

## Will the big Divi Payers Continue to Deliver?

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Major trends can be overlooked amidst daily stockmarket volatility. Since March, investors have focused on the sharp recovery in share prices. In most portfolios this has almost reversed the previous six months' of losses. Yet, one key worrying trend has persisted. Dividend cuts have continued through the recovery – indeed, they even seem to have accelerated this year. Should investors be more concerned about income prospects? Even sectors viewed as providing safe income, like utilities, could be the next to disappoint.

Previous bear markets in the past half century saw income from shares little changed as share prices fell. This stable income from shares meant that many investors found the volatility much easier to cope with. High dividend yields also helped provide support for share prices. For private investors, dividend cheques mean maintaining living standards in retirement. For investing institutions, income is key to controlling funding costs for pension schemes. Income is viewed differently from capital by investors; realising capital gains to provide cash does not seem prudent.

This year, just a few, more defensive, sectors - like pharmaceuticals, oil majors, tobaccos, and utilities - have resisted the trend of dividend cuts. However, there may still be dangers in some of these. Low growth defensive sectors are generally challenged by low inflation. This makes it hard to grow sales and dividends. Utilities, in particular have regulatory and pricing pressures that create dividend risks. Investors relying on utilities for income may be disappointed.

Utilities typically have high bank debt, recognising that their profitability should be relatively stable. But this year has seen the debt ratings agencies signal warnings for some utility companies that borrowing risks have increased. This usually leads to higher financing costs if action is not taken by managements. In other sectors, companies with rising debt costs have often cut dividends, as adding to borrowings by paying out cash makes no sense. Already, in recent months, some utilities have issued more shares to

make their balance sheets safer. However, this can be at the expense of future growth.

Debt costs are not the only challenge to dividends. Even in supposedly defensive areas, some companies will need to address pensions deficits. The warning earlier this year from the Pensions Regulator, that security of pensions must come before dividends, shocked many companies with pension funding deficits.

And, utilities could also find that discussions on the terms of their franchises might involve lower dividends. The water utilities are currently undergoing their five-yearly funding review. The Regulator's draft proposals are tough on both allowed capital expenditure and pricing for the next five year period. In addition, incentives to produce operational and capital investment efficiencies have been pared back. While the final decision in November may be slightly more generous than these draft proposals, for most water companies dividend growth from 2010 will be difficult.

The process is creating uncertainty, and analysts were surprised by how tough the Regulator's stance appears to be. But it does highlight the pressures on government finances, and the need for shareholders to be seen to be bearing some of the pressures on consumers and the public purse.

Major economies still have a lot of spare capacity, which should contain inflationary pressures. Even as the UK economy recovers, unemployment could persist at high levels, and inflation could remain surprisingly low. This is a particularly difficult background for utilities, as revenues are largely linked to inflation. While electricity consumption proved relatively stable in previous economic cycles, it has fallen more sharply in this recession. Very high current dividend yields in some companies are pointing to the risk of dividend cuts. Indeed, companies with dividend yields of 6% or more are being given little credit in their share prices for the payout.

Low share prices relative to the cash paid out by companies are a stockmarket signal to boards to be more prudent with cash. Institutional investors would rather suffer less immediate income if it saved the penalty of later refinancing with heavily discounted shares. Dividend cuts may be viewed favourably by many – once cuts become fashionable, it is hard to stop. The water sector might wait until November before announcing any change to strategy, but the Regulator seems determined to focus utilities on customers at the expense of shareholders.

Shares have a role to play in providing income with growth prospects. It just will not be as simple as it seemed in the past. In future, investors may also need to look beyond utilities. Dividend yields that still look too good to be true, may prove to be just that.

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