June 21, 2021

SKBA Market Update

A Reflection on the Suspense in "Suspend"

What happened to dividends during COVID-19

Do you have a favorite movie? Have you seen it a couple of times? Does it occur to you that the knowing the outcome takes away some of that suspense, and yet the story endures? At SKBA, our favorite movie is one that stars <u>Dividends</u>; it is one we have watched over and over and over again for decades, and it does not seem to get old even absent any suspense.

Last April, we wrote about the 'Suspense in Suspend' in regards to the wave of dividend suspensions washing over companies in the midst of the uncertain impact of the pandemic on the global economy. Even then, we knew how the story would turn out: dividends would eventually be restored for most companies, with some lower than they were prior to the crisis due to a change in earning power. Nonetheless, we find the lessons imparted in this most recent episode are enduring. Bear with us as we recap what happened to U.S. corporate dividends through a tumultuous 2020.

Dividend Policy in a Pandemic…

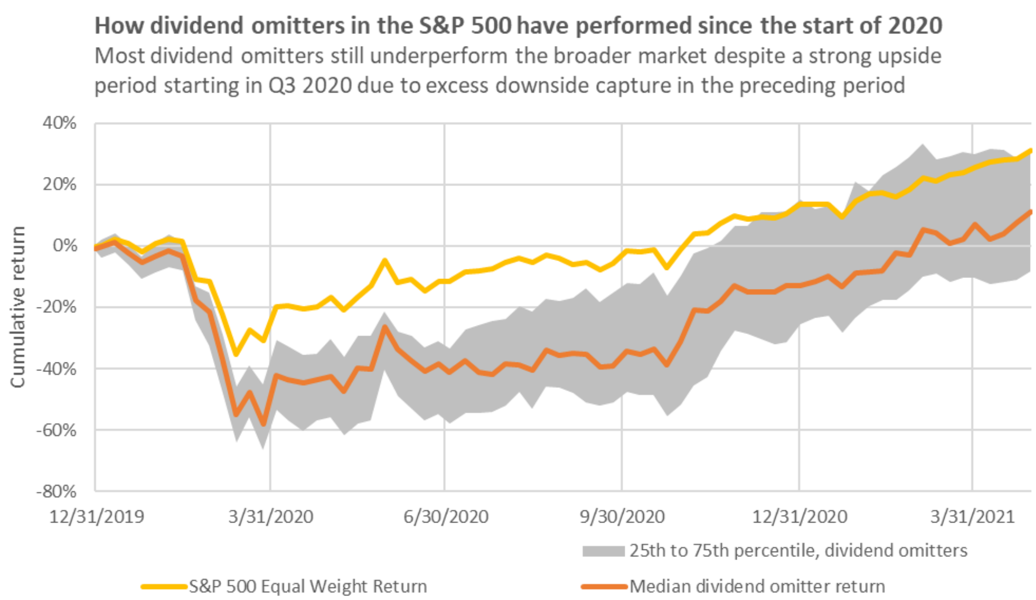
By the end of the second quarter of 2020, more than 12% of the dividend payers in the S&P 500 had either cut or suspended their dividends. "Suspension" had become the new term for omission. The sheer breadth of the unprecedented fundamental impact to the economy brought about by the swift shutdown meant that these dividend suspensions were not strong signals of deteriorating earning power as they might have been observed to be in the past. Furthermore, we held the belief that some suspensions would lead to dividend restorations in two or three quarters as the economy reopened and rebounded.

With the shelter in place orders at the onset of the pandemic, even fundamentally strong companies faced an unprecedented challenge with the sudden evaporation of demand. Companies like The Walt Disney Company provided an excuse, or cover, for other management teams that were uncertain of the near term to suspend their company's own dividend. Even if they had the means, they had lost the will to pay. It was not just the poorly-managed or junk-debt-rated companies that were suspending dividends.

Yet we also know that excesses had been building in the stock market for some time driven by an era of easy money that clouded capital allocation priorities. Corporate management had the freedom to engage in an all-of-the-above approach to capital allocation. Just by issuing cheap debt, a company could fund capital expenditures, raise dividends, and buy back stock to their heart's desire. Yet, when it came time to weather a fundamental setback like the economic impacts from COVID-19, these companies would be required to change their tune, reversing promises previously made. The breaking of said promises, particularly on dividends, has usually not been received positively by the market.

Dividend Suspension = Stock Declines

Our evaluation of dividend suspensions and cuts in the first half of 2020 within the S&P 500 index confirmed our hypothesis that dividend risk gets priced in by the market negatively and ahead of the actual event. The median dividend suspender or cutter declined more than 20 points worse than the average stock in the S&P 500 index—as measured by equal-weight S&P 500 index—ahead of its dividend announcement. Subsequent to the dividend suspension or cut, these companies continued to struggle. Typically, dividend suspenders matched the average return of stocks in the index despite having a greater potential to rebound with any recovery, such as what we saw as the market bounced back sharply in the second quarter of 2020. Dividend suspending stocks for the first half of 2020 were simply down and out from a return standpoint. They were hit harder during the March decline and didn't experience a meaningful recovery during the subsequent rebound during the rest of the year.



Data & Sources: Price returns weekly through 5/28/2021, Factset pricing and individual company reports for suspensions

A high dividend yield relative to the company's own history is still, we believe, indicative of a valuation extreme that can provide attractive future risk-adjusted returns. When the market gets as pessimistic as it did in March and into April of 2020, prospective downside risk was indeed minimized for the more than 250 stocks in the S&P that were then able to increase dividends over the remainder of the year. That fleeting moment was a once-in-a-cycle opportunity to invest in companies at valuation lows that they would not see again in the year ahead.

*Pendulums from **out** to **in** favor…*

As we look back, what the last year has emphasized to us is the importance of assessing dividend risk. Not all companies with high dividend yields relative to their own history are telling the same story. Downside protection is not afforded simply by virtue of a dividend payment. Rather, it is the backing of that dividend through both a means and a willingness to pay that provides the downside protection. High dividend risk can offset and nullify downside protection that might be otherwise provided by an out-of-favor and higher-than-market dividend yield. We found this hypothesis to be consistent with our analysis of dividend suspensions during COVID-19.

By our count, we found 41 dividend suspensions in the S&P 500. To describe some of the bottom up trends driving suspensions, we put these stocks into three groups as tabulated below:

S&P 500 Divided & Index Activity | 2020 & 2021

SKBA Grouping	Subcategories & Companies	Dividend Suspensions	Dividend Restorations	Dividend Restoration Timing Discussed	Index Exits	Notes
Retail	Retail (Nordstrom), restaurants (Darden) and associated supply chain (Molson Coors)	15	7	1	4	Reopening beneficiaries, high progress on dividend restoration but also index casualties
Travel	Airlines (Delta), hotels (Marriott), casinos (Wynn), cruise lines (Carnival)	14	0	0	0	High leverage and liquidity actions bar near-term restoration, restoration timeline longer than others
Others	Hospital groups (HCA), energy and extractives (Marathon), automotive (GM) among others	12	5	1	1	
Total		41	12	2	5	

Source: Individual company reports and press releases through 5/31/2021

As the economy continues to reopen and recover with the rollout of vaccines, we have seen the retail group lead the way on dividend restoration with the rest, excluding travel, following suit. As we move further along in 2021 there is the potential to see a broad-based increase in overall dividend payments.

Returning to a prior dividend commitment for a select number of these dividend restorers is only one step towards enhancing downside protection. Now that these impacted sectors are in-favor due to their potential for higher expected earnings from reopening tailwinds, dividend yields have declined as their stock prices have risen. Remarkably, we have seen some companies go from out-of-favor in March of 2020 to in-favor by March of 2021.

The Road to Dividend Restoration…

One example of the confidence in a stock running ahead of the restoration of dividend and earning power is Darden Restaurants, the operator of the Olive Garden chain of restaurants among others. Darden was one of the first to restore its dividend, doing so in late September, even prior to the encouraging news that efficacious vaccines would meaningfully accelerate timelines for reopening. This first restoration of the dividend was an effective dividend cut, which we viewed as a prudent realization that both returning to normal earnings and returning to a smaller balance sheet may take time. Two earnings releases and dividend increases later, the company has now fully restored the prior dividend policy.

Darden is exemplary in many respects, second to restore a dividend in the S&P 500 and it is in rare company as a stock ahead of the S&P 500 where more than two-thirds of dividend suspenders continue to trail the index. Yet the curse of this winner is the burden of expectation. Rising dividend risk provided Darden with little downside protection in the trough of COVID in March and April of 2020. Moreover, as the company recovered, and as we wrap up May of 2021, a low dividend yield relative to the company's own history indicates heightened expectations and a vulnerability to incremental disappointments (i.e. lack of downside protection) once again.

It may seem premature to declare the dividend suspension saga over, especially as the majority of "suspenders" have yet to restore their dividends; but, the **suspense** in dividend suspensions has disappeared amid the tide of rising expectations with the improving economic backdrop for these companies. Our new post-credits antagonist (a la Disney's Marvel Cinematic Universe) are those high expectations, and how we negotiate both a return to normal life and normal earning power in that backdrop. As this next chapter begins, our protagonist and focus remain the same: dividends. We will continue to pay attention to dividends and evaluate what they tell us about earning power and dividend yields with a focus on downside protection.

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