Growth stocks and dividends – a winning combination

Howard Nowell
UK Institutional Director
Janus Capital International Limited

After years of taking a back seat in the minds of growth investors, dividends are once again becoming an increasingly important component of total returns, particularly in the United States. But dividends are only part of the story. We believe the most attractive large-cap growth opportunities reside with companies that strike the right balance between dividend distributions, business reinvestment and other productive uses of excess cash flow. We think rigorous fundamental research, in-depth free cash flow and balance sheet analysis remain critical in identifying whether or not firms are using capital wisely and pursuing the most appropriate mix of strategies in potentially delivering the strongest long-term shareholder value.

Year-to-date (through 30 September 2010), more than 175 stocks in the S&P 500 Index have increased or initiated dividend distributions, while only three have decreased or eliminated them. This greater emphasis on dividends may seem like a new phenomenon to today's investors, many of whom began investing during the 1980s and 1990s. But it is only over the past 20 years that many growth companies stopped paying dividends and instead retained their excess cash to reinvest in the business, repurchase their own shares in the open market or pursue merger and acquisitions (M&A) activity. Over a much longer period, however, dividends have played a more significant role for stocks in general (see Figure 1).

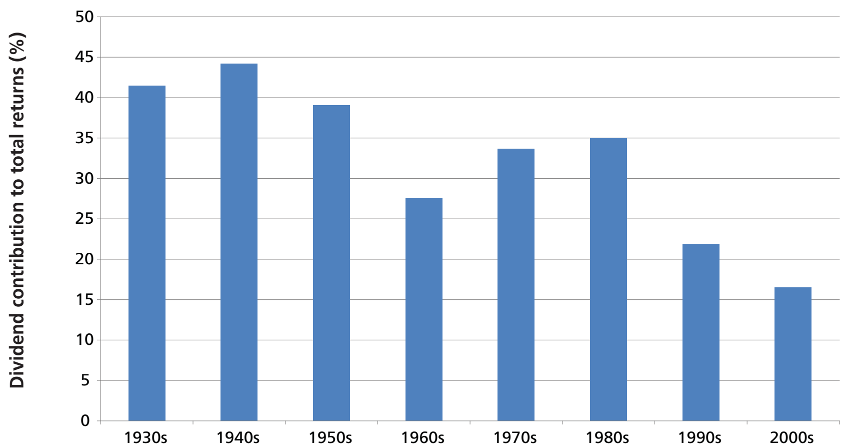
Changing dynamics for large-cap stocks

The influence of dividends on returns for U.S. stocks over the past 80 years has trended downward – particularly throughout the past two decades – as firms have focused instead on reinvesting free cash flow into the business, repurchasing stock and/or making large acquisitions. Another driver behind the downtrend in dividend yields in the 1990s and 2000s was the growing dominance of the technology sector, particularly in large-cap indices such as the S&P 500 Index. Many of these companies were in their high growth phase and maintained little to no dividend.

The pendulum is now shifting back in the United States, as a growing number of firms – most noticeably technology companies – are returning cash to shareholders in the form of dividends.

That said, investors should be careful not to chase yield as not all dividends are created equal. Some may be more sustainable than others and understanding the dynamics impacting each company's dividend payout requires in-depth

Figure 1: Dividends as a component of U.S. Equity Returns (S&P 500 Index)

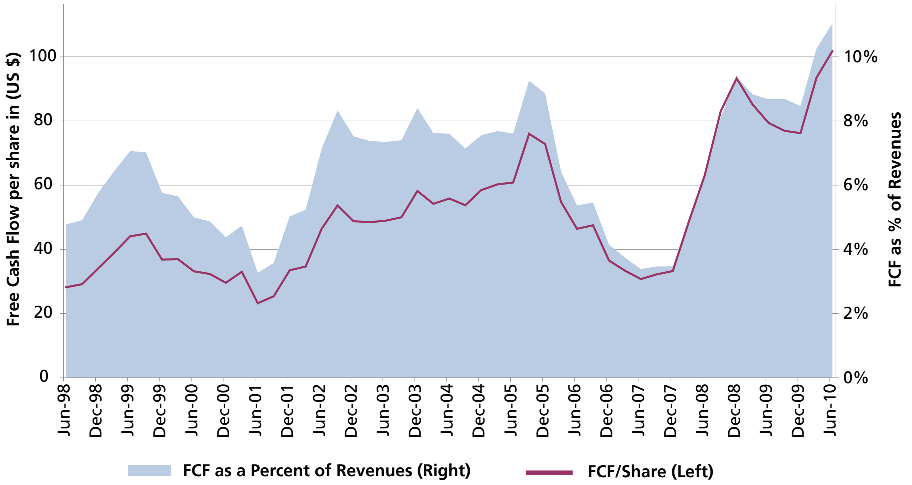


Source: Morningstar; Through 31/12/2009

"a growing number of firms – most noticeably technology companies – are returning cash to shareholders in the form of dividends" analysis of the firm's capital structure, business model and management incentives, among other things.

Free cash flows, management's intent and balance sheet health are some of the more important determinants of whether a firm can or cannot pay a dividend. Generally speaking, we are seeing higher quality earnings from many companies as indicated by improving free cash flow trends. Figure 2 looks at free cash flow (FCF) per share and FCF per share as a percentage of revenues for the S&P 500 Index over the past 12 years. It shows that firms' free cash flow generation has not only recovered from the recession, but that it was at a 12-year high at the end of June 2010.

Figure 2: S&P 500 Free Cash Flow as a percentage of revenues (on per share basis)



Source: Bloomberg; Through 30/06/2010

Uses of free cash flow

The decision to begin paying dividends is not a simple one however. Coming out of the financial crisis, many companies have been reluctant to use their cash reserves, stockpiling them instead as a defensive measure should liquidity dry up again or the economy descend back into a recession. In other cases, companies have been using the cash to pay down debt and improve balance sheet health. Though we view the deleveraging trend as positive, many shareholders have become increasingly frustrated that companies are not making better use of idle cash. With paltry cash returns weighing down many firms' overall return on invested capital and because all capital has a cost, we generally believe management teams are obligated to return idle cash to shareholders, provided they are unable to invest in projects that earn a return greater than the company's overall cost of capital.

Companies generally can use excess cash in five ways:

- Business reinvestment
- M&A activity
- Debt reduction
- Stock buybacks
- Dividend distributions

In the new economic climate, many firms have re-evaluated the effectiveness of each category, and there has been a growing realisation that a prudent, strategic mix of these capital deployment opportunities may produce the most beneficial shareholder value.

Business reinvestment

From our perspective, there are two basic forms of business reinvestment or capex (capital expenditure): maintenance and growth. Maintenance capex is simply the capital needed to maintain the current production level of a company's factories, equipment and other assets. Growth capex, on the other hand, is capital used in an attempt to increase or improve the firm's production capacity and/or market penetration. Companies that generate cash flows above the maintenance capex requirements have the ability to reinvest in the business in an attempt to foster growth and create shareholder value. The key question for any management team to ask is whether or not the expected internal rate of return for a given investment or project exceeds the firm's weighted average cost of capital. If it does, the investment has a better chance to create value; if not, management should look at alternative uses for its excess cash, such as dividends or share repurchases.

M&A activity

M&As have also proven to be problematic. Many high-profile acquisitions failed to deliver anticipated synergies or sustainable growth. Moreover, academic research and numerous case studies have illustrated that M&A activity can prove more beneficial for acquired firms than for acquirers.

Debt reduction

Typically, management incentives are closely tied to the company's equity performance. As a result, improving equity returns, which in many cases can come at the expense of bond holders, is generally the focus. This makes leveraging up the balance sheet somewhat more appealing to management. However, reducing debt can be an intelligent use of capital primarily because it may put the company in a better long-term position to return cash to shareholders in the form of dividends.

Stock buybacks

In theory, stock buybacks can be advantageous; but in practice, many have proven to be poorly timed, particularly during the 1990s and early 2000s. The dismal track record for buybacks reinforces the notion that management teams may not be well-equipped to judge the value of their companies.

Dividend distribution

Dividends have garnered more attention lately as an increasingly viable use of capital that can enhance shareholder value. Conventional wisdom says that if a company pays a dividend, management views its growth prospects as limited or constrained, and therefore has decided to return cash to shareholders. Conversely, if a company retains more of its free cash flow to reinvest in the business, or has a low payout ratio, the belief is that it will be able to grow faster. But this is not necessarily the case. A company can pay a dividend and not constrain its growth because it is the returns a company generates on its capital that generally dictate growth. In theory, and often in practice, a company that produces high returns on its capital needs to invest less capital to get the same level of return, thus potentially freeing up more cash to distribute to shareholders or reinvest in the business. Companies with improving returns over time and a sustainable growth rate will likely be able to pay out greater dividends.

Sector trends: technology, consumer and industrials

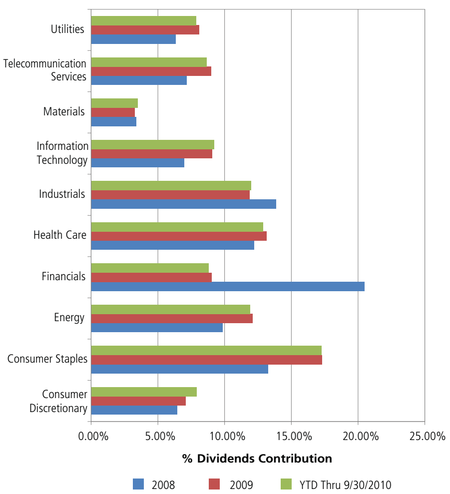
There has been a clear and consistent pattern of large-cap firms expanding their dividend commitments. While this trend has manifested itself differently industry by industry, firm by firm, it is interesting to note that many growth-oriented sectors have steadily increased their dividend contributions to the overall market (see Figure 3).

Technology

Nowhere has the trend to increase or initiate a dividend payment been more significant than in the technology sector. During the 1990s, approximately 90% of the large-cap technology companies offered no dividend, and the remaining 10% provided a dividend yield much lower than the S&P 500. Today, roughly 50% of large-cap technology firms pay a dividend, with 25% at or above the index.

This relatively recent emphasis on dividend payments is partly due to maturation within the sector. As the technology industry has matured, growth rates have come down from their rapid pace, but remain attractive. As such, introducing dividends has been a natural progression for many companies. It also reflects a desire on the part of these firms to expand their investor base and serves as an acknowledgment of some of the industry's missteps in chasing earnings growth at all costs.

Figure 3: Sector contributions to S&P 500 dividends



Source: Standard and Poor's; Through 30/09/2010

Consumer

During the economic crisis, many consumer companies became much more efficient, capitalising on cost savings from technology investments and also making significant spending cutbacks when necessary. As a result, many have extremely strong balance sheets and solid cash flows driven by higher margins and continued business growth through emerging market exposure. In contrast to the technology sector, the trend toward greater dividend payouts within this sector is less a function of a maturing industry, in our view, and more a function of strong balance sheets and better operating efficiencies.

Industrials

Within the S&P 500 Index, 85% to 90% of industrial companies pay a meaningful dividend despite the capital-intense, cyclical nature of many businesses. We think dividends force management to decide the best way to use excess cash. Over the last decade, many U.S. industrials have become extremely efficient businesses by implementing process management models, lean manufacturing and just-in-time production. They have also aggressively expanded their businesses globally, which makes them much more diversified than they were in the past. Many of these companies are emerging from the recent recession with extremely solid balance sheets and relatively high cash levels. In previous economic downturns, these firms were not nearly as well run or cash-efficient, and many were forced to reduce their dividends during past recessionary periods.

Conclusion

Overall, we believe the general market focus on dividends should prove beneficial to growth-oriented large-cap investors, particularly given current return expectations. The positive attributes of dividend-paying stocks are well-documented: the potential for more stable returns, strong defensive characteristics and significant long-term compounding benefits. Many firms that have instigated dividend increases or initiations are trading at attractive price levels and offer compelling risk/reward characteristics. In addition, we think shareholder demand trends may result in higher multiples for dividend-paying companies relative to non-payers.

Ultimately, dividend payouts should be viewed as one of several viable options that firms have to deliver shareholder value. Generating consistent, high-quality growth requires a skilful combination of capital investment and disbursement strategies that best fit each specific firm situation. As such, fundamental, bottom-up research can help identify which companies have the cash flow efficiencies, innovation capabilities, growth potential and dividend strategies required for long-term success. We think these are the growth firms with the most potential to reward investors over time.