Dividend spike meets needs of the majority

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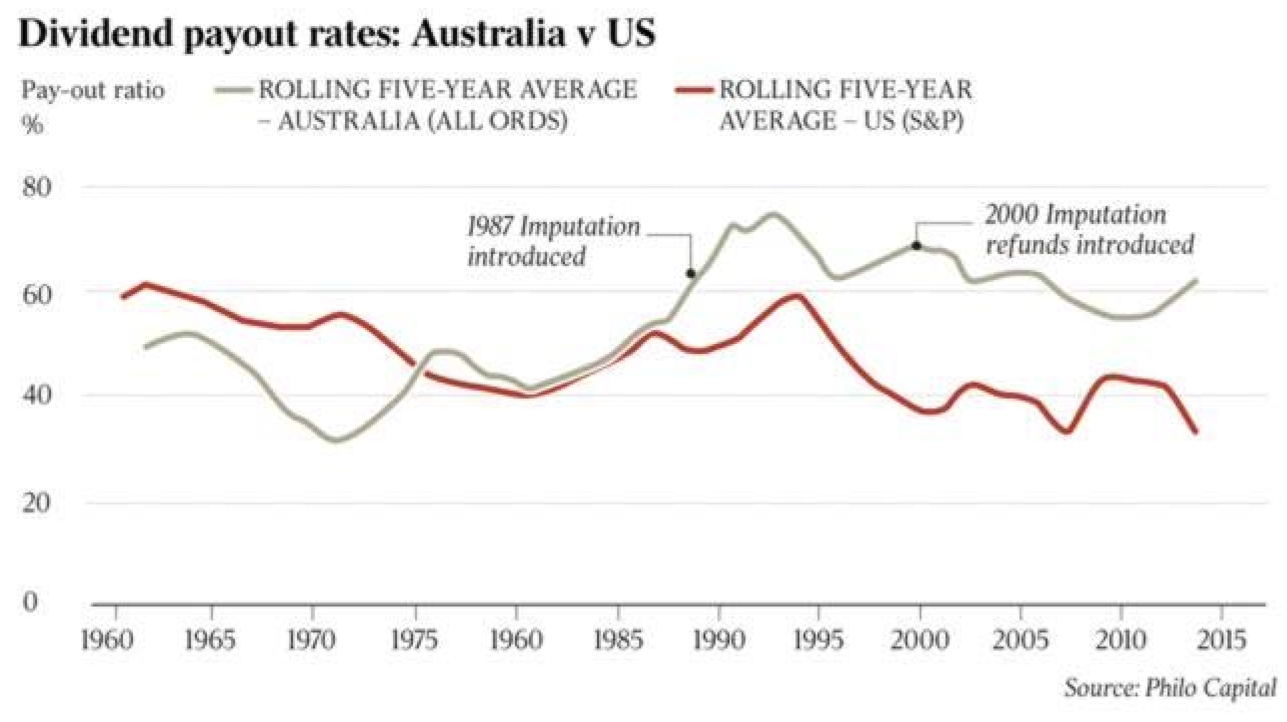

Dividend payouts. *Source:* TheAustralian

THE profit-reporting season for companies listed on the stock exchange has completed, to no serious damage.

More than half of them announced profits above average expectations — and, even though much of the gains were from cost-cutting not enlarged revenues, most investors were pleased. Two thirds of companies increased their dividends, bringing joy to most investors but annoying a minority, some of whom were fiercely critical of the lift in dividends.

Disagreement on dividends is long-established. Some successful investors have treated dividends as the tangible source of value in shares. John D Rockefeller, a heavyweight investor, had a straightforward view: “The only thing that gives me pleasure is to see my dividends coming in.”

At the other extreme is the US company Berkshire Hathaway, which doesn’t pay dividends to its shareholders; earnings are reinvested in existing businesses or used to acquire new subsidiaries. Shares in Berkshire Hathaway recently topped $US200,000 each. Clearly, there’s more than one way of building investors’ wealth.

Australian companies are more Rockefeller than Buffett. Dividend payout ratios here now stand at 75 per cent — compared with just 30 per cent in the US, where dividends are taxed twice and capital gains are lightly taxed.

Listed companies in Australia will increase their dividends, in total, by about 18 per cent in the two years to October. And the list of companies that have surprised recently with higher-than-expected dividends is long and varied — and includes Amcor, BHP, Caltex, Commonwealth Bank, CSL, Domino Pizza, Rio, Santos, Sonic Health Care, Suncorp, Telstra and Wesfarmers.

Each company board has to decide the best way of using available cash. The main alternatives are to pay dividends (including "special dividends"), retire debt, return capital directly to shareholders, spend on share buybacks, and to grow the company organically or through acquisitions.

To my mind, the higher dividend payments we're now seeing match the needs of the majority of shareholders. With interest rates unusually low, many investors are on the hunt for yield; our tax system makes dividends highly attractive to Australian residents; franking credits have no direct value to the company holding them but mean a lot to investors, particularly those on low rates of tax; dividends were cut during the global financial crisis; and quite a few companies are holding a lot of cash.

Critics of the recent dividend increases say boards have gone too far in responding to investors' demands for yield. The high dividends are a signal that companies can't find scope to grow. Some companies that are good dividend payers will find it hard to maintain current dividends when the economy has its next downturn. And companies "should" allocate more cash to spend on plant and equipment and less on dividends. (This advice could be as badly timed as the very different suggestions made two to three years ago that super funds "should" reduce holdings of shares and increase holdings of bonds.) Before the tax reforms in 1987, dividends were taxed twice and capital gains were untaxed on assets held for more than twelve months. In those days, as little as a third of Australian after-tax profits was paid out as dividends; the rest was kept to finance growth. Some companies used their retained earnings wisely; most didn't.

In general, there's a lot to be said for profitable companies paying good dividends and, from time to time, raising additional equity capital — via rights issues, placements, dividend reinvestment arrangements and shareholder purchase plans — to finance major steps in their growth path.

Of course, high dividend payout ratios will dampen the growth in dividends in the next year or two; but in that time frame across-the-board cuts in dividends don't seem a major risk.

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