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Shan Gnanendran, CFA – Vice President, EMEA Investment Strategy | +44 207 508 0458 | shan.gnanendran@citi.com
Jeffrey Sacks, Head – EMEA Investment Strategy | +44 207 508 7325 | Jeffrey.ian.sacks@citi.com

European Dividend Strategies should outperform in 2021

Summary

- While dividend strategies have historically performed well during periods of market volatility, they underperformed in 2020, hindered by widespread dividend cancellations, reductions, and suspensions. We believe **long-term income investors should revisit dividend strategies in 2021**, focusing on sectors and companies with strong balance sheets and reliable cashflows that are able to sustain dividends and preferably also grow dividends.
- Rates staying lower for lower (highlighted in Outlook 2021 – Overcoming Financial Repression), presents investors with continued challenges in finding yield opportunities. In that context, **Europe and the UK markets have some of the most attractive dividend stories globally**, supported by the largest yield gaps to sovereign bonds.
- **While there is now improved broad appeal in European dividend strategies, selectivity can further enhance the opportunity.** Divergences exist at both the sector and company level. Consumer staples, healthcare, utilities and technology dividends have remained relatively stable, while dividends in the financials, materials, and energy sector are showing upside potential following a challenging 2020. At the company level, we are focused on those with strong balance sheets and cashflows.
- **Dividend grower strategies have proven their outperformance characteristics over the long-term.** Since early 2003, dividend growers in Europe have provided annualised total returns of 6.9%, versus broader Europe which has returned only 4.2%. Furthermore, the long-term effects of compounding should also not be underestimated. Since 1995, reinvested dividends have accounted for over 50% of total returns in both Europe and the UK.

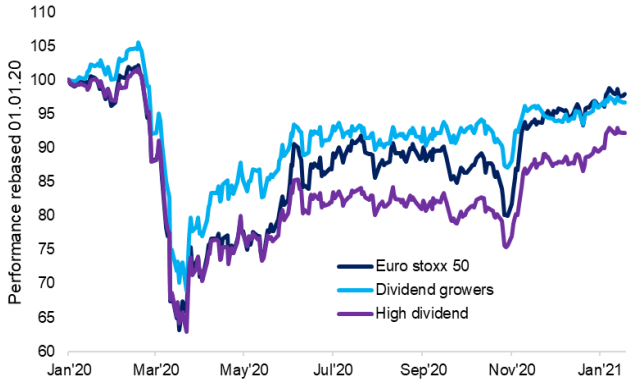
Four reasons why dividends strategies should outperform in 2021

1. Reversion to mean, following last year's underperformance

Dividend strategies underperformed in 2020 as Covid-19 resulted in significant cash flow pressures. Combined with additional governmental and regulatory pressures, dividends were slashed across the board. At the peak of the crisis, more bearish estimates pointed to total overall dividends being cut over 60% of 2019 levels, which included virtually all European bank dividends being suspended. By the end of 2020, European futures indicated 32% of SX5E dividends were cut in 2020.

Consequently, European dividend growers underperformed the Euro Stoxx 50 by 1.3%, while high dividend strategies underperformed by just under 6% **- figure 1.** Furthermore, as **figure 2** shows, while dividends are not expected to fully recover to pre-pandemic levels in the coming year, we have **high conviction that dividends will rebound from their 2020 lows as the GDP growth rebound (as the pandemic eases) supports an earnings and cashflow recovery (**Q4 Earnings Preview: Leaving 2020 Behind).

Figure 1: 2020 underperformance of dividend strategies



Source: Bloomberg as of January 20th 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. Dividend growers which have consistently grown their dividends for the past 10 years, represented by the S&P 350 Europe Dividend Aristocrat Index. High Dividends represented by MSCI Europe High Dividend Index.

Figure 2: Recovery in dividends to take time

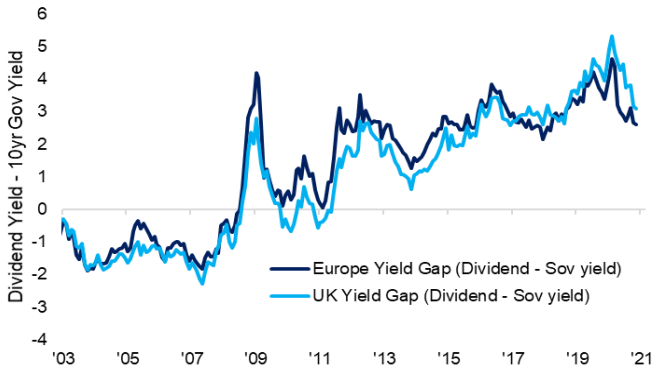
Source: Bloomberg as of January 20th 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

2. Yield gaps remain historically wide

Given today's backdrop of historically low policy rates and both sovereign and corporate bond yields, income orientated investors are faced with few opportunities within the fixed income space. With rates being kept below inflation rates, real returns for bonds are unattractive. As confirmed by the European Central Bank this week, rates in Europe are set to remain historically low for a sustained period of time. The Bank of England in early February will likely re-iterate a similar message.

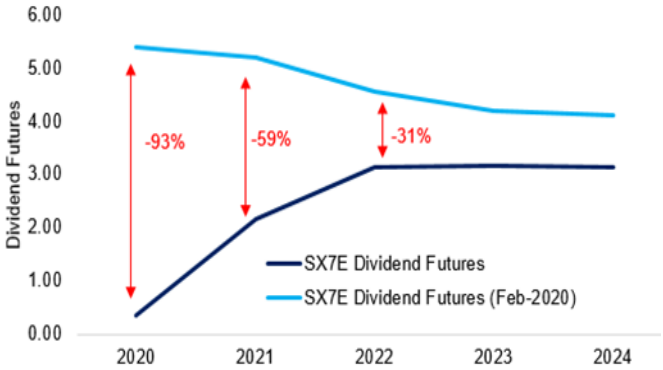
The relative income argument of equities over fixed income remains compelling. Even after the recent fall in absolute dividend yields, yield gaps relative to sovereign bonds also remain wide (2.7% for Europe, 3.0% in the UK) – **figure 3**. For investors looking specifically in the corporate space, dividend yields also remain significantly higher than those offered on comparably rated corporate bonds, given dividend yields of 2.2% and 3.3% in both Europe and the UK are significantly higher than their IG bond equivalent yields of 0.26% and 1.45% respectively.

Figure 3. European and UK yield gaps



Source: Bloomberg as of January 20 2021.

Figure 4. Bank dividends recovering in 2021-24



Source: Bloomberg as of January 20 2021

3. Dividends being reinstated in 2021

While the initial pandemic stage saw widespread cuts, broader dividend cuts were less severe than initially forecast, with a number of companies now reinstating their 2021 dividends. Of the 50 companies in the Euro Stoxx 50, 13 companies had either cancelled or omitted their 2020 dividend payment (these 13 companies account for 20% of the Euro Stoxx 50 market-cap). While this was a challenge for 2020, many of these companies have now reinstated their 2021 dividend, including the likes of Adidas, Airbus, Safran and Koninklijke Philip's (*). Having initially delayed its dividend payment, Deutsche Post paid its full annual dividend in September.

Similarly, looking at the FTSE 100, 27 companies have either cancelled or omitted their 2020 dividend (accounting for 20% of the FTSE 100 market-cap). Many of these are also set to resume paying dividends in 2021, led by sector leaders such as Glencore and Next (*).

(*) For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed.

The resumption of bank dividends will be an important 2021 catalyst. European banks accounted for approximately a quarter of all European dividends in 2019. Following suspensions in 2020, both the European Central Bank (ECB) and the UK Prudential Regulatory Authority (PRA) have now allowed dividends to resume in 2021. UK banks can now resume dividend distributions capped at the higher of 20bp of CET1 ratio at end-2020 (or 25% of 2019 and 2020 combined net income), while European banks can pay dividends at the lower of 20bp of CET1 ratio or 15% of 2019 and 2020 combined profits. The latter will therefore be slightly more conservative.

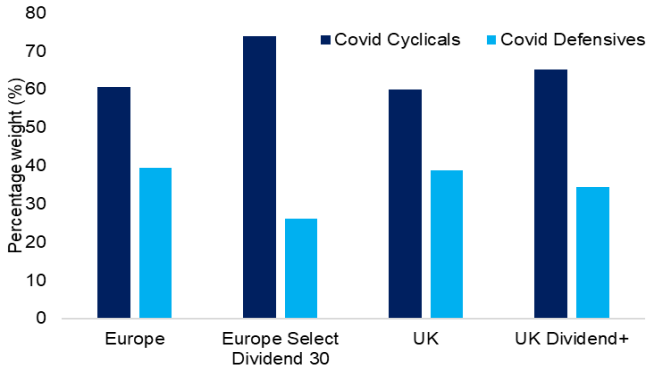
While bank dividend payments virtually stopped in 2020 (bank dividend futures were down 93% in 2020), a return to full shareholder pay-out levels will take time. Bank dividend futures suggest 2021 dividends are 59% lower versus pre-pandemic levels and 2022 dividends are expected to only 31% lower versus pre-pandemic levels - **figure 4.**

4. Dividend strategies skewed to "Covid cyclicals" and Value

At a global level we favour "Covid cyclical" sectors, which can benefit from the mean reversion and the relative catch-up opportunity. Both Europe and the UK have a higher-than-average weighting in "Covid cyclical" sectors. Furthermore dividend-orientated strategies are heavily biased towards "Covid cyclicals", with a weighting in Europe and the UK of 74% and 65% respectively **– figure 5.**

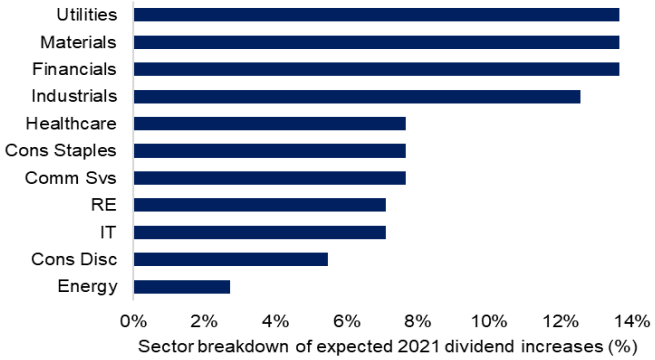
At a global level we also favour value stocks. High quality dividend paying companies tend fall within our definition of value, given their historically predictable and stable cash flows. We believe the recent rise in bond yields and the steepening of the curve can support near term value, further supporting dividend-focused strategy relative outperformance.

Figure 5. Dividend payers skewed to Covid cyclicals



Source: Bloomberg as of January 20 2021. "Covid Cyclicals: Financials, industrials, materials, real estate, consumer discretionary. "Covid Defensives": IT, healthcare, communication services, consumer staples, utilities. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

Figure 6. Sector breakdown of companies expected to increase 2021 dividends (%)



Source: Bloomberg as of January 20 2021

Dividend investing can be enhanced through sector and company selectivity

Strong expected average earnings rebounds in 2021 (32% in Europe ex UK and 38% in the UK) should see dividends better supported. While pay-out ratios remained under pressure in 2020 as earnings declined, notable divergences exist and so returns can be enhanced through greater selectivity at both the sector and company level.

While more "Covid defensive" sectors such as **healthcare, utilities, consumer staples** and **technology** have seen their dividends stay relatively stable throughout the pandemic, looking ahead "Covid cyclical" sectors can show the greatest upside potential to dividend policies (3 of the top 4 sectors ranked by expected 2021 dividend increases are Covid cyclicals) **– figure 6**. For instance:

- **Financials:** Following the 2020 suspension, bank dividends are being partially reintroduced in 2021 with the approval of the European Central Bank and UK's Prudential Regulatory Authority.
- **Energy:** While broader energy sector dividend pay-out ratios are under deep pressure, companies such as Royal Dutch Shell and Total have altered their dividend policies and cut dividends to more manageable levels (*).
- **Materials:** Despite pay-out ratios in excess of 100%, materials companies could see significant earnings and cashflow improvements in 2021 as the commodity prices rise and the cyclical economic pickup gathers momentum, enhance their ability to resume payments.

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We focus on companies that comfortably pay dividends as well as those that could grow their dividend pay-outs. For instance, as the bottom of **figure 7** shows, European dividend growers maintain a pay-out ratio of 69% while still paying yields above the regional index (3.0% versus 2.2%). UK dividend growers hold a pay-out ratio of 94% while still paying dividend yields at 3.3%, which is in-line with the broader index. Balance sheet and cashflow strength are important drivers of the ability to pay and to grow dividends.

Figure 7. European and UK sector breakdown

	Europe-ex-UK						UK					
Sector	Dividend Yield (%)	DVD Payout Ratio (%)	FCF Yield (%)	2020 EPS y/y %	2021 EPS y/y %	2022 EPS y/y %	Dividend Yield (%)	DVD Payout Ratio (%)	FCF Yield (%)	2020 EPS y/y %	2021 EPS y/y %	2022 EPS y/y %
Communication Services	4.2	68	11.8	-14	12	12	3.8	-	17.6	-20	21	17
Consumer Discretionary	1.5	90	3.9	-68	215	26	0.9	939	3.6	-47	47	29
Consumer Staples	2.2	58	4.7	-12	10	9	4.2	79	6.5	-4	6	8
Energy	5.8	-	4.4	-75	153	37	6.2	-	8.9	-96	1336	45
Financials	2.3	83	50.4	-34	22	17	1.6	99	71.1	-47	34	23
Healthcare	2.3	83	5.3	-1	8	10	3.8	80	4.9	-1	12	15
Industrials	1.5	72	4.7	-41	57	20	1.8	-	4.3	-62	138	17
IT	0.7	34	2.8	1	15	17	1.5	61	3.5	-3	-1	11
Materials	2.5	213	5.4	-19	37	11	3.3	114	4.7	14	31	-12
Utilities	3.2	117	0.5	-8	13	6	5.3	117	0.3	-7	5	7
Overall	**2.2**	**98.2**	**11.2**	**-29**	**32**	**16**	**3.3**	**743.1**	**17.9**	**-35**	**38**	**15**
DIVIDEND GROWERS	**3.0**	**59.9**	**7.7**				**3.3**	**94.4**	**5.4**			

Source: Bloomberg as of January 20 2021. These sectors are represented by constituents within both the MSCI Europe-ex-UK and MSCI UK indices. EPS growth expectations are based upon Factset consensus estimates. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

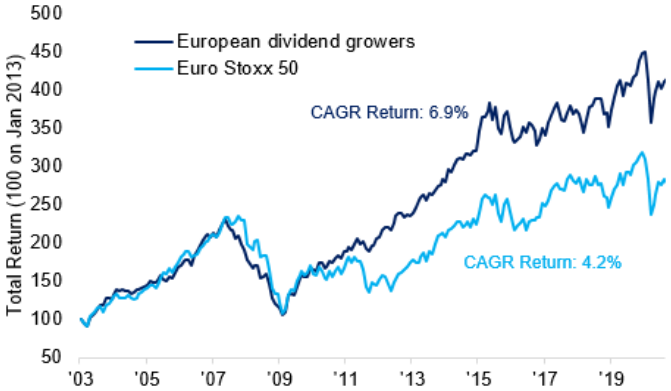
Long-term benefits of dividend strategies

Companies that can sustain dividend growth and continue to fund business expansions are likely to emerge from this crisis stronger and see their equity prices outperform in 2021. Dividend growers in Europe have shown long-term outperformance characteristics, with overall less volatility. Since early 2003, dividend growers in Europe have provided annualised total returns of 6.9%, versus broader Europe which has returned only 4.2% - **figure 8**. They have also done so with an overall lower standard deviation of returns.

Furthermore, compounded dividends have been the largest contributor to overall total returns in Europe. As **figure 9** demonstrates, re-invested dividends have accounted for approximately 50% of total returns since 1995. We believe income-oriented investors should remain adequately invested in dividend strategies for the long term.

Figure 8. Dividend growth strategies tend to outperform in the long-term

Figure 9. Dividends have contributed 50% of total returns over the long-term



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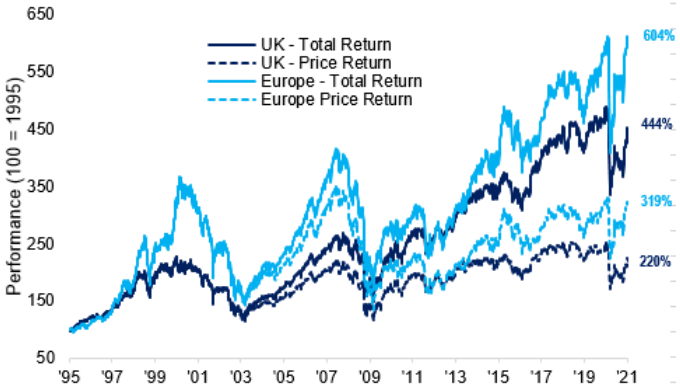

Source: Bloomberg as of January 20 2021. This refers to the price and total return of both UK and European equities, represented by both the FTSE 100 and the Euro Stoxx indices.