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Citi Global Wealth Investments

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UK sees rising share buybacks, rising dividend payouts and rising M&A activity

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Summary

- **Overweight UK equities**. We went overweight in November 2020 and added to our overweight in February. The UK market has risen 11.2% so far this year, and 17.2% over the past 12 months. However, it is still 7% below the pre-COVID high and 10% below the all-time high. In addition to a very sharp recovery in average EPS growth of over 60% this year, a key reason for our overweight position is the cheap market valuation of 13X. There are now clear catalysts for some of the value to be unlocked, with the sharp rise in share buyback activity, companies resuming dividend payments and many raising their dividend payouts. Firms that are not cost-cutting and streamlining their business models to drive the necessary cashflow, are increasingly facing the threat of takeover. Many of these takeovers are from foreign companies, which are encouraged that the Brexit fallout is less than feared and the COVID vaccine progress has been rapid.
- With companies either being more proactive in using their cash-piles or risking facing predators, there is very likely to be rising institutional interest in the market. Underpinning this growing institutional interest is low ownership in a cheap market with great cyclical exposure, value, and dividend attractions. Our advice is keep buying the broader market as the individual catalysts help to drive overall price levels higher.

Historic reason for the UK's high dividends and sub-par growth

Over the past 20 years, the UK market has generated a 134% total return, of which only 14% came from capital appreciation and the bulk from dividends. This is largely because the UK has pension and insurance company savings systems which are biased in favour of dividends rather than capital appreciation. There are three main factors behind this bias: 1. Typical funds have a finite life, as most are closed to new members. 2. Most funds are very small, with an average size of only £300 million. 3. Pension funds and insurers are structurally risk-averse, needing to ensure that assets match long-term liabilities, and for that reason they tend to prioritise income in their equity investments as that helps to make their returns more predictable.

As UK institutional ownership of UK companies dominates, their risk-averse approach with their investment decisions impacts corporate behaviour. While there are exceptions to this, many UK companies have tended to be overly risk-averse, in that way reflecting the aims of their institutional owners. This at times has favoured incremental projects not game-changing strategic shifts into disruptive technologies. It partly explains why the UK has had so little listed company exposure to the booming technology sector over the past decades. Therefore, the institutional bias has led to many years of over-distribution and also sub-par growth. Globally exposed successful UK growth companies like Dyson and Ineos have remained private, and many smaller growth companies, especially in the technology sector, have gone public in the US market instead of the UK market.

The Brexit and COVID impacts on growth and dividends

The decision to leave the EU in mid-May 2016 had a significant negative impact ahead of the UK's final departure at the end of 2020. Domestic companies slowed their investment and capex plans, given the high level of uncertainty about the terms of the eventual withdrawal. Overseas investment into the UK slowed for the same reason, with the added reason of domestic political uncertainty which led to three prime ministers, a hung parliament, and a disunited cabinet. Consumer spending was held back despite the low interest rate environment.

The early stages of COVID then had a disproportionate negative impact on the UK economy, as the services sector (80% of UK output) collapsed in the face of the huge supply and demand shocks. In addition, the pandemic containment plan was unsuccessful in the early stages. The economy suffered the worst recession in 300 years, falling by almost 10% during 2020, even after a 4th quarter pickup – **figure 1**. Most companies faced immediate cashflow pressures, leading to dividends being cancelled, postponed, or reduced.

The pressures on growth and dividends were reflected in the stock market. UK equities fell in relative terms for five years, and the valuation multiple fell to as low as 12X prospective earnings – **figure 2.** In absolute terms, the FTSE 100 now still trades at a cheap multiple of 13X versus 23X for the MSCI World Index.

Figure 1: UK GDP YoY change

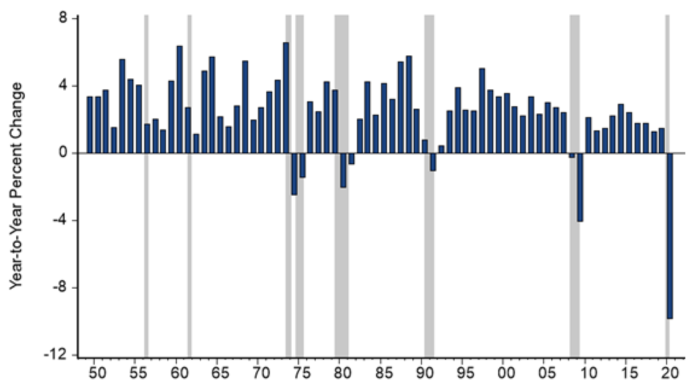
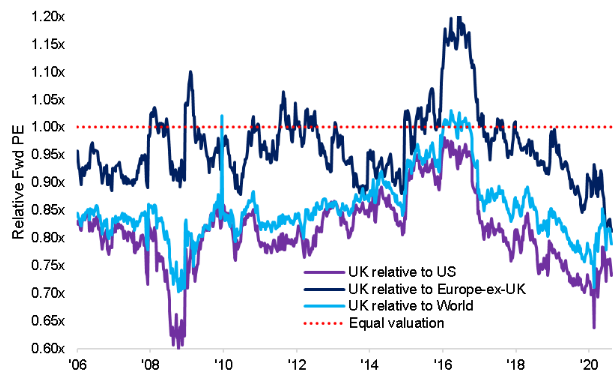


Figure 2: UK market is cheap in absolute and relative terms. Relative forward 12-month price to earnings



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The Global Investment Committee moves overweight UK equities in November 2020

Even before the EU trade deal and the vaccine progress were announced, the UK market was clearly oversold, under-owned, and undervalued. The FTSE 100 index has over 60% in cyclicals, so offered significant exposure to the sharp economic rebound from the autumn 2020 lows. Average EPS growth this year is likely to be over 60%. However, the market is only up 11.2% so far this year and is still 7% below its pre-COVID high. As the pace of the economic upturn and the EPS growth upturn slows, significant further gains and further unlocking of value needs catalysts. Fortunately, these catalysts are increasingly visible at the company level, with signs of more proactive activity, some of which is proactive and some of which is reactive to corporate predators.

Rising UK corporate cashflows support dividends and buybacks

There are two trends gathering momentum and both are uses of rising cashflows. Firstly, there are more companies resuming dividend payments, and in many cases, raising their dividend payout ratios. Secondly, many companies are now looking to raise their returns on equity through share buybacks. They are taking these actions in order to bolster their share prices, by offering more dividends, or more growth, sometimes both. The two most undervalued sectors – banks and energy – are leading the way.

Banks: In the early stages of the COVID recession in March 2020 last year, the UK Prudential Regulation Authority (PRA), the financial services regulator, barred banks from paying dividends. However, it is now relaxing that regulation. Lloyds Bank recently restored their dividend. The Royal Bank of Scotland Group went further in announcing that £3bn would be returned to shareholders through dividends and share buybacks. As well as the PRA relaxation, the banks are being helped by the stronger economy, which is supporting loan growth and widening margins.

Energy: The firmer oil price has been supportive for cashflows and higher shareholder payouts. Shell recently raised its dividend by 38% from the previous quarter. BP posted $2.4 billion surplus cashflow in the first half of this year, reduced its debt below its $35bn target, and announced a $1.4 billion buyback. BP’s dividend was raised by 4%, and management stated that if the oil price remains at or above $60/barrel then it would look to make share buybacks of $1 billion a quarter and raise its dividend by 4% annually until 2025.

The trend towards higher payouts is broadening. Miners are seeing strong commodity demand especially for iron ore and copper. As a result, Anglo-American announced a share buyback and RTZ announced a record dividend payout. Diageo, the largest whisky producer in the world, recently raised its dividend by 5%. BAT has grown its dividend every year since 1999 and will do so again this year. The London Stock Exchange raised its dividend by 7%, integrating Refinitiv the financial data group which they bought for $27 billion, which led to significant cost-cutting.

There are also more “special dividends” being announced. These are one-off bonuses to shareholders. The dividend monitoring company Link Group calculate that £1.4 billion of special dividends were paid during the first half of this year by UK listed companies, much greater than during the whole of 2020. Momentum is high, with Link expecting £12 billion for the full year. The special dividends are often bigger than regular dividends and sometimes amount to 20% or more of a company’s share price. Some of these are paid by mining companies like Rio Tinto – which has paid two special dividends so far this year – as a result of booming commodity prices. Other dividends like that of insurer Admiral, retailer Tesco, and water company Pennon, result from surplus cashflow with very limited investment and acquisition opportunities in their mature sectors.

Rising UK corporate investment intentions

In aggregate AJ Bell has estimated that FTSE 100 dividends will grow by 25% this year to £67.9 billion, giving an average yield of 3.7%, with dividend cover up to 1.83W which is the highest since 2014. While dividends are the tangible return from equity ownership, excessive cash return to investors can lead to cuts in investment, which ultimately lowers long-term profitability. So, it is extremely encouraging that even as dividend payments resume and many payouts rise, along with a spate of share buybacks, the corporate sector is showing increasing confidence to invest in several recent surveys. The Deloitte CFO survey showed 71% of chief financial officers plan to raise UK investment in the next 12 months. The recent Confederation of British Industry (CBI) survey showed strong investment intentions from both manufacturers and retailers. The Accenture-IHS Markit survey of the UK business outlook showed the highest level of capital expenditure this year compared with the last 6 years. The UK-US Trade Association found that more than half of 600 US companies with UK operations planned to raise their UK investment in the coming months, and one-third of them showed strongly rising confidence in the UK outlook.

The rising investment intentions are partly based upon Brexit being less problematic than anticipated, plus the great government vaccine development, procurement and rollout programme. Companies are seeing this being reflected in a consumer demand pickup. The jobs market is strong, and low interest rates are encouraging much mortgage fixing which is helping drive the property sector. What is more, there are unplanned COVID-savings equating to around 10% of GDP, which will be partly spent on consumer goods – **figures 3 and 4.**

Figure 3: UK consumer confidence picking up

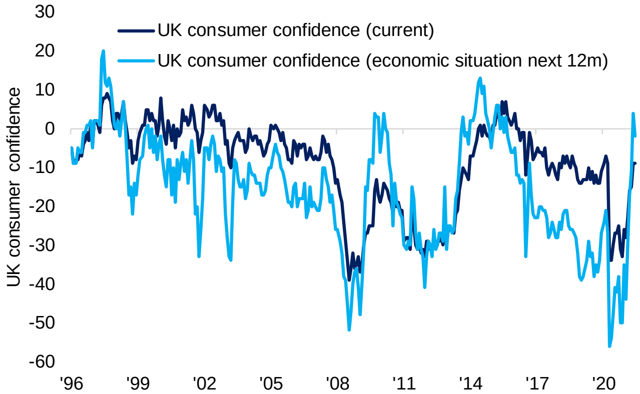
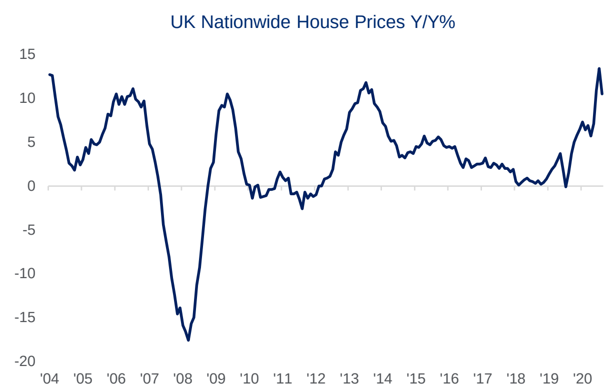


Figure 4: Rebounding UK house prices



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Rising level of UK corporate mergers and disposals

Companies not able to raise cashflow by way of organic growth are under rising pressure to generate growth through more efficient use of capital. This involves shedding inefficient non-core businesses or through buying growth businesses. There are some companies with strong cashflows and rising payouts, who still have pressing needs to shed assets in order to shift strategic direction. For example, BP needs to finance its long-term energy transition agenda, aiming for a 30-35% reduction in emissions by 2030, reaching “net zero” by 2050. This means building renewable energy capacity like wind and solar as well as “convenience and mobility” assets like electric vehicle charging points, to compensate for cutting production from its hydrocarbon business by 40% by 2023. This requires a substantial cost reduction programme. Last year, 10,000 jobs were cut, as the company aims to make up to $5bn savings by 2023. BP has also recently sold $10 billion legacy hydrocarbon assets and is seeking buyers for $5 billion more to hit its disposal target by 2025. Part of these proceeds will be spent on low-carbon energy, with $4 billion planned expenditure by 2025.

Rising level of UK corporate takeovers and buyouts

Companies with little cashflow and no proactivity are potential targets, particularly those with strong brands, sizeable market shares, and share prices that are low compared with their intrinsic asset values per share. Bid activity for UK listed companies has picked up markedly this year, with the combined value of takeover attempts involving UK targets reaching almost £156 billion. This is the highest total for 14 years and up from £45 billion in same period last year (Source: Refinitiv). Within this the pace of private equity (PE) buyout bids for UK-listed companies is the fastest in 20 years so far this year. The number of leveraged UK buyouts is up almost 60% in 2021 compared with 2019. In terms of the total number of bids across both listed and unlisted firms, there have been 2,463 bids in the UK so far this year, the highest number since 1998. There have been approaches for 13 listed UK companies. These are some of the reasons cited by buyers, particularly foreign buyers: the UK’s “pro-business environment”; confidence driven by the UK’s effective vaccine development and rollout; the UK’s liberal attitude towards takeovers, making it an easy place to buy and restructure companies; and the relative cheapness of UK equities compared to other markets.

In addition, there are 3 factors driving this pickup in corporate activity:

Firstly, there is rising business confidence, reflected in many of the statements accompanying recent results. This is leading to more deals, while it is also notable how average deal sizes are increasing,

Secondly, the upturn is more than pent-up corporate demand after the pandemic period of inactivity. There is now much strategic positioning. Some companies are seeking to secure future supply chains, which have proved vulnerable during the pandemic. Some are seeking scale and diversification as defences against potential unpredictable shocks. Some have an increasing growth mindset after sustained periods of cost-cutting. Some are needing to make dramatic business model shifts as environmental pressures grow, particularly in the energy sector. Finally, as the growth upturn is uneven across sectors, some are looking for smaller deals to bolster growth without business model shifts.

Thirdly, there is cash on the sidelines, particularly from the PE sector. The shorter investment cycles in PE between entry and exit are feeding the transaction flow. In addition, the strong historic PE investment performance has led to strong inflows into PE funds which need to be invested. Cheap debt is fuelling leverage for many of these PE deals. There is reportedly around $413 billion of PE firepower earmarked for European investment. With leverage their prospective returns look attractive for cheap UK listed stocks. In addition, in the second quarter there were the first signs of US SPACs looking to buy European assets. With many PE and SPAC buyers being foreign, the likely pickup in business travel in the coming months as the pandemic eases is likely to bolster cross-border activity. Finally, some of the corporate raiders have been able to raise significant capital around the ESG theme, which is growing in importance for institutions.

Examples of different rationales for UK corporate activity

1. **Activism to prompt management actions**

   For example, there is currently an insurer and FTSE 100 member whose management is reacting to its activist and second-largest shareholder which has been demanding more cost-cutting and higher shareholder distributions. The company's recent half-year results showed its best revenue performance in a decade, feeding through into a strong rise in cashflow, and a £750 million share buyback was announced. This was less than the £5 billion demanded by the activist shareholder, but a further £4 billion is promised by next summer. Debt has been reduced by £2 billion with a further £1 billion promised over the months ahead. Businesses in eight countries have been sold, for a total of £7.5 billion. Management announced their aim for £300 million of annual cost savings. With its solvency ratio of 203%, management has stated that it will be returning capital in excess of 180%. The interim dividend is up 5% from a year ago. The shares have risen 4.4% since the announcement.

2. **Changing business models from the buyers**

   There are three big business model-changing tends. Firstly, oil majors are transitioning into integrated energy companies, while trying not to weaken the prospects for their fossil fuel assets. Secondly, miners face environmental, social and governance issues. The third big trend is the increasing focus on healthcare, as demonstrated in the example below:

   A US tobacco company has made a competitive and hostile bid for a FTSE 250 respiratory drugs company, which is a developer of inhalers and inhaled medicines, including for smoking-related conditions, generating royalty revenues from drug patents that it has licensed to other companies. The bidder is highlighting its keenness transform its business model into a 'healthcare & wellness' company. It envisages a 'smoke-free' future and is intent on spending $9 billion to move in that direction, with around $1.4 billion of that earmarked for the bid. The offer is contentious. Twenty leading respiratory medicine organizations in Europe and the US have warned that its activities could be restricted if purchased. Outrage that a company selling products that cause lung diseases buying another that is developing therapies to treat those conditions, also led to a cross-party political backlash in the UK.

   Despite this controversy and despite the target's board having previously accepted a lower offer from another company, the V board is now recommending the bid. They are standing up to the pressure from campaign groups, to achieve the best price for their shareholders. The share price is now at a 60% premium to the share price before takeover interest became public.

3. **Increasing focus on alternative energy**

   This alternative energy focus is driving UK as well as European corporates. The rationale is reducing carbon footprints. Environmental pressure is the emerging force in sales or separation of CO2-intensive or oil-linked businesses. For example, a European company is carving out its cash-generative soda ash business used in glass and detergents, 60% of the groups CO2 emissions. Another French company sold its acrylic business as .acrylics relies on petroleum to create products. Several companies are looking for growth within this unstoppable trend, making 'add-on' acquisitions as they look to become producers of electric car battery materials

4. **Focus by foreign buyers on UK companies with strong brands and high cashflow**

   The contested bids for the UK's fourth largest supermarket chain are demonstrating overseas demand for an undervalued company with great brand strength. The company is very well established, employs 120,000 people and has been listed in London for over 50 years. Before the bids, their share price was very close to where it was five years ago, having paid out 90% of net income in regular and special dividends over that period. So, strong cashflow and high payouts were insufficient to attract investor interest.

   A PE consortium recently raised its second offer, valuing the supermarket chain at nearly £10 billion. The offer is at a 52% premium to the target's share price in June 2020 before takeover interest began, and a 7% premium to its first offer. As another PE group is considering raising its bid an extended bidding war is likely. As the UK Takeover Panel reviews the bids, this is demonstrating their growing regulatory involvement in what are perceived as asset-stripping bids by aggressive leveraged overseas PE buyers. In many cases, local potential bidders are restricted by competition issues.

5. **Focus on sectors where the UK has companies which have significant global presence**

   Let us consider two of these, defence and chemicals:

   Defence sector: Two US defence groups are battling to a buy a FTSE 250 company with roots back to the mid-19th century, which derives 46% of its revenues from defence, which employs 14,000 people in 14 countries. The company makes high-strength composite parts, sensors, landing gear components, and seats for Airbus, Boeing, Bombardier, Rolls-Royce. After the board recommended a bid valuing the company at £6.3 bn, a further bid was tabled last week valuing the company at £7 billion. The offer is 30% higher than the target's shares have ever traded, and the shares are up 16% since the bids were announced. The target's chairman has asked ministers to intervene if any bidder tries to buy without giving binding commitments on investment and jobs.

   Chemicals sector: There have been £20 billion worth of deals in the first quarter of 2021 across all of Europe including the UK, compared with £32 billion for all of 2020. Within this there is a big increase in the number of carve-outs and buyouts. For example, a Swiss company sold its speciality ingredients business to two US PE companies, allowing it to focus solely on the booming healthcare industry. The sale was well-timed, with more awareness of the need for cleanliness buoying the ingredients business whose specialty is controlling harmful microbes.

Conclusion

At a global level, we are increasingly focused on quality companies as the pandemic progresses. The UK has many listed companies that meet our quality criteria, including strong brands built up over many years, and strong balance sheets and cashflows. However, for a prolonged period, local institutional demands have been mainly for high income and less for capital gain, and then the five-year acrimonious Brexit negotiations held back foreign portfolio investor interest. As a direct consequence of these two factors, the stock valuations of many of these quality companies are cheap even after the 17% market rally over the past 12 months.

UK listed companies broadly fall into three categories:

1. Some companies are proactively starting to use their balance sheets and cashflows more aggressively. In a world of financial repression, with interest rates at historically low levels for a prolonged period, the investor demand for income and rising payouts is going to remain very high.
2. Some companies are adjusting their business models. As there are more environmental pressures driving the need for business model changes, stakebuilding from activist investors is likely to remain high.
3. Some UK companies, which are doing very little to enhance shareholder value, increasingly face the threat of takeover. More contested takeover activity is very likely. Competition in new growth areas is high, and buyers in contested bid situations are also increasingly seeing broad UK shareholder support for their actions. Bidders will continue to have access to cheap capital for the foreseeable future.

Our Global Investment Committee's overweighting UK equities is not dependent on higher payouts and more M&A activity. The UK market is the cheapest, with the highest current dividend yields, with the highest earnings growth, of all the markets we follow. Nevertheless, value needs catalysts, and that is what the higher payouts and more M&A activity are providing. Our advice is keep buying the broader market as the individual catalysts drive overall price levels higher.

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Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.
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Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

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