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No go for growth: Animal spirits little match for the cult of the dividend

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SEEK chief executive Andrew Bassat bought to a head the battle between those focused on dividends and those who want growth. **Josh Robenstone**


by **Vesna Poljak**

Fund managers and chief executives are no strangers to battles behind closed doors.

But when SEEK co-founder and boss Andrew Bassat returned fire at those investors who challenged his five-year investment plan, saying some "care more about next week's profit than anything else", it was the flashpoint in a debate that defined Australian business in 2015.

The trade-off between investing for growth and short-term returns has escalated in the past year, as competing forces heighten the pressure on both parties.

Investors are still counting on equities to deliver income – returns have been poor under the weight of the commodities rout and bank capital raisings, and the top 20 stocks are perceived to be mature businesses.

But asset allocators still demand constant top-quartile performance from fund managers.

Companies that have found the right balance are the same ones that have blitzed the return tables this past year: Domino's Pizza Enterprises, TPG Telecom and even toll-road operator Transurban.

The Reserve Bank of Australia was quick to identify the absence of what it calls the "animal spirits" when the central bank became frustrated that low interest rates were not translating to lower return hurdles in boardrooms. This was reflected in a plunging national capex survey and dismal outlook for business spending. But boards have argued return hurdles have come down, and that it would be unwise to plan around low rates forever.

'ANXIOUS TIMES'

"It does take a lot of courage to be a CEO making a long-term decisions in a short-term market," said Dion Hershan, head of Australian equities at Goldman Sachs Asset Management. "We're just in anxious times, generally speaking."

It is sensibly argued that dividends have made the Australian sharemarket safer in times of crisis.

But Hershan says in some cases this has gone too far – it's not hard to spot businesses, or even industries, in Australia that have been starved of capital.

"Our sense is there's too much focus on short-term outcomes and an undue fixation on dividends.

"We're not against dividends. But paying dividends is the path of least resistance and boards and management teams are getting rewarded for it."

Australian dividends enjoy a protected status in that companies have created a discipline around meeting the dividend forecast and those who cut their dividend are savaged. The cash value of dividends paid out by the big four banks alone is $20 billion annually. When the banks asked investors for more capital beginning in May, they did so without putting a dent in the dividend.

If bingeing on dividends is symptomatic of the broader short-termism that everyone agrees has crept into the market, Australia is probably not unique in that respect. But it does make it difficult for a CEO to have an impact as a leader.

REMUNERATION STRUCTURES SKEWED TO SHORT-TERM

"Very often we're asking companies 'how are you going to grow?', because you learn so much from the answer," Hershan says.

One big problem that many experts point to is the fact that executive pay structures still reward managers too richly for short-term strides. The emphasis on hitting total shareholder return targets is one key criticism, because the easiest way to do that is to pump up the dividends.

"There's no doubt that a lot of remuneration structures – although they have improved – are still skewed to the short-term," Hershan says. "It takes a couple of years for CEOs to settle into their role, they don't have a long time to make big decisions."

One of the findings of a report published by Blenheim Partners and MGSM in December on the challenges of attaining growth was that the quarterly reporting vision is holding back big ideas. It was not specifically critical of dividend culture but suggested that risk aversion was "fundamental" to Australian cultural values, and painted the United States as a more "romanticised" environment for a leader playing the long game.

"This mindset is driving a bias to short-term growth agendas rather than being inclusive of the sustainable growth that is essential for the long-term viability of Australian companies. If this environment drives companies to simply strive for incremental growth, the long-term sustainability of those businesses is questionable," the report argues.

Businesses that fall into the trap of short-termist thinking become vulnerable to disruption, it adds.

Many fund managers see the distribution of dividends in the context of a bigger capital allocation process, not just the company-shareholder relationship.

JUST REINVESTING 'IN THEIR OWN IDEAS'

"We're allocating capital to good investment opportunities. If companies keep all of their capital to themselves, they just reinvest in their own ideas," says Paul Taylor, who manages the Fidelity Australian Equities Fund.

"Let's assume nobody pays a dividend and everybody uses that cash to reinvest in their business. That creates an extreme inefficiency in the market because every company is self-funding their growth.

"Some companies are growing at 50 per cent, 10 per cent, 5 per cent, minus-20 per cent. The company that's growing plus-50 needs the capital."

He also references research that shows higher payout ratio companies outgrow lower payout ratio companies because the higher ratio creates a "capital discipline".

Taylor agrees with the sentiment that the Australian equity market is a workhorse, not a racehorse.

"Even if you do have a high dividend payout ratio, you can get capital back to do things. That doesn't stop investment," he says, because companies can raise cash quickly. "Fund managers love good investment opportunities."

But boards can also make mistakes when they think they are appeasing the investor base by giving capital back. BHP Billiton has adopted the idea of a progressive dividend policy, which signalled a commitment to stable returns on the down side of the commodities cycle after a sequence of poor capital management decisions.

A PRO-CYCLICAL STRATEGY

The problem is this is a pro-cyclical strategy for a classic cyclical company and investors argue BHP would have been better served by having a higher payout ratio through the cycle, even if that meant lower payouts in dollar terms today. The thinking is that a more sophisticated appreciation of capital into the top of the cycle may have precluded the company from investing blindly at the peak in commodity prices.

Maybe, maybe not. But no serious fund manager believes BHP can sustain its dividend much longer as bond holders become agitated and commodity prices are yet to settle.

Chris Stott, chief investment officer at Wilson Asset Management, says CEOs can make life easier for themselves by having a thoughtful and honest pitch for investors to avoid any "sticker shock" when briefing the market with a new strategy.

"Companies that invest for growth over the medium to longer term, and have a clear articulated strategy in terms of return hurdles, and clear criteria in terms of what they can achieve on capital, will win on the day," he says. "REA, Carsales, SEEK … they were all losing money 10 or 15 years ago. It's typically in these land grab phases, investing for growth, I would call it. And look at them."

When that fails, there's always the Gerry Harvey strategy.

"If you don't believe us, sell your shares and stop complaining," the Harvey Norman chairman told shareholders at his annual meeting in November after avoiding a second strike over remuneration and mounting a defence of the company's governance.

'WE'RE SUPPOSED TO BE ENTREPRENEURIAL'

Harvey Norman made a $34 million investment in a dairy farm, which prompted questions about the relevance to electronics retailing and the independence of directors who endorsed the idea. "We're supposed to be an entrepreneurial company. We're meant to be expanding and looking for opportunities, but the minute you do it you get your head bashed in," Harvey said at the time.

A better test of Australian investors' appetite for risk is the Insurance Australia Group China experiment. When Peter Harmer was announced as the next chief executive of Insurance Australia Group in October, he declared he would be focused on growth in Asia and particularly in China. But 10 days later, IAG announced it would scrap its China plans after facing severe pressure from shareholders.

If the mood conveyed to the company by its biggest investors is any guide, Australian fund managers were more interested in IAG keeping its focus on Australia than persisting with trying to build a viable business in the Chinese market, or buying a bigger one to go national in China. IAG's existing footprint was small, arguably troubled, and needed greater investment.
It is true that fund managers have long memories. And equally true that many Australian businesses have failed when forced to play the away game.

In Investors Mutual's statement in response to IAG pulling back on China, the asset manager invoked the unflattering history of businesses that have chased "new direction or jurisdiction, often involving undue risk", naming Lion Nathan's attempt to follow Fosters into large-scale wine acquisitions and Crown's pre-crisis rumblings for a piece of Las Vegas as examples.

DIVIDENDS HIGH ON LIST

In a rare insight into the tradecraft that dictates how boards and funds managers interact, Investors Mutual revealed it wrote to the board directly, secured a meeting with management and wrote a second letter to the board "restating our views and reminding IAG of the scale of losses that the company had incurred for its shareholders because of its previous overseas forays in the past 10 years".

Not surprisingly, the issue of dividends was high on Investors Mutual's list of suggestions for IAG's board and new chief executive.

"IML suggested that instead of expanding into a risky geography like China, the company prudently pay some of its current surplus capital to shareholders in the shape of special dividends – as Suncorp has done. We also believe that the company should reserve a portion of its capital to organically expand its presence and scale in Australia through profitable areas of the Australian general insurance sector where IAG appears under-represented."

IAG's backdown was symbolic of the power balance in today's market. But in a triumph of marketing, IAG soon dropped "Australia" from its corporate "identity" to reflect its regional presence – proving, perhaps, that some companies can have it both ways.

Still, if boards and managers are feeling the heat from their shareholder base, they might be surprised to learn just how high a standard fund managers are being held to by the gatekeepers of the asset management industry – a group that is, somewhat ironically, focused on the interests of superannuation funds, the most long-term investors of them all.

"I think the main reason we're so short term-focused is investment managers are more than ever scrutinised on short-term performance," one fund manager says. "None of the asset allocators are looking at your long-term track record. If you deviate for a month or two, my goodness, you're in there answering questions."