April 9, 2020

SKBA Market Update

The Suspense in "Suspend"

There's a new phrase some companies have recently adopted, "We have decided to suspend our dividend." It's a drastic step taken in response to extreme events. But what is it really supposed to imply? We wait in suspense for the answer!

It is a reasonable excuse to use the COVID-19 crisis as a reason to omit one's dividend. The term "omission" implies permanence. Most often in past cycles, if a company omits its dividend, the implication is that it is facing a long-lasting challenge to its business and profits that warrants a drastic step in slashing the dividend. It is not good news.

Today, however, the word for omission is now suspension. On the surface it implies a different perspective, one that is temporary in nature. No doubt, the plunge in corporate revenues for a vast array of companies due to the economic shut down has created a severe cash flow crunch. A decision to temporarily suspend the dividend can be understood in this light. Therefore, we would expect a company that suspends its dividend now to reinstate it to its prior level as soon as the cash flow crisis is over in four to six months.

For SKBA, as dividend investors, this poses an analytical problem that we've managed through before in 2009. Back then bank balance sheets were indeed being tested, and we expected significant dividend cuts among financial companies. Then Director of the National Economic Council, Lawrence Summers, stated that banks that received TARP money to shore up their balance sheet should not be paying dividends. This was perceived as a command, not an option. One-by-one in domino-like fashion, banks slashed their dividend rates by 80% to 100%. We conducted our own analysis to determine which banks could restore former dividend levels the quickest and selectively added to our bank investments as a result.

Today is almost no different, except the potential wave of dividend suspensions has just begun. By our count, among stocks in the S&P 500, 15 have omitted, or rather suspended, their dividends so far. Three energy companies have cut dividends but not suspended them. These three cuts imply the companies have decided that their normal earning power has been permanently lowered by the current conditions hurting oil consumption.

The list of 15 can be categorized as follows:

Industry	# Companies with Omitted/Suspended Dividends
Retail/Clothing	5
Hotels, Restaurants & Leisure	4
Airlines	2
Autos	2
Capital Goods	1 (Boeing)
Mining	1

This list is not surprising given the difficulties companies in these industries face.

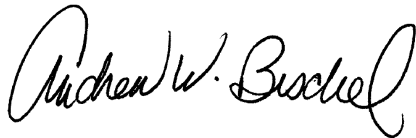
In our opinion, those that survive today's health/economic crisis without cutting or suspending dividends are to be commended. Two of our favorite examples of companies with such commitment are Chevron and Genuine Parts. Both have a long history of maintaining dividends through thick and thin. Chevron last cut its dividend in 1937 during the Great Depression. Both companies have maintained conservative balance sheets with leverage that we deem to be manageable during this most severe downturn. Our analysis of companies now focuses on each company's ability to cover fixed obligations and dividends from cash and credit lines even if profits are temporarily absent.

Our view is those who do sustain dividends should see the reward in higher valuations on the other side of the COVID-19 crisis. But what about the ones who have chosen or chose to suspend their dividends? Is "suspend' a code word for full restoration post crisis? Or will it become an excuse to permanently cut the dividend? This will be an additional area of focus of our bottom-up analysis on who is using the suspension to hide the fact that they've managed their debt leverage poorly.

We believe too many companies have borrowed money to buy back stock. But both buybacks and dividend payments result from both the will and financial capacity to sustain them. From our perspective, nothing has changed since 1998 when we had a NYU professor conduct a study on companies' priority in the use of cash flow. When the goin' gets tough, the first things to go are buybacks. And buybacks are dead dead dead—for now. The current end to buybacks—at least the vast majority of them—will either help companies, like banks, to shore up bank capital, or for others to sustain their dividend payments through these tough times.

We will be on the lookout for companies that chose to suspend dividends as a scapegoat when their real problem will be their inability to restore them when the crisis is over. We will evaluate them on the prospect of a permanent cut in dividends and its implication for underlying earning power.

Our very best wishes to you,



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