

Payout Ratio: The Most Influential Management Decision a Company Can Make?

In today's equity market, payout ratios have a meaningful impact on both equity valuation and the overall cost of capital. Our analysis suggests there is an optimal payout-ratio range that can lead to a higher price-to-earnings multiple, especially within a high-quality subset of the market where stable operating models give most companies the flexibility to sustainably implement higher payout ratios.¹ When we examine the payout ratio's impact on the cost of equity and the cost of debt, we also find an optimal range of payout ratios that can help to minimize the cost of both equity and debt. In conclusion, we argue that many U.S. companies have the potential to optimize payout ratios to gain a fundamental competitive advantage.

Payout ratios and equity valuation

A company's payout ratio is simply the proportion of its net income that gets distributed to shareholders in the form of regular dividends.² Though the payout ratio does not receive the same widespread investor focus as other measures like earnings per share (EPS) or dividend yield, this straightforward metric has an outsized impact on the valuation of equities. In an earlier paper, we highlighted that high payout-ratio U.S. companies were being rewarded with richer price-to-earnings (P/E) multiples, despite generally undistinguished earnings-growth expectations.³ In this paper, we examine the payout ratio more closely to better understand its overall effect on a company.

Not all companies have the stability in their operating models to sustainably implement higher payout ratios, so analyzing the entire equity market may not be the most useful approach to assessing the impact of payout ratios on valuations. To enhance the applicability of our analysis, we constrain our research universe to a *high-quality subset* of the S&P 500® Index, isolating only those companies with a history of stable, non-negative earnings.⁴ This universe of 298 companies is diversified across all S&P sectors and has exhibited a higher return on equity than the broad market from January 2004 to November 2012. We observe that within this high-quality subset, higher payout-ratio fractiles generally had higher market multiples over the 52 weeks through November 23, 2012 (see Exhibit 1 left, page 2). Additionally, within this universe, we define *quality payout growers* as companies that have demonstrated positive earnings-per-share (EPS) and dividend-per-share growth, and have increased payout ratios by 5% or more. When we assess the impact of a change in payout ratio on valuation, we discover that the market has rewarded these companies by expanding their P/Es over the past 23 months. On the other hand, high-quality companies without these characteristics have seen their valuations contract (see Exhibit 1 right, page 2).

We believe that a combination of quantitative factors and qualitative factors has boosted the strength of the relationship between payouts and valuation. On the quantitative side, the current environment of low nominal Treasury yields has driven investors to the more risky segments of fixed income—for example, high yield—and to the more income-oriented segments of equities, temporarily elevating the significance of payout ratios. On the qualitative side, the increasing income needs of retiring baby boomers are likely foreshadowing a longer-term shift in investor preferences toward less volatile dividend-oriented equities; this secular tailwind for the significance of payout ratios may already be having an impact in the market (see Payout and valuation regression results, page 2, for additional details on the historical connection between the payout ratio and valuation).

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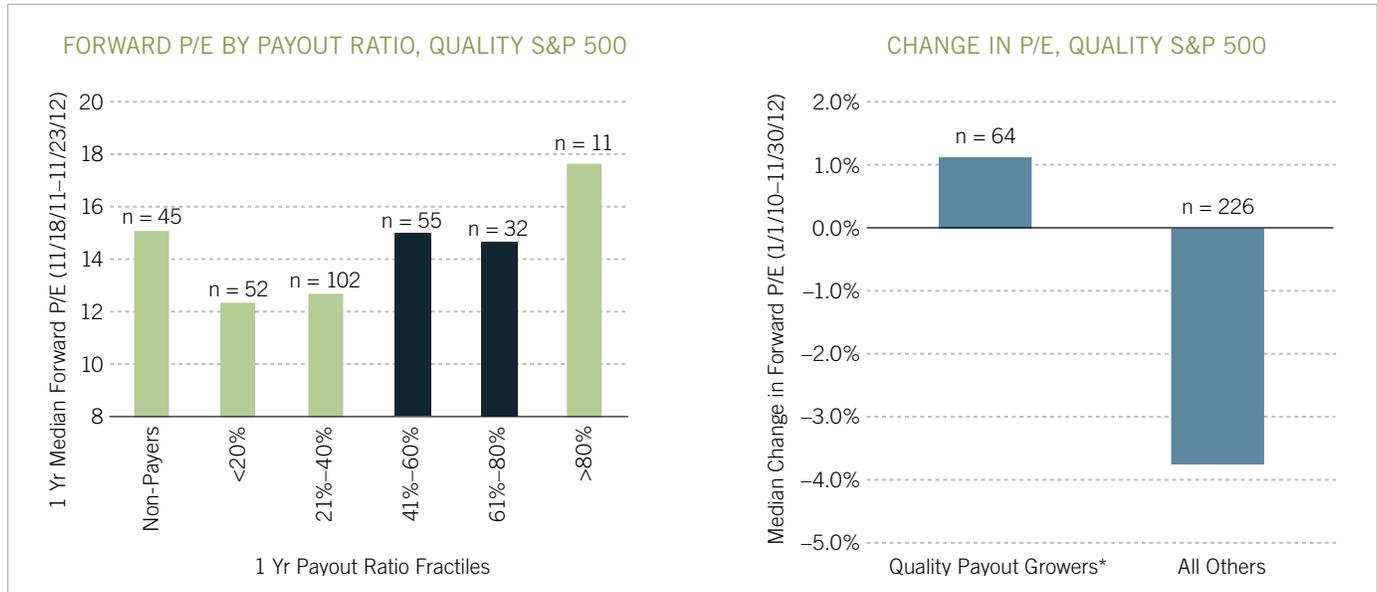
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KEY TAKEAWAYS

- The dividend payout ratio policy established by the board of directors and the management team has a significant impact on a company's valuation and cost of capital.
- Within a high-quality subset of the U.S. equity market—including only companies that have a history of stable, positive earnings—our research shows that an optimal payout ratio between 40% and 60% is generally associated with a lower beta (cost of equity) and a lower credit default swap spread (cost of debt), thus reducing the cost of capital and creating a structural competitive advantage.
- A large proportion of this high-quality subset has a current payout ratio outside the targeted 40%–60% range, which suggests that many companies have the opportunity to enhance their valuations through this capital allocation lever.

EXHIBIT 1: Forward valuation has generally increased with the payout ratio, with the positive relationship most apparent among quality payout growers.



Forward = next 12 months, n = number of observations. Excludes companies without EPS estimates. *Quality payout growers = high-quality S&P 500 companies with increases in payout ratio greater than 5% plus increases in EPS and dividends per share over period. Left chart: weekly data from Nov. 18, 2011 to Nov. 23, 2012. Right chart: point-in-time P/E multiples, comparing Jan. 1, 2010 to Nov. 30, 2012 end points. Source: Bloomberg.

Payout ratios and the cost of capital

We want to understand what might be driving the observed relationship between payout ratios and valuations. Our analysis suggests that an optimal payout ratio level is associated with a lower cost of capital, which we demonstrate by separating the impact of the payout ratio on the cost of equity—represented by beta—and the cost of debt—represented by the credit default swap (CDS) spread.⁵

Within the high-quality subset of the equity market, as we move from lower payout-ratio fractiles to higher fractiles of 41%–60% and 61%–80%, the predicted beta declines significantly, thereby lowering the cost of equity (see Exhibit 2 left, page 3). This stands to reason, since we expect lower volatility and thus a lower cost of equity for a company that reliably returns more of its earnings to shareholders. At payout ratios above 80%, however, the predicted beta increases, reflecting the market’s skepticism about the sustainability of such high payouts. Additionally, we observe that the market has rewarded these quality payout growers with a demonstrably lower beta, while giving a higher beta to the remainder of the universe (see Exhibit 2 right, page 3).

In a similar vein, the CDS spread, which measures the cost of debt, narrows as we move from the lower payout-ratio fractiles to the 41%–60% fractile, at which point the CDS spread reaches an inflection point. Above 60%, the median CDS spread again widens (see Exhibit 3 left, page 3). We believe this relationship exists because an extremely high payout ratio may mean that a company has less of a cushion for servicing debt, while an especially low payout ratio might indicate more volatile cash flow from

Payout and valuation regression results

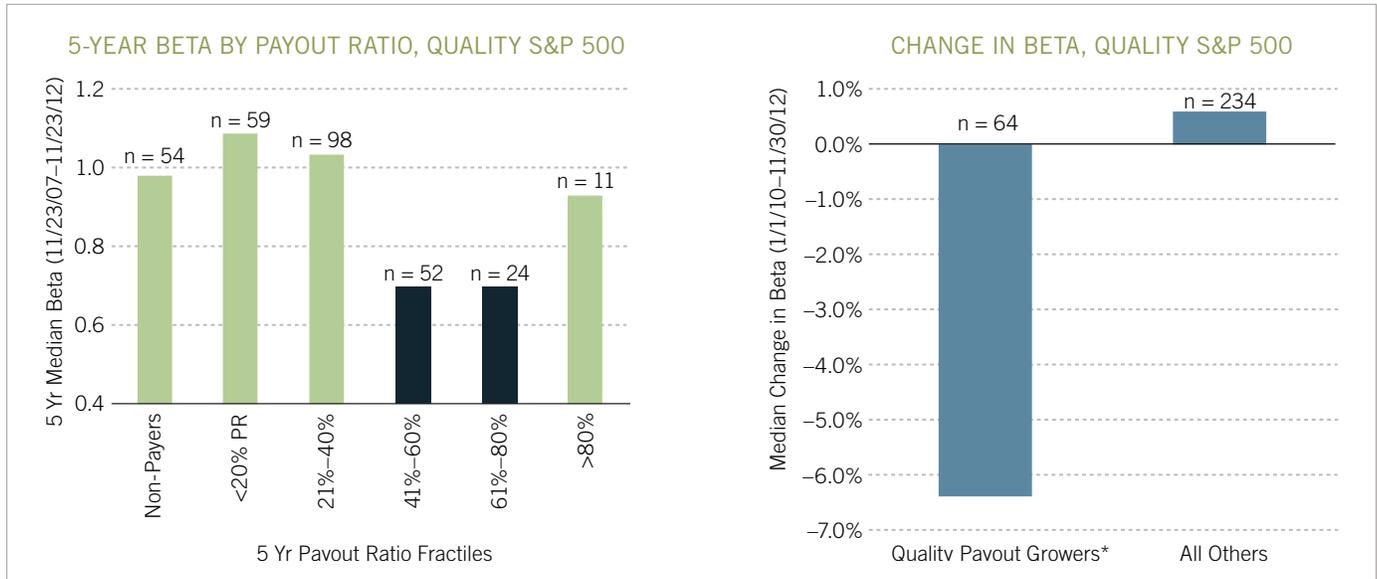
To determine whether the recent positive relationship between payout ratio and valuation has existed historically, we perform a multiple regression analysis during the 2004–2011 period. Our analysis demonstrates a causal relationship between changes in payout ratio and changes in valuation—that is, as payout ratios increased, forward P/E multiples also tended to increase over a year-long period. This provides evidence to support the claim that an increase in the payout ratio can actually bring about an increase in valuation, holding profitability, returns, and other factors constant.

Regression Results, % Change in Forward P/E as Dependent Variable

Independent Variables	Statistically Significant at 5% Level	Interpretation
% Change in Fwd EPS	Yes	Larger EPS change => Smaller P/E change
Change in Payout Ratio	Yes	Larger payout ratio change => Larger P/E change
Market Cap	Yes	Higher market value => Smaller P/E change
ROE ⁶	No	N/A
Leverage ⁶	No	N/A
Sector	N/A	N/A

Note: Regression includes 2,193 observations from 2004 to 2011 at non-overlapping annual frequency. Changes measured over 12-month period. Fwd = next 12 months. See endnotes for definitions of ROE and leverage.

EXHIBIT 2: Predicted beta has varied with the payout ratio; among quality payout growers, beta has declined dramatically, thereby lowering the cost of equity.

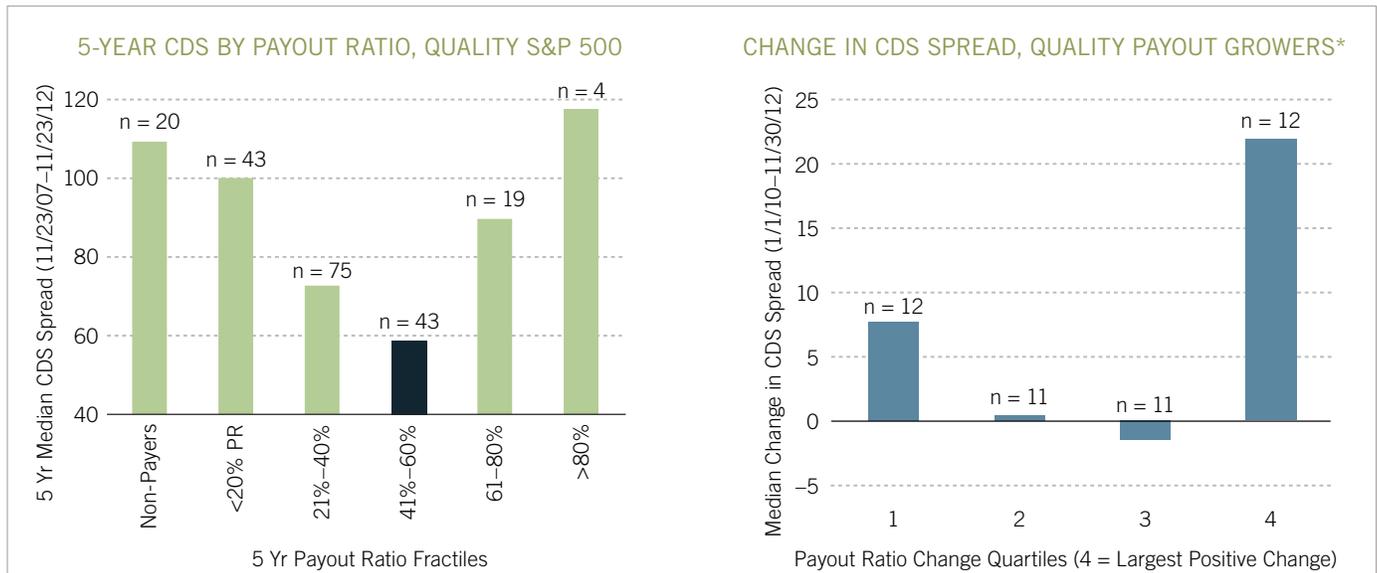


*Quality payout growers = high-quality S&P 500 companies with increases in payout ratio greater than 5% plus increases in EPS and dividends per share over period. Left chart: weekly data from Nov. 23, 2007 to Nov. 23, 2012. Right chart: point-in-time betas comparing Jan. 1, 2010 to Nov. 30, 2012 end points. See endnotes for definition of predicted beta. Source: FactSet, Bloomberg.

the underlying business model and a less disciplined strategy to return capital. Likewise, when analyzing the impact of a change in payout ratio on the CDS spreads of quality payout growers, we arrive at similar conclusions—namely, that there is a “sweet spot”

in payout-ratio increases which has been associated with narrowing CDS spreads, and that beyond that sweet spot, CDS spreads have widened, thereby raising the cost of debt (see Exhibit 3 right, below).

EXHIBIT 3: The CDS spread has narrowed as the payout ratio has declined, but only up to a point; this inflection suggests that an extremely high payout ratio may raise the cost of debt.



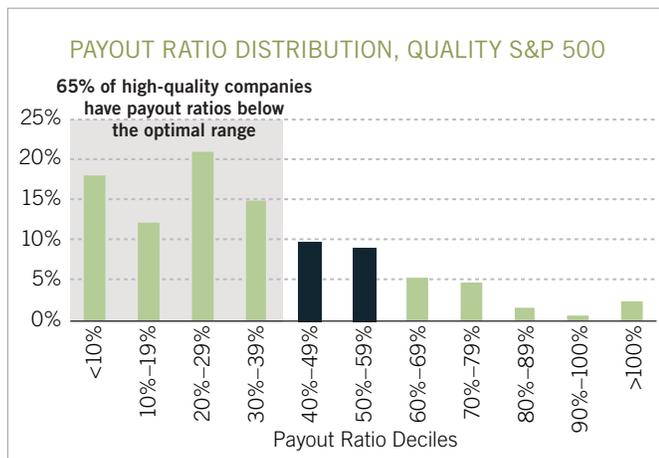
CDS spreads reported in basis points. Excludes companies without CDS spreads. *Quality payout growers = high-quality S&P 500 companies with increases in payout ratio greater than 5% plus increases in EPS and dividends per share over period. Left chart: weekly data from Nov. 23, 2007 to Nov. 23, 2012. Right chart: point-in-time CDS spreads, comparing Jan. 1, 2010 to Nov. 30, 2012 end points. See endnotes for definition of CDS spread. Source: Bloomberg.

Identifying an optimal payout ratio

Taking into account the implications for both valuation and the cost of capital, there appears to be an optimal payout ratio between 40% and 60% for the high-quality subset of the U.S. equity market. This is a broad range, with an individual company's optimal payout ratio depending on the particulars of its business model and its reliance on debt and/or equity financing. Some of the reasons that a company may target a payout ratio below the 40% threshold include:

- A high degree of volatility in a company's underlying cash flows
- An early stage in a company's lifecycle and/or its product offering
- An above-average appetite for acquisitions requiring more cash on hand

EXHIBIT 4: Many high-quality U.S. companies have payout ratios below the 40%–60% range.



Note: Number of observations = 298. Weekly data from Nov. 15, 2011 to Nov. 15, 2012. Source: Bloomberg.

It should come as no surprise that each of these scenarios is typically associated with a higher cost of capital. Conversely, when a stock has a payout ratio above this optimal range, questions about the sustainability of its dividend and earnings come to the fore, which may also drive up the cost of capital.

We have shown that this optimal payout-ratio range can support both a higher valuation and a lower cost of capital. Despite such advantages, a meaningful proportion of companies that have business models stable enough to support payout ratios within the optimal range do not take advantage of this opportunity: In our high-quality subset of the U.S. equity market, 65%—or 195 of 298 companies—have payout ratios below 40% (see Exhibit 4, left). The median payout ratio for the high-quality subset stands at 29%.⁷ By way of historical comparison, the median payout ratio for the S&P 500 over the entire period from 1980 through 1999 was substantially higher at 45%.

Investment and management implications

From an investment perspective, identifying companies with both the business model and the willingness to pay higher dividends may continue to be a successful strategy as long as interest rates remain low. Even if interest rates begin to climb, the positive relationship between the payout ratio and equity valuation may persist, but perhaps be less robust. A payout ratio within the optimal range of 40% to 60% generally signals that a company has greater capital allocation discipline and its business model generates stable free cash flow.

Management teams often focus attention on operational tactics to lower the cost structure, thus gaining a fundamental advantage versus the competition. Our research shows that company management teams and boards of directors can set payout ratios to provide a fundamental cost advantage—a cost of capital advantage—which may create long-term shareholder value.

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Past performance, dividend rates, and payout ratios are historical and do not guarantee future results.

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Investing involves risk, including risk of loss.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

It is not possible to invest directly in an index. All indices are unmanaged.

Index definitions

Standard & Poor's 500 Index (S&P 500®) is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

Endnotes

¹ Our high-quality subset of the U.S. equity market is defined as any constituent of the S&P 500 Index from January 2004 to November 2012 that (1) had no negative calendar-year earnings per share (EPS) over the 2004–2011 period and (2) was in the bottom 50th percentile of EPS volatility based on the coefficient of variation, a normalized measure of dispersion calculated as the ratio of standard deviation to the mean using annual observations over the 2004–2011 period.

² In our analysis of payout ratios and equity valuation using the high-quality subset of the S&P 500 Index, regular quarterly dividends are included, while special one-time distributions are excluded.

³ See "What if the Market is Revaluing Dividends?" Fidelity Investments Leadership Series, March 2012.

⁴ See endnote 1.

⁵ Beta is a measure of a stock's risk relative to the market, as represented by a benchmark index, which has a beta of 1. Our analysis uses predicted beta, a forecast of a stock's sensitivity to the market based on fundamental risk factors sourced from the Barra risk model; a beta of more (or less) than 1 indicates that a stock is expected to be more (or less) volatile than the benchmark index. A credit default swap (CDS) is a derivative contract designed to transfer credit exposure from the seller to the buyer, for which the buyer is paid a premium—or spread—over the life of the contract; the larger the spread, the greater the likelihood of default by the issuer.

⁶ ROE, or return on equity, is net income before extraordinary items available to common shareholders, divided by average common shareholders' equity. Leverage is the ratio of net debt to market capitalization.

⁷ Median payout ratio is 29% for the high-quality subset and 30% for the S&P 500 in aggregate. Source: FactSet as of Nov. 30, 2012.

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