BKI INVESTMENT COMPANY LIMITED

BKI INVESTMENT COMPANY

ABN: 89 615 320 262

March 2021

BKI is managed by Contact Asset Management
AFSL 494045

QUARTERLY REPORT

THE COMING RECOVERY IN DIVIDENDS

Welcome to the 29th edition of the BKI Quarterly Report, prepared by Contact Asset Management (Contact).

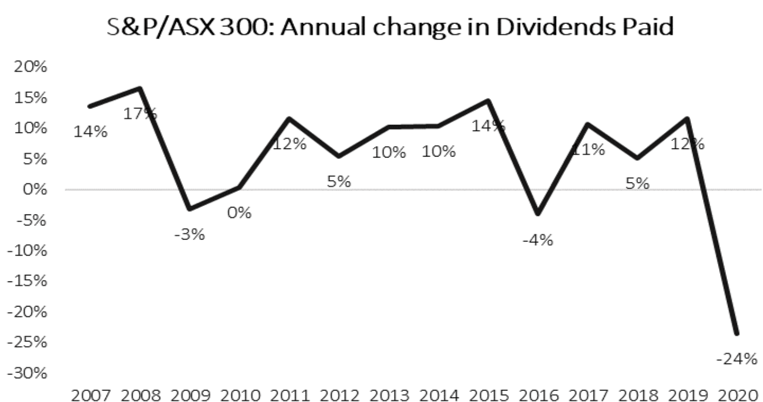
2020 will be long remembered for many things. For those Australian investors reliant on dividends as an income stream, 2020 will be remembered as a dividend drought. In the face of a global pandemic and economic uncertainty, Australian corporates cut dividends as revenues stopped and JobKeeper was introduced – an understandable strategy. The upside is that emergency capital raisings were far lower than originally feared and significantly less than during the 2008/09 Global Financial Crisis – we explore this in greater detail below.

We believe that the lack of widespread, dilutive capital raisings is an important launchpad for a recovery in dividends. Investor sentiment has now turned – quite significantly. The economic recovery is underway, and we expect this to translate into a better 2021 for income focused investors.

How much did Dividends fall in 2020?

2020 was a dividend drought. According to Factset, the total amount of dividends paid by S&P/ASX 300 companies was $61 billion, a decline of 24% on 2019.

The timing of the pandemic and the impact on the economy meant that both first half and second half dividends were impacted in calendar 2020. Reflecting on the August 2020 reporting season, Commsec noted that the percentage of reporting companies that elected to pay a dividend was just 68% compared to the average over the previous 20 reporting seasons of 86%.



Source: Factset, Contact Asset Management

The hit to dividend income started early in the year. Many corporates cancelled dividends altogether. For example, in early April 2020, electronics and furniture retailer Harvey Norman cancelled its dividend due to an "abundance of precaution" and uncertainty over the duration of the COVID-19 pandemic. At the time, several of its international stores had been closed on Government decree. The decision meant that the company would retain $150 million in cash. "In the present environment, the board believes that preserving cash is the most prudent course of action to protect shareholder value," the company said.

Harvey Norman was not alone. Other consumer discretionary names such as Adairs Limited and Flight Centre Group also cancelled the dividend and there were countless dividend payment deferrals by others. As it turned out, Harvey Norman was

a "COVID-winner" as Australians stuck at home spent up big on home furnishings and appliances. Harvey Norman now has no debt and has more than made up for the cancelled 12 cent dividend through the distribution of 44 cents in fully franked income since late June.

While many dividend deferrals were eventually paid, the economic environment was still uncertain at the time of the August reporting season. Thus, Boards continued to take an understandably cautious tone. In other industries, the regulator stepped in. The Banks were restricted from paying out more than 50% of earnings as dividends to protect the integrity of the financial system.

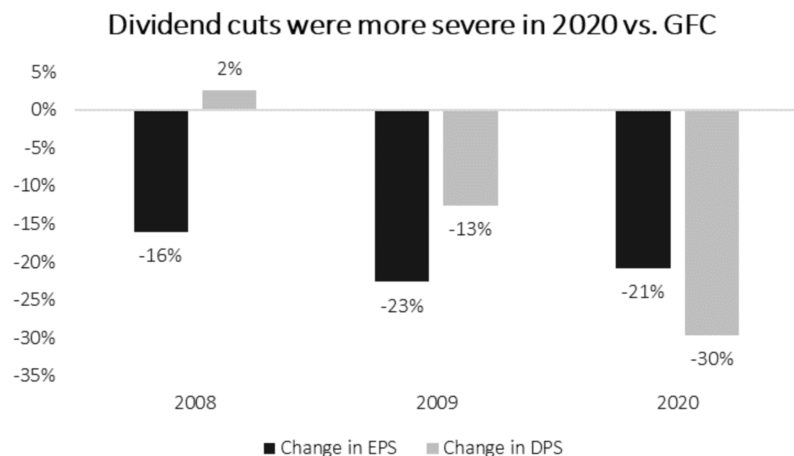
This was reflected in the BKI Investment Company First Half 2021 Results. As disclosed on page 5 of the First Half 2021 Results Presentation, released to market on 21 January 2021, 15 of the top 25 holdings in the portfolio cut their dividends. With 3 of these holdings not paying a dividend at all.

How does the dividend drought of 2020 compare to the Global Financial Crisis (GFC)?

The approach taken by Boards in navigating the 2020 crisis was quite different to the 2008/09 Global Financial Crisis. While we saw a few emergency capital raisings from March to June 2020 to protect balance sheets, it paled into significance compared to 2008/09. In those dark days, Australian companies raised more than $92 billion in secondary market issues, mainly to deal with excessive leverage. In 2020, while the raisings were material ($51 billion according to Bloomberg including IPOs), the "emergency" raisings were balanced by companies in high growth sectors, such as technology, raising capital to accelerate growth initiatives.

Why is this significant for the dividend recovery? On a per share basis, investors have generally not been diluted by big (and often heavily discounted) capital raisings. As earnings recover, corporates do not have an excess of new shares on issue that also qualify for the dividend. We believe this is an important starting point to commence the dividend recovery.

Nevertheless, the pain in 2020 was significant. As depicted in the chart on the right, dividends were cut more than earnings declined. The hit to dividend income was far worse than the GFC.



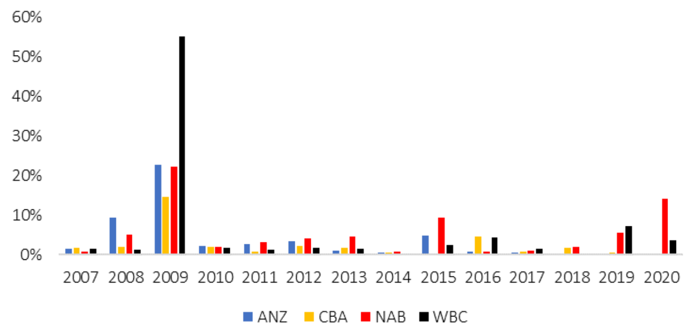
Source: Factset, Contact Asset Management. Figures are based on the EPS and DPS of the S&P/ASX 300 Index

A case study: the Banks

Traditionally, the big four banks have paid meaningful dividends. In 2020, that source of income for shareholders was slashed as the banks were required to stay "unquestionably strong" from a capital viewpoint. The regulator imposed restrictions on dividend payments of the banks to ensure as much protection as possible to the bedrock of the Australian financial system.

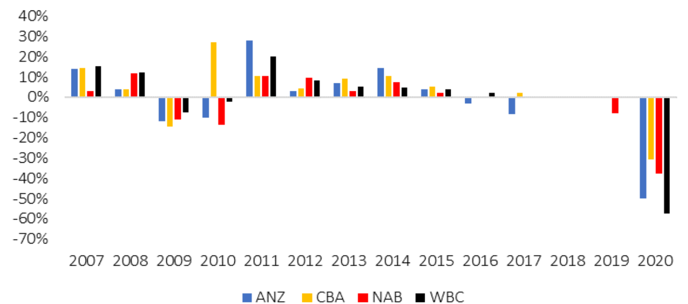
As we reflect on the COVID-19 versus GFC experience regarding capital management, the Big 4 banks provide a useful case study. The following charts make a powerful point in outlining the vast difference between the GFC and 2020 regarding capital allocation:

- **On capital raisings:** In 2009, every bank tapped the market in deeply discounted raisings. In 2020, only NAB and Westpac raised capital. For NAB, the raising coincided with a new CEO who wanted a fortress-like Balance Sheet. For Westpac, the bank had additional challenges including a massive Austrac fine.



Source: Factset, Contact Asset Management

- **On dividends:** while dividends were cut in 2009/10, the recovery in 2011 was reasonably swift. The hit to bank dividends in 2020 was far deeper and included ANZ and Westpac paying no dividend at all in May 2020.

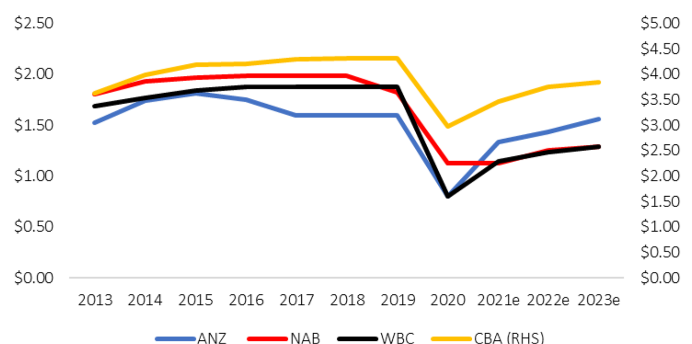


Source: Factset, Contact Asset Management

So where to now for the Banks? Sentiment has turned quickly. In August 2020, the general view was the expectation of a slow grind out of economic recession and a coming fiscal cliff with the end of Government stimulus packages such as Jobkeeper. One sell side economist, who to be fair summed up the thoughts of most, was quoted in the AFR in late August, "Banks won't have anywhere near the recovery in dividend levels that they enjoyed post the global financial crisis because this is an employment-led, forbearance-induced crisis." That view has likely now changed.

The economic recovery has been solid, and Australia's major banks now appear to be well capitalized and indeed over-provisioned. This was highlighted in the recent Westpac result where the bank wrote back approximately $500 million in provisions, boosting earnings significantly in the process. For each of the big 4 banks, loan deferrals continue to fall, asset quality is improving and the capital positions are strong.

This has the potential to be an enormous tailwind to boost future earnings growth. The following chart shows that a recovery in bank dividends is now expected.

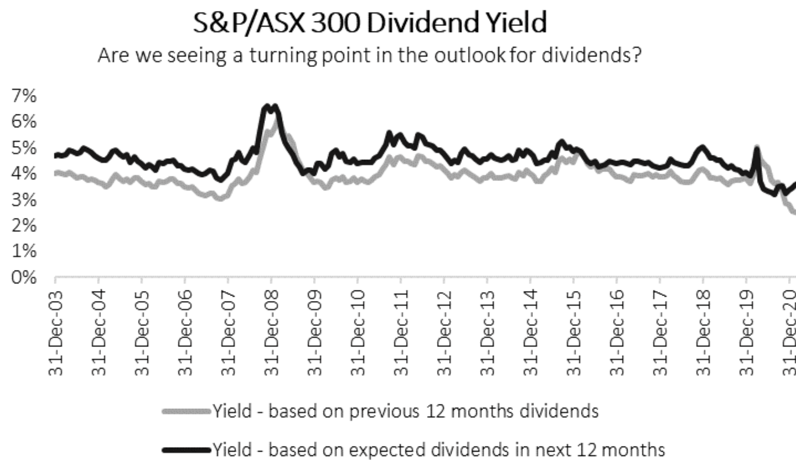


Source: Factset, Contact Asset Management.

What is the consensus outlook for dividend yield for the total market?

We now expect a significant recovery in the outlook for dividend income in 2021 and 2022. In fact, earnings growth has rerated to the extent that dividends are expected to increase by 25% in 2021 vs 2020. Indeed, it is possible that dividends will recover to near pre-COVID-19 levels by 2023.

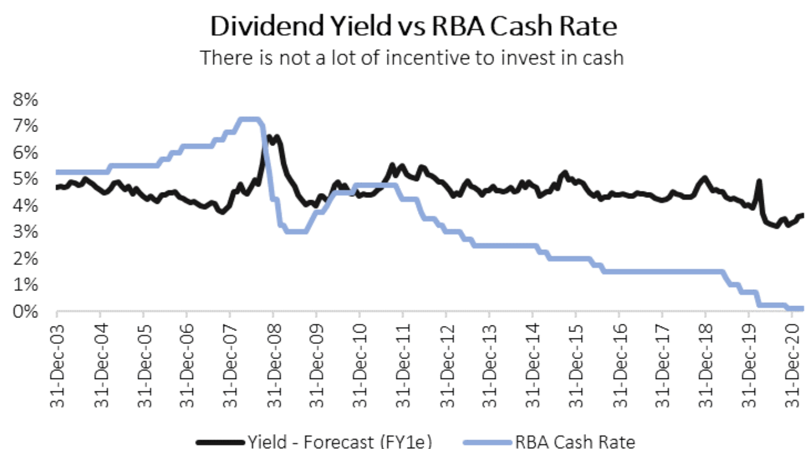
The following chart is interesting as it shows a turning point appearing between historical dividends (based on the past twelve months) and the expectations for coming dividends. The forecast yield is now starting to trend towards more normalized levels above 4% (and this is before the benefit of franking credits). This will be a welcome tonic for income focused investors.



There will be some sectors that remain under stress. Despite the successful control of the spread of community cases of COVID-19, certain sectors such as aviation and international tourism remain pressured. For companies within these sectors, it may take several years before they see a sustained recovery and can start paying dividends again. On the flipside, COVID-19 has been a boon for some industries such as retail and property and dividends will recover quickly. In all, we are likely to see dividends staging an uneven recovery.

Dividend income for the S&P/ASX 300 is expected to increase by 25% in 2021 vs 2020. This is material. Only six months ago, most investors were expecting little to no growth in dividends at all. Upgrades continue to roll through for many companies as the recovery plays out.

We see numerous opportunities for dividend growth in our portfolio holdings in the near-to-medium term.



Source: Factset, Contact Asset Management.

Term deposits are not appealing

We remain optimistic on the prospects for the market in the medium term, particularly given a low interest rate environment and a so far benign inflationary situation. Australia will continue to attract offshore capital and our dealing with the economic and health crisis has been world class.

The dividend yield on equities is attractive, with dividend yields for 2021 and 2022 forecast to be 4% to 5%, compared to cash rates and fixed interest products below 1%. In addition, franking benefits are unique to the Australian market and provide a source of upside for domestic investors – particularly retirees. We see little incentive to hide in cash.

Conclusion

Last month, we wrote that the recent reporting season highlighted plenty of reasons for optimism. The recovery in earnings for the majority of sectors continues to gain momentum. We are very optimistic that the next results season will deliver a meaningful recovery in dividends. Balance Sheets are generally solid and the high-quality management teams navigated COVID with innovation and a cost-conscious mindset.

Investors should be positive regarding a return to a more attractive yield from their Australian Equities investments. With term deposit rates at historic lows, there seems to be a high opportunity cost of investing in cash. We expect that the growing differential between dividend yields and term deposits will provide important support for markets. After a dividend drought in 2020, we look forward with enthusiasm to a more lucrative 2021 for dividend income.

Disclaimer and Important Information

The material contained within the BKI Investment Company Limited Quarterly Report (The Report) has been prepared by Contact Asset Management on behalf of BKI Investment Company Limited. Figures referred to in The Report are unaudited. The Report is not intended to provide advice to investors or take into account an individual's financial circumstances or investment objectives. This is general investment advice only and does not constitute advice to any person. The opinions within The Report are not intended to represent recommendations to investors, they are the view of BKI Investment Company Limited and Contact Asset Management as of this date and are accordingly subject to change. Information related to any company or security is for information purposes only and should not be interpreted as a solicitation of offer to buy or sell any security. The information on which The Report is based has been obtained from sources we believe to be reliable, but we do not guarantee its accuracy or completeness. Investors should consult their financial adviser in relation to any material within this document.