expected to continue to be challenged in the medium term, after the economy recovers, or where their prices have risen beyond what our investment managers believe are reasonable based on their earnings potential.

Holdings our investment managers have added to since late February, include:

- **Amcor** – to benefit from increased demand for packaging of food, beverage, pharmaceutical, medical, home and personal-care products.
- **Link Group** – retains a market leading position in outsourced administration services which are expected to benefit from corporate outsourcing and more recently benefiting from increased listed company corporate actions such as capital raisings.
- **Boral** – to likely benefit from increased infrastructure construction from expected fiscal stimulus and better valuation.
- **Origin Energy** – continues to benefit from reduced debt costs, strong cashflow generation leading to balance sheet deleveraging, long-term gas supply contracts to Asia, and increased residential demand.

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