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Lloyds Banking Group

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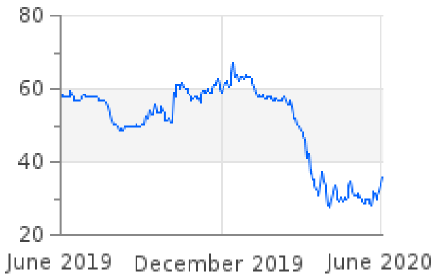
UK dividend hunters need to make "growth sacrifice" to get highest yields

Price:	35.545
Market Cap:	£25.15 billion

1 Year Share Price Graph



Share Information

Code:		LLOY
Listing:		LSE
52 week	**High**	**Low**
	73.66	**25.675**
Sector:		**Banks**

Website: **www.lloydsbankinggroup.com**

Company Synopsis:
Lloyds Banking Group has many household names like Lloyds Bank, Halifax, Bank of Scotland and Scottish Widows. Lloyds Banking Group is a leading UK based financial services group providing a wide range of banking and financial services, focused on personal and commercial customers.

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Dividend yields for FTSE 350 companies are much higher than US and European shares but due to macroeconomic, political and sustainability issues, some analysts suggest this an "illusion".

What's more, those hunting for the highest yields may need to "sacrifice" growth and sustainability in their investments, research suggests.

READ: UK dividends hit record levels in 2019, but small firms lag behind the big hitters
The average forecast dividend yield for UK large and mid-cap stocks is not far off 4.4% on a 12-month forward basis, around a percentage point ahead of equivalent European shares and well over double those in the US.

In the past year there has been a theme, if not quite a trend, of high-yielding FTSE companies cutting their dividends - see Centrica PLC (LON:CNA), Vodafone PLC (LON:VOD), Marks and Spencer PLC (LON:MKS) as examples - sparking debates about whether this is a good or bad thing.

Regardless of the rights or wrongs, a key debate is "how attractive to investors that premium yield is", argue analysts from UBS in a recent investment strategy note, which also examined the relative attractions of individual UK stocks if the post-election bounce does not emerge.

Firstly, comparing the UK and Europe against the US, the reason for the disparity in dividend yields is that US corporates have a different approach towards returning capital, generally favouring buybacks.

This does not tell the whole story, notes Russ Mould, investment director at AJ Bell and former investment banking analyst himself.

Risk premium
"The dividend yield remains a key part of the investment case for UK equities," he says, both in comparison with overseas stock markets, in absolute terms and in relative terms compared to the yield available on government bonds, where the premium from shares over the ten-year gilt stands at pretty much record highs.

As well as the difference between UK and US approaches to investor returns, the FTSE 350 dividend yield has been at a premium because of the risks associated with owning UK equities.

At present, investors are demanding a premium yield to compensate themselves for three perceived dangers in particular, says Mould, "the risk of economic upset in a post-Brexit world; the combination of relatively low dividend cover and relatively high debt; and dividend concentration".

The post-election bounce in domestically focused stocks is evidence that investors were also demanding a premium to help compensate them for the perceived risk of a Labour government.

"That risk has passed for five years - in theory - and as a result, share prices have risen and the dividend yield has come down.

"If these other fears are assuaged, then share prices could go higher, further decreasing the yield as investors become more confident in the prospects for UK stocks."

The yield illusion and growth sacrifice

The UK equity market's high yield versus other equity markets comes, argue the UBS strategists, with neither dividend cover nor leverage very stretched, something that others like Mould quibble with.

But what the strategists did highlight, which can't be quibbled with, is that the Footsie's high headline yield is concentrated in a small number of companies.

The "yield illusion" comes from the small concentration of stocks that bump up the average, with more than half of the FTSE 100's dividend payments coming from just ten stocks: Royal Dutch Shell (LON:RDSB), HSBC Holdings PLC (LON:HSBA), BP PLC (LON:BP.), British American Tobacco PLC (LON:BATS), GlaxoSmithKline PLC (LON:GSK), Rio Tinto plc (LON:RIO), AstraZeneca PLC (LON:AZN), Lloyds Banking Group PLC (LON:LLOY), BHP Group PLC (LON:BHP) and Vodafone PLC (LON:BHP).

While saying a smaller number of larger companies have higher yields is not necessarily that significant, UBS makes a more dramatic find that grouping companies by the size of their dividend yield shows that investors and companies seem to need to accept a "growth sacrifice" and perhaps a sustainability sacrifice to access the highest returns.

In other words, those stocks that yield more than 6% have lower forecast p/e valuation ratios on a market cap weighted basis compared to those yielding 3-6% and those yielding below 3% (see the Figure 17, and the 6%-plus group also a forecast to face negative earnings growth (see Figure 18).

What's more, the "sacrifice" that investors interested in sustainability and yield need to make is that the companies that yield the most in the UK on average have the lowest environmental score than for the other groups of yield, with the energy sector making up almost half of the group of higher-yield FTSE 350 companies, followed by banks, tobacco and basic resources.

"This not a surprise given the sectoral exposure of that yield but nonetheless is relevant given the inexorable increase in focus on ESG issues," UBS says.

Index investor issue

This is an issue that must be watched, agrees Mould, especially by those investors who own tracker funds or ETFs that target income from the UK equity market.

As a heavy weighting of the FTSE 100's dividend come from just ten stocks, "investors need to be comfortable with the business prospects, cash flows and balance sheets of those ten names before they pile into the UK stock market purely on the basis that it has a fat dividend yield".

While UBS was sanguine on debt and earnings cover, Mould has a note of caution.

"While allowances can be made for certain firms," he says, such as utilities, consumer staples or real estate investment trusts, he would want earnings to cover company dividend payments two times, if not more.

"Such a level of cover provides a nice buffer and some insurance against something unexpected going wrong, such as a global economic downturn that hurts profits."

But earnings cover across the FTSE 100, based on just ordinary dividends not special payouts, has not reached that

2.00 times level since 2014, he notes, though has bounced back from lows in 2016 to a forecast around 1.69 times in 2020.

After the high profile dividend cuts last year, there could be more to come in 2020, especially if there is an unexpected global downturn in 2020 or 2021.

With dividend growth forecast by analysts to slow down to the a low-single-digit rate in 2020, Mould says, "This may be a tacit acknowledgement by company boards that they need to focus on investment and servicing debt and not just handing out cash to curry favour with yield-starved investors."

Companies offering "a margin for error" in 2020
Alongside its dividend analysis, UBS also screened for UK companies where expectations of growth are lower over the next two years than the recent past to find companies that potentially offer "a margin for error" if the UK economy does not accelerate as quickly as some of the recent rerating would imply.

Or in other words, companies that arguably have a lower level of risk if consensus forecasts do not expect a higher return in the future, "particularly in an environment where the degree of macro acceleration remains a key debate".

Companies rated 'buy' by UBS within these screens are Barclays (LON:BARC), Barratt Developments (LON:BDEV), Berkeley Group (LON:BKG), DCC (LON:DCC), Land Securities (LON:LAND), Lloyds, Morrisons (LON:MRW), Next (LON:NXT), Persimmon (LON:PSN), Sainsburys (LON:SBRY), Taylor Wimpey (LON:TW.) and Tesco (LON:TSCO).

With sterling one of the main "shock absorbers" for London's capital markets amid the slings and arrows of the Brexit process over the last four years, the UBS strategists noted that the pound may appreciate further as perceived risk continues to fall in the UK.

Despite the headwind to earnings for London's international-facing businesses if sterling strengthens, it was noted that a number of these companies have surprised with positive absolute performances, perhaps suggesting that there is "a valuation and positioning positive that could potentially offset the currency negative".

Examining the possibility that UK stocks are cheaper than their international doppelgangers, the analysts calculated the resulting moves of consensus earnings forecasts for those companies if the pound appreciates back to the level seen in the three months leading up to the referendum, which was around $1.4, and liaised with sector analysts to understand sensitivity to a move in the pound for each company.

This offered up 'buy'-rated names that would "still look relatively cheap", being BP, BAT, Melrose Industries (LON:MRO), Rolls-Royce (LON:RR.) and Vodafone.

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