

Spring 2020

How will dividend stocks respond to COVID-19?



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The volatility fueled by the coronavirus outbreak is reminiscent of prior periods of market stress in which investors worried that dividend-paying companies would decrease or suspend their payments. Although 2020 could prove to be the most challenging year for dividend payers since the financial crisis, the sector make-up and impact of dividend cuts should be different. Additionally, many companies appear financially healthy and therefore able to maintain, increase or initiate dividends, despite the uncertainty. Our outlook for dividend sustainability is thus cautiously optimistic.

SHOULD INVESTORS EXPECT COMPANIES TO CUT THEIR DIVIDENDS?

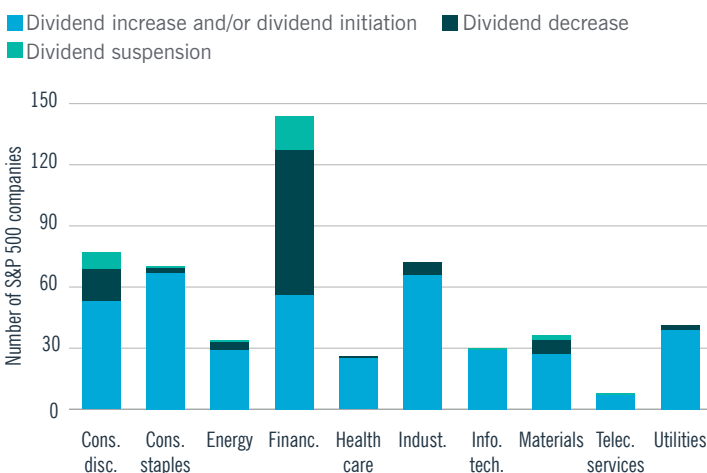
Historically, the sectors most likely to cut or suspend dividend payments in times of crisis has depended largely on the specific drivers of the economic stress. Our analysis of dividend actions by companies during two severe market downturns, the 2008-09 financial crisis and the 2015-16 global oil price collapse, demonstrates this.

2008-09: Pop goes the housing bubble

The financial crisis was precipitated by a housing bubble abetted by lax lending standards, resulting in mortgages and mortgage-backed securities of poor credit quality. When the bubble burst, banks were hit by massive asset write-downs, which tightened financial conditions globally and led to the Great Recession. In 2008, 41 companies decreased their dividend, and 21 announced suspensions. In 2009, 68 companies cut, while 10 suspended.

Not surprisingly for a credit-driven crisis, the financials sector had the largest number of dividend cuts in the two-year period, as shown in Figure 1. The consumer discretionary sector experienced its share of cuts and suspensions amid soaring unemployment, lost personal income and a steep decline in consumer spending. A number of other sectors, including health care, utilities and consumer staples, were more resilient, resulting in far fewer dividend cuts.

Figure 1: Financial firms led all sectors in cutting dividends in 2008-09

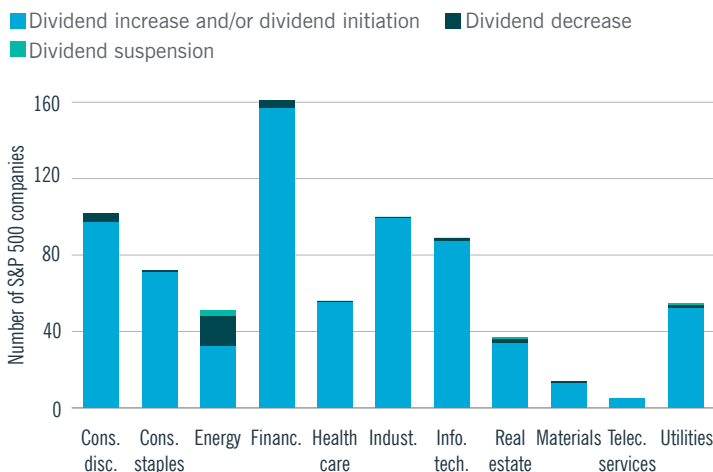


Data source: Standard and Poor's from 1 Jan 2008 – 31 Dec 2009. **Past performance is no guarantee of future results.** Securities are free float adjusted, classified in accordance with the Global Industry Classification Standard (GICS®), and screened by size, liquidity and minimum free float. It is not possible to invest in a index.

2015-16: Oil's slippery slope

From 10 June 2015 to 11 February 2016, crude oil prices plummeted by more than 57%, from \$61.36 to \$26.19 per barrel.¹ This sharp and sustained drop in the price of oil exposed the vulnerability of companies, particularly in the energy sector that were generating cash flows insufficient to fund their capital spending and production growth targets. As oil prices declined, companies struggled to pay existing debt obligations, let alone sustain their dividend payments. As a result, the energy sector saw the greatest number of dividend cuts and suspensions during this period compared to other market sectors, as shown in Figure 2.

Figure 2: Collapsing oil prices led to the energy sector's dividend cuts in 2015-16



Data source: Standard and Poor's from 1 Jan 2015 – 31 Dec 2016. **Past performance is no guarantee of future results.** Securities are free float adjusted, classified in accordance with the Global Industry Classification Standard (GICS®), and screened by size, liquidity and minimum free float. The real estate sector only includes dividend actions beginning Aug 2016, based on the sector inception. It is not possible to invest in a index.

Good news was hiding in plain sight

While financial headlines during these two crises may have accentuated the negative, it's worth noting an obvious but perhaps underappreciated fact: Most dividend-paying companies grew their dividends in both 2008-09 and 2015-16.² In fact, for the four years combined, dividend increases accounted for the overwhelming majority, 86%, of all dividend actions taken.³

- **2008:** 62 reductions or suspensions, but **241** increases
- **2009:** 78 reductions or suspensions, but **157** increases
- **2015:** 19 reductions or suspensions, but **351** increases
- **2016:** 21 reductions or suspensions, but **351** increases

While there are no guarantees, it's clear that dividend sustainability is possible even in the face of extreme shocks to the system.

WHAT MIGHT INVESTORS EXPECT FROM DIVIDEND-PAYING COMPANIES?

Unlike the previous two crises, the current turmoil is being fueled not by credit or market factors, but by a global health emergency in the form of the COVID-19 pandemic. The policy responses and countermeasures to the outbreak, in turn, are driving the world toward a potentially deep recession. Against this backdrop, many companies have begun drawing down lines of credit or taking advantage of low rates by issuing debt while they can. Share buybacks have been put on hold or significantly scaled back to preserve cash, especially among companies that are seeking government assistance. Further, some companies have already moved to lower or suspended dividends as they seek to shore up their balance sheets, build cash positions, improve flexibility and align payouts with their uncertain earnings outlooks.

While we think the remaining months of 2020 will likely see the most dividend cuts and suspensions since the financial crisis, the sectors most affected, and the specific impacts of these cuts, should be different.

Five sectors to watch

While the current demand shock and subsequent policy responses have implications for every economic sector, we believe companies in the following areas may be disproportionately affected — and thus more likely to decrease or suspend their dividends:

1. Financials. We anticipate fewer dividend cuts in the financials sector compared to 2008-09. One issue that bears close scrutiny is the impact of falling interest rates on net interest income.

- Within the sector, banks are most at risk for dividend cuts. During the financial crisis, all but two dividend-paying banks cut their dividends.⁴ That said, banks are generally much better capitalized today — with healthier credit books and lower payout ratios. Additionally, companies exhibited strong performances on Fed stress tests, which are designed to ensure adequate capital and liquidity in a stressed scenario. During the test, banks continue to

pay dividends and suspend stock buybacks — exactly the actions we have seen them take in the current crisis to date.

- Consumer finance firms may also seek to reduce dividends, but this will be driven largely by the specifics of the recently enacted fiscal stimulus. Capital markets and insurance currently face little risk of dividend cuts, in our view.
- Regardless of their financial soundness, banks could potentially face pressure from regulators to cut or suspend their dividends. Central bank authorities in Europe have already urged banks to halt remaining 2020 dividend payments, and many have agreed to do so. Fed Chair Jerome Powell, in contrast, has stated that such suspensions by U.S. banks are not necessary “at this time.” Whether this view will change as the crisis continues to unfold remains to be seen.

2. Consumer discretionary. Given social distancing, shelter-in-place edicts and other countermeasures put in place to stop the spread of the virus, this sector is likely to be one of the most severely impacted — particularly companies related to travel, leisure, restaurants or retail.

- Hotels have seen a dramatic drop in occupancy rates. Marriott International, Inc. already suspended its dividend, and other hotels could follow.
- Casinos, theme parks, cruise lines and other leisure companies have temporarily closed or ceased operations. The dividends of many operators in these industries may be at risk, led by cruise lines.
- Many restaurants are offering limited hours and service levels or shuttering stores altogether. Darden Restaurants, Inc. announced in mid-March that it was suspending its dividend, and other casual dining establishments may follow suit. For now, quick-service operators appear relatively better positioned given their drive-through sales, but they will warrant close monitoring if locations fully close or traffic decreases dramatically.

- Auto sales are likely to decline substantially, impacting not only OEM names but also the entire supply chain. Ford Motor Company has already suspended its dividend, and component suppliers may be close behind.
- Sales for many retailers have dropped off precipitously as many have been forced to close their doors. Apparel and department stores already facing secular challenges from online shopping before the pandemic are most likely to suspend their dividends. Macy's, for example, has done so, and others look poised to take action as well.

3. Energy. This sector is being buffeted by both lower demand and higher supply. On the demand side, travel restrictions and other countermeasures to stop the spread of the coronavirus have contributed to oil's 66% decline from the beginning of 2020.⁵ As for supply, efforts to reduce output in the face of a global oil glut were complicated by a price war between Saudi Arabia and Russia.

- Deepwater oil services and E&Ps are the most vulnerable to plummeting oil prices. Highly levered E&Ps in particular are the likeliest candidates for dividend cuts, or in some cases, potential bankruptcies.
- MLPs and midstream C-corps, however, have suffered sharper price declines than E&Ps. This is somewhat unusual, but MLPs and midstream C-corps had a high level of retail ownership, so it's possible that selling pressure has simply overwhelmed buyer interest in the current environment. Some weaker MLPs have already started to cut their dividends by as much as 50% (DCP Midstream ML) and 90% (Targa Resources Corp.), mostly due to highly levered balance sheets.⁶

4. Industrials. Extraordinary pressure on the energy sector, coupled with travel bans, could lead to dividend cuts among industrials, too.

- The industries most at risk are airlines and commercial aerospace amid anticipated high-double-digit declines in air traffic and airline capacity due to travel restrictions. These factors, along with low fuel prices, are creating an oversupply of aircraft, as demand for new, fuel-efficient planes recedes.

- Boeing, Airbus and Delta Airlines are among the companies in these industries that have suspended their dividends due to liquidity constraints.⁷

5. Materials. This is a highly cyclical sector. As such, it's likely to see some dividend cuts, as it did in 2008-09. Among industries, basic chemicals appears to be at the greatest risk of needing to reduce dividends. With dividend yields around 10%, a flattening production curve for global ethylene/propylene and oil prices in the doldrums, this group could find it very difficult to compete going forward.

We consider the six remaining sectors — communication services, consumer staples, health care, information technology, real estate and utilities — to be in better shape than the other five. As a result, we don't believe they will experience a significant number of dividend cuts or suspensions.

NAVIGATING THE CRISIS WITH A FOCUS ON FUNDAMENTALS

We are cautiously optimistic about the prospects for dividend sustainability in the current market, while recognizing that experiences will differ among sectors. In conducting fundamental research on dividend-paying companies, we will continue to monitor the rapidly changing environment and the challenges it poses for companies we consider for investment. Ultimately, our perspective is broader and longer-term than a focus on potential dividend actions in the context of the coronavirus crisis. As always, we favor high-quality, dividend-paying companies with healthy balance sheets, free cash flow acceleration, capital flexibility and sustainable payout ratios.

For more information, please visit nuveen.com.

Endnotes

- 1 Based on the West Texas Intermediate (WTI) – Cushing, Oklahoma crude oil price (daily observations). Source: U.S. Energy Information Administration via FRED
- 2 Increases include first-time dividend payments from companies that previously did not pay a dividend
- 3 Standard & Poor's
- 4 Standard & Poor's
- 5 The WTI – Cushing, OK crude oil price began the year at \$61.15 per barrel and stood at \$20.51 per barrel on 31 March 2020. Source: U.S. Energy Information Administration via FRED
- 6 FactSet
- 7 FactSet

Glossary

OEMs (Original equipment manufacturers) are auto parts makers that supply components to auto manufacturers, who use the parts to assemble vehicles sold under their own brand name. **E&P** (Exploration and production) – E&P, or “upstream” energy companies, are principally engaged in finding oil and/or natural gas deposits, extracting these resources through well drilling or other methods and selling their output to “midstream” companies, such as processing and storage facilities and pipeline operators. **MLPs** (Master limited partnerships) are investment structures that pay no income taxes at the corporate level if it generates 90% of its income from qualified sources as defined by the Internal Revenue Service and distributes at least 90% of its earnings to its investor partners. The MLP ownership structure is most commonly seen in the midstream energy sector. **Midstream C-corps** are midstream energy operators organized as “C-corps,” the traditional corporate structure of publicly traded companies.

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