MLC IncomeBuilder – the improving outlook for dividends

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While the economic recovery means the outlook for corporate earnings has improved, many Australian companies continue to act with caution for their dividend payments.

COVID-19 caused a dramatic drop in economic activity in 2020…

2020 was a challenging year for investors who rely on Australian shares for income. The unexpected emergence of COVID-19 forced the Federal and state governments to implement a range of measures throughout the year to limit the spread of the virus. While these measures were ultimately successful, they resulted in a significant contraction in economic activity and lower profits for many Australian companies across a range of industries.

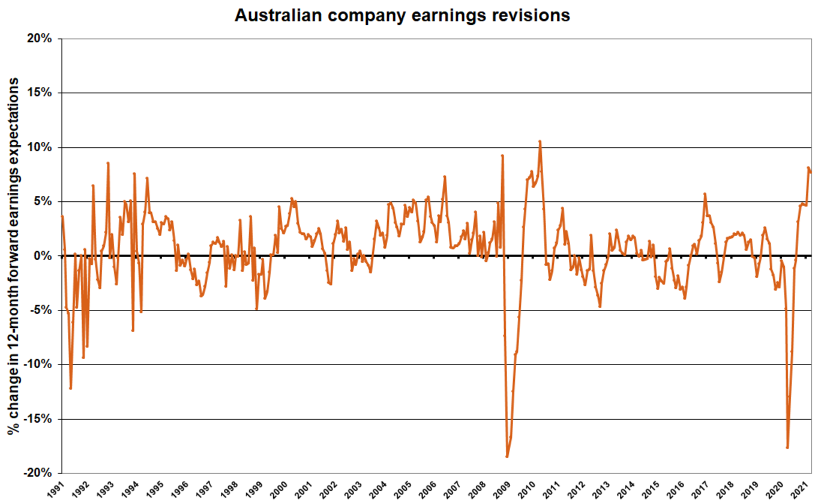
Companies with the flexibility to do so responded to the difficult trading environment and uncertain outlook by reducing their operating costs, accessing government support programs and, in some cases, raising additional equity to underpin their financial position. In addition to these measures, many companies chose to preserve capital by cutting dividends. Sharply lower earnings forced some companies to defer paying a dividend or cancelling them altogether.

… but 2021 has seen Australia's economy stage a remarkable recovery

With the virus spread virtually eliminated in Australia (so far), effective management of infections, and the commencement of the vaccination program both here and overseas, the market is looking to the future with more optimism. Australia's economy has staged a remarkable recovery. The economic decline was not as deep as forecast, the recovery has occurred quicker than expected, and business and consumer sentiment surveys have rebounded. As a result, the recent profit reporting period yielded better results than those we saw in August/September last year with some improvement in dividend payouts by a range of companies.

Expectations that the rollout of the vaccine in 2021 would further lessen the economic impact of COVID-19 has resulted in a growing number of companies raising their earnings forecasts (Chart 1).

Chart 1: A growing number of companies have raised their earnings forecasts



Source: MLC Asset Management Services Limited. As at 31 March 2021.

While the outlook for the economy has improved, the economic and market circumstances faced by the banks in the second half of 2020 were still challenging. This was evident from the 10.8% fall in the December half's cash net profit of Commonwealth Bank of Australia (**CBA**, 3.6% portfolio weighting). However, with the easing of capital management controls imposed on financial companies by the Australian Prudential Regulatory Authority in 2020, which limited dividend payout to no more than 50% of profits, the CBA increased its interim dividend paid in March 2021 to $1.50 per share. This was 53% higher than the $0.98 cents per share (cps) final dividend last year but was still 25% below last year's pre-COVID interim dividend. This latest dividend represents a payout ratio of 67% (the % of earnings paid to shareholders as a dividend) and is below the company's target payout range of 70% - 80% of earnings. This suggests that the banks may take some time to return their dividends and payout ratios to pre-COVID levels. Further clarity on this should emerge from the half year profit announcements by **ANZ** (8.6%), **Westpac** (9.0%) and **National Australia Bank** (8.8%) for the half year period to 31 March 2021. The four banks have a collective weighting of 30% within the MLC IncomeBuilder portfolio.

Some insurance companies also experienced challenging conditions:

- **QBE Insurance Group** (2.3%) recorded a large loss and decided not to pay a final dividend, although it hopes to resume dividend payments at its interim results announcement mid-2021, should global economic conditions not deteriorate materially.
- **IAG** (0.8%) paid an interim dividend of 7.0 cps but this was 30% lower than last year's corresponding dividend.
- In contrast, **Suncorp Group** (3.7%) maintained the interim dividend at 26 cps, although the 65.2% payout ratio was markedly below last year's 89.5%.

Food retailers recorded good profit growth and declared higher dividends:

- **Woolworths** (2.9%) increased its interim dividend by 15.2% to 53 cents per share (cps) after recording a similar increase in profit for the half year to 31 December.
- **Coles Group** (3.7%) increased its interim dividend by 10% to 33 cps as net profit increased by 14.5% from last year's corresponding period.
- **Metcash** (1.5%) also grew its earnings, enabling the company to raise its interim dividend by 33.3% to 8 cps.

After cancelling its final half dividend last year due to the adverse impact COVID had on its businesses, **Tabcorp** (2.9%) has been able to resume paying dividends to shareholders due to improving operating conditions and capital management initiatives. The interim dividend of 7.5 cps paid in March represents a payout ratio of 80%, which is at the upper limit of its 70% - 80% payout range. However, gaming and entertainment group The **Star Entertainment Group** (2.2%) elected not to pay a dividend for the half year to 31 December 2020 as it has prioritised a reduction in its borrowings.

The investment in **BHP Group** (2.8%) has been very beneficial to fund income as the 91.5% increase in the price of iron ore (to 28 February 2021) enabled it to pay a record dividend of US$1.01 cps (A$1.31 cps) for the half year to 31 December 2020. This was equivalent to an 85% payout ratio and an increase of 55% on the previous corresponding period's dividend. Despite the weak oil price for much of last year, record production of over 100 million barrels of oil equivalent allowed **Woodside Petroleum** (2.3%) to pay a second half dividend of US 12 cps, although this was 78% below the previous corresponding period dividend.

The 2020 calendar year was a challenging one for the listed property sector, especially those who own retail-oriented properties. However, retail conditions showed signs of improvement in the second half of the year despite the prolonged lockdown in Victoria. **Scentre Group's** (2.1%) operating profit grew 11.6% in the December half of 2020 and 98.5% of total Westfield retail centre space is leased. After not paying a first half distribution, Scentre Group paid 7.0 cents per unit (cpu) to investors for the second half to 31 December and gave guidance that it expects to distribute at least 14.0 cpu for 2021. **Stockland Group** (1.7%) paid a distribution of 11.3 cpu for the six months to 31 December 2020, up 6.6% on the previous half and committed to a payout for the full year toward the lower end of the target payout ratio range of 75% - 85% of funds from operations. Diversified property owner **GPT** (1.5%) paid a final distribution of 13.2 cpu, representing a distribution payout of 100% of free cash flow. However, due to uncertain operating conditions, GPT chose not to provide earnings and distribution guidance for 2021.

Telstra (6.6%) is one of the fund's largest stock holdings. The company paid an interim dividend of 8 cps, in line with last year's 8 cps interim dividend which included a special dividend of 3 cps. The company said it expected to distribute another 8 cps fully franked dividend in the second half.

A range of companies in different industries also contributed to the fund's income. As a result of strong financial results with half year earnings per share rising 14% from last year's, global packaging company **Amcor** (2.8%) paid a quarterly dividend of US11.75 cps compared with 11.5 cps in the same quarter last year. However, considerably lower profits resulted in **Origin Energy** (1.8%) paying a reduced dividend of 12.5 cps unfranked compared to last year's 15 cps fully franked dividend. Despite lower profits, **Orica** (1.9%) paid an unfranked dividend of 16.5 cps, which represents a payout ratio of 50%. In line with its payout policy of 45-60% of company earning, **Brambles** (2.6%) paid a dividend of US 10 cps. **Nine Entertainment's** (1.5%) 5.0 cps interim dividend was unchanged from last year's corresponding period.

Other fund investments that did not pay a dividend in the most recent profit reporting period were **Boral** (1.3%) and **Incitec** Pivot (2.5%).

Investors can expect IncomeBuilder's distribution to take some time to return to pre-COVID levels

While the economic recovery means the outlook for corporate earnings has improved, many companies are acting with caution before returning to pre-COVID dividend payments and payout ratios. As we saw in the recent profit reporting period, some sectors and companies have performed well despite COVID-19. However, there are many who remain vulnerable as government support programs like JobKeeper are withdrawn. These companies are preferring to retain capital rather than paying it to shareholders and continuing to restrict dividend payout ratios until the outlook for their industry and the success of the vaccination program becomes clearer. As a result, the fund's distribution will also take some time to return to pre-COVID levels.

We believe the fund is well placed to access the gradual recovery in dividends and resume annual distribution growth with tax benefits due to the experience and research skills of the two investment managers we've appointed to manage IncomeBuilder, Maple-Brown Abbott and Antares Equities. The active investment style and deep company research practiced by both managers will help position the fund's investments appropriately as the economy continues to recover and companies revise their dividends and payout ratio policies back towards pre-pandemic levels.