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ASIAN EQUITIES

RESEARCH PAPER
Long term opportunity for growing income

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Research paper

Asian equities representing a long term opportunity for growing income

Asian Equities
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Abstract

The Asia ex-Japan region offers an outstanding opportunity for long term investors to benefit from a powerful dynamic of growing earnings streams augmented by an even bigger potential increase in dividend income.

Asia today offers a somewhat unique combination of recovering earnings streams, strong balance sheets, growing free cash flow yields coupled with a modest prevailing dividend payout ratio and supportive valuations.

Figure 1. Expanding opportunity set with the inclusion of China A-Shares

	Benchmark	Stocks with market cap > USD 1B[1]	Number of stocks in the benchmark[2]
Asia ex-Japan	MSCI Asia ex-Japan	1,483	637
China A-Shares	Pending MSCI inclusion from 6/2018	1,915	222[3]
US	S&P 500	1,966	500
Europe	STOXX 600	1,243	600

Source: FactSet, MSCI

Despite the Asia ex-Japan region (including China A-Shares) possessing more listed stocks with a market capitalisation greater than US$1 billion than either the US or Europe, it retains a de minimis weighting in most global portfolios. This is highlighted in Figure 2 below, whereby Asia ex-Japan's economic heft is not represented by its weighting in the MSCI AC World Index.

Figure 2. Asia under-represented

	MSCI AC World weight %	Market Capitalisation (USD Billions)	GDP Weight%
Asia ex-Japan – (pro-forma A-Share Inclusion) [4]	10.1	4,272	24.3
US	55.3	21,832	24.7
Europe	21.8	9,017	21.8

Source: MSCI, as at July 2017. World Bank as at December 2016

There has been positive steps taken from a range of companies across the region in recent times giving us confidence that corporate management teams across Asia are becoming increasingly aware of the virtues of growing dividends as well as simply growing earnings.

Based on historical analysis over the last five years, we observed a clear pattern of outperformance of those companies that displayed an increasing payout ratio versus those who recorded a stable or declining payout ratio. In other words, the market would appear to 'reward' those stocks able to offer both growth in dividends and earnings rather than simply growth in earnings. This can be seen over the five year period where the top two quartiles ranked by share price return displayed an average payout ratio increase of 1.1% whereas the bottom two returning quartiles showed an average payout ratio decline of 7.0%[5].

1 Data from FactSet as at 2 May 2017
2 Data from MSCI as at 31 July 2017
3 MSCI June 2017 presentation titled "China A-shares Inclusion", Page 2.
4 Estimate based on Asia ex-Japan weight in MSCI AC World i.e. 10% (as at June 2017) plus 0.1% (taken from the MSCI June 2017 presentation titled "China A-shares Inclusion", page 8)
5 FactSet. The data set looked at all companies listed in the Asia ex-Japan region over a 10 year period (May 2007-May 2017). This universe was filtered to include only companies that had continuously displayed cumulative growth in earnings over the 10 year period. This resulted in 140 companies, whereby analysis was performed on the last 5 years of data (31/5/12 – 31/5/17). The payout ratio movement was calculated by taking the difference between the 2012 and 2017 payout ratios for each company.

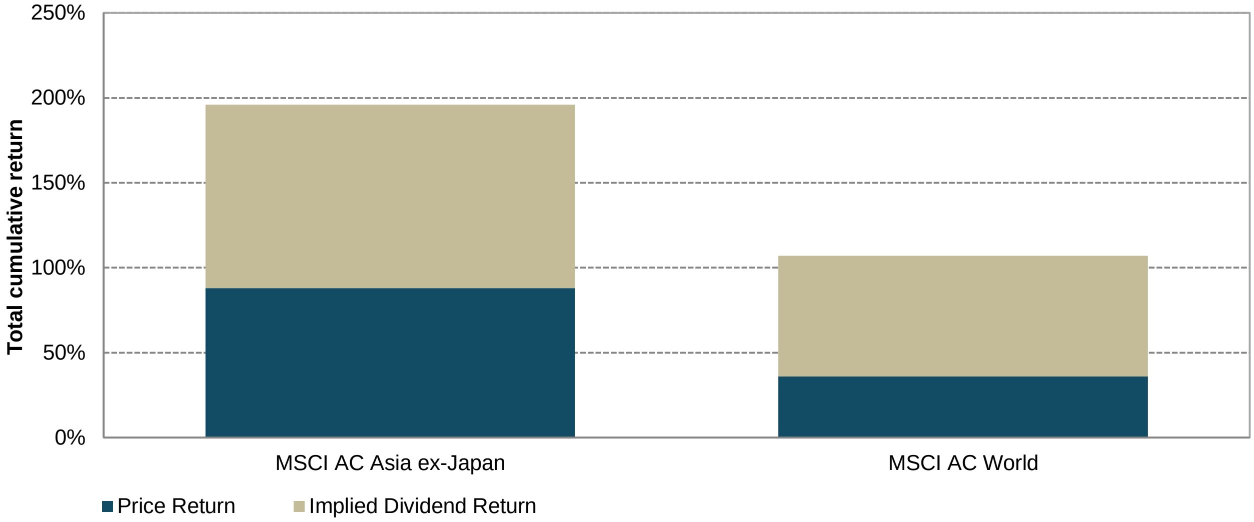
Scope for enhanced returns from growing dividends from Asian equities

"A bird in the hand is worth two in the bush"

Of all Aesop's fables, none should resonate more with investors than this famous expression. The long term cumulative return from equities including dividend income is more than double the return generated from the movement in price alone (see Figure 3). In other words, the value of a more certain dividend, 'a bird in the hand', is indeed worth twice that of an uncertain return from a strategy reliant solely on capital growth. At Maple-Brown Abbott, we have long recognised the virtue of income within our valuation framework. The cumulative return provided by income, combined with the anticipated growth in earnings capitalised at a specified terminal price earnings multiple, is calculated to form an expected rate of return for each stock we invest in. As well as being a critical risk mitigant in down markets, adherence to a clearly defined distribution policy also instils an important element of discipline for all capital allocation decisions within a particular company.

The impact of dividend income on long term returns

Figure 3. Total Return Composition



Source: FactSet; Total returns are in USD for the period 1 Jan 2000 to 30 June 2017.

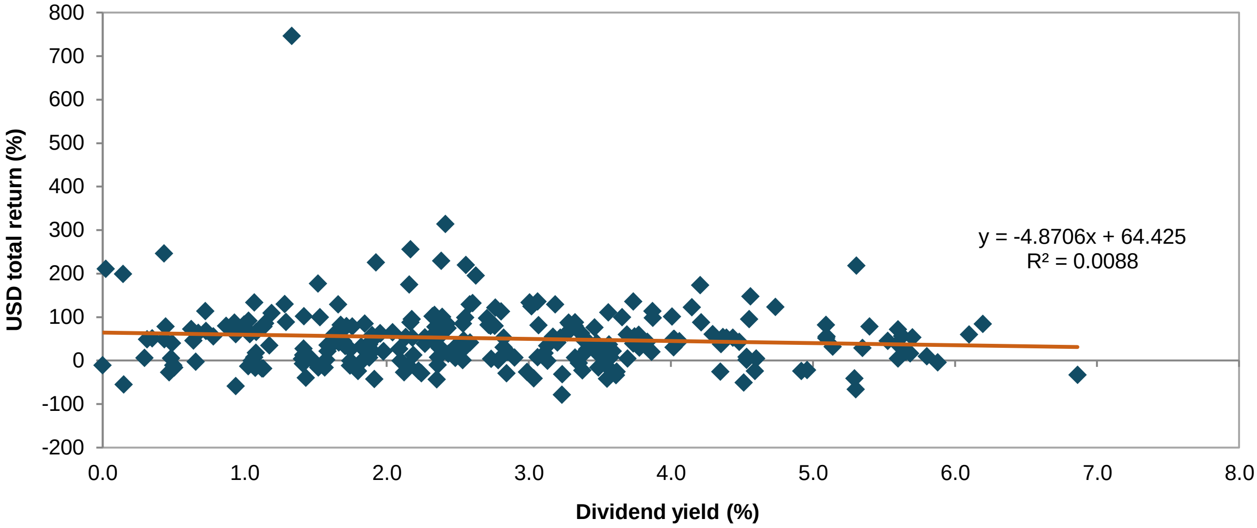
What may seem a modest yield on an individual basis in any given year can indeed have a powerful impact on total returns over the longer term. Through the power of compounding, the impact of reinvesting dividend income has had a profound impact on the total returns received by investors in most markets across the globe.

A strategy focussed solely on high dividend paying stocks is not necessarily the most rewarding approach however. Since the Global Financial Crisis such strategies have enjoyed a significant renaissance, with billions of dollars being committed to a range of factor based yield strategies in what has become a very crowded trade. In addition, the areas of the market with the highest yield tend be in more mature lower growth sectors with minimal commensurate earnings growth. Over the last decade, the two highest yielding sectors in the Asia ex-Japan region, namely Telecommunication Services and Energy, have both underperformed the broader market of that region despite their dividend advantage[6].

[6] FactSet. Data relates to MSCI AC Asia ex-Japan Index over a 10 year period (May 2007-May 2017). The GICS sectors with the highest 10 year average dividend yields were Telecommunication Services (3.56%) and Energy (2.89%) Both sectors underperformed the MSCI AC Asia ex-Japan Index over the same 10 year period.

Indeed, based on our analysis there is little statistical evidence to support the efficacy of dividend yield as a deterministic factor on its own of company outperformance over the last five years as can be demonstrated in Figure 4 below.

Figure 4. Dividend yield is not a statistically significant factor on its own[7]



Source: FactSet, as at May 17, MBA.

What the market appears to reward more favourably however are those companies that can generate dividend growth at an even faster pace than earnings. Over the last five years, it was clear that the performance of those stocks that were able to generate dividend per share growth in excess of earnings growth did noticeably better than those who demonstrated growth in earnings but a decline in their payout ratio.

A number of current and former portfolio holdings such as Advantech, Samsung Electronics, SK Telecom, Hon Hai, Coway Co, Guangzhou Automobile and Guangdong Investment all satisfied these criteria and have generated meaningfully to portfolio alpha over the years.

The favourable pre-conditions for dividend growth can be reasonably attributable to strong balance sheets, scope for increased payout ratios and prospects for earnings growth. Compared to both emerging and developed markets alike, the Asia ex-Japan region appears uniquely placed to offer investors enhanced returns from increased dividend distributions amply funded from strong balance sheets and recovering earnings similar to the individual stock examples referred to above.

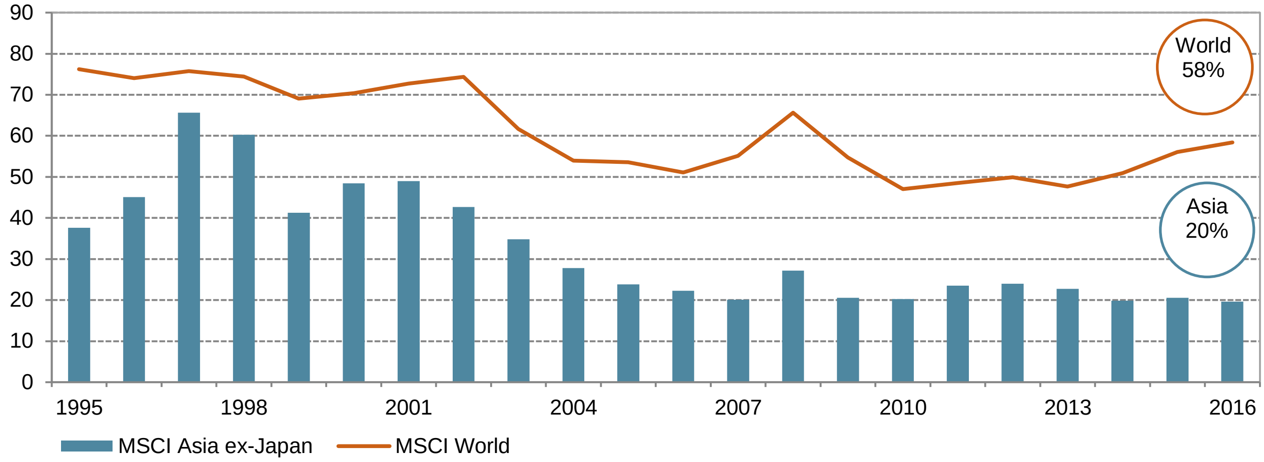
[7] FactSet. The data set looked at all companies listed in the Asia ex-Japan region over a 10 year period (May 2007-May 2017). This universe was filtered to include only companies that had continuously displayed cumulative growth in earnings over the 10 year period. This resulted in 140 companies, whereby analysis was performed on the last 5 years of data (31/5/12 – 31/5/17). Dividend yield is calculated as the average of the annual dividend yields over the 5 year period.

Strengthening balance sheets in Asia

Much has been written about the accumulation of debt within the Asia ex-Japan region in recent years. Whilst it is true that corporate balance sheets remain somewhat stretched in India and in selected areas within China, the aggregate financial health amongst the 650 or so listed companies in the regional benchmark[8] is very strong and is getting stronger as highlighted in Figure 5 below. Indeed the Asia ex-Japan region is second only to Japan with respect to the number of companies with a net cash balance sheet[9]. Since the dark days of the Asian financial crisis, management teams across the region have increasingly adopted a very conservative position with regards to their capital structure. This places Asia in an enviable situation compared to the rest of the world with respect to the flexibility and capacity to fund and sustain growing dividends in addition to capital reinvestment.

Asian balance sheets: a position of strength

Figure 5. MSCI Asia ex-Japan vs. The World*: Net debt to equity



*MSCI World Index excludes Emerging Markets

Source: CLSA, Global Microstrategy (Dividend wave 2017: Screening for surprises), March 2017, data annual 1995-2016

Compared to the rest of the Emerging Markets (EM) cohort, Asia also compares very favourably, as shown in Figure 6. With the exception of Russia, all of the major non-Asia based EM countries retain elevated debt burdens, making them considerably less well positioned to offer a growing and sustainable income stream that might be expected from Asia.

Figure 6. Net debt to equity of the major non-Asia Emerging Markets[10]

	2016 %
Brazil	81.1
South Africa	31.2
Russia	18.9
Mexico	83.6
Poland	29.5
Turkey	42.6

Source: FactSet, CLSA Data as at December 2016

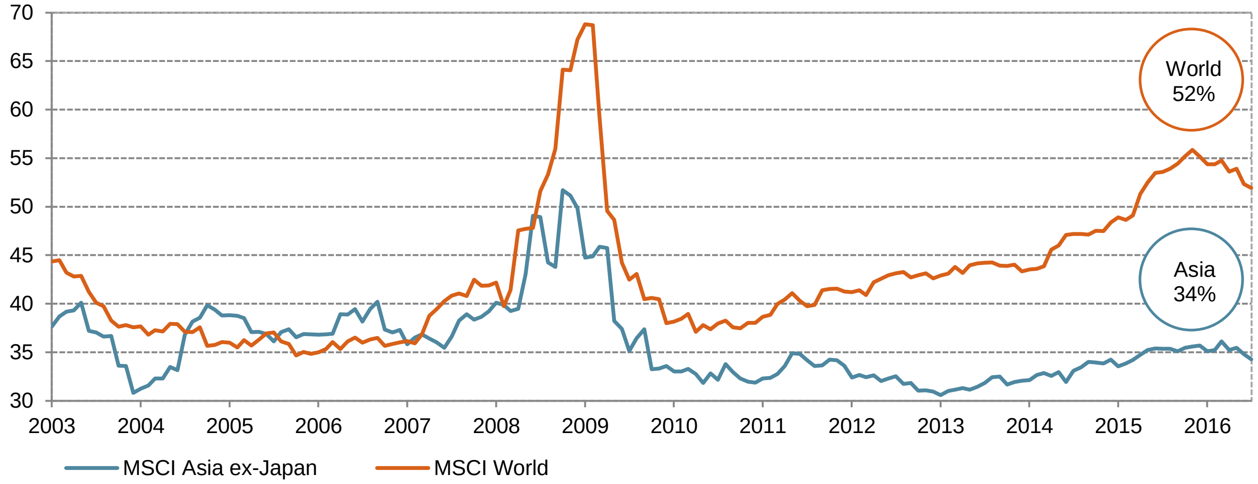
[8] Index refers to MSCI AC Asia ex-Japan
[9] Source: CLSA, Global Microstrategy (Dividend wave 2017: Screening for surprises) March 2017, data as at June 2017
[10] Net gearing is bottom-up aggregated with free float adjustment based on current MSCI universe

Low payout ratios across Asia offer scope for higher returns

In addition to ample financial resources, the foundations for increased distributions are in turn well supported by virtue of their low starting base. Standing at just 34% as at the end of June 2017, the payout ratio for the Asia ex-Japan region is considerably less than that for the Developed World aggregate of 52% and the Global Emerging Markets aggregate of 49%[11].

Dividend catch up provides scope for higher returns

Figure 7. Dividend payout Asia vs. World*

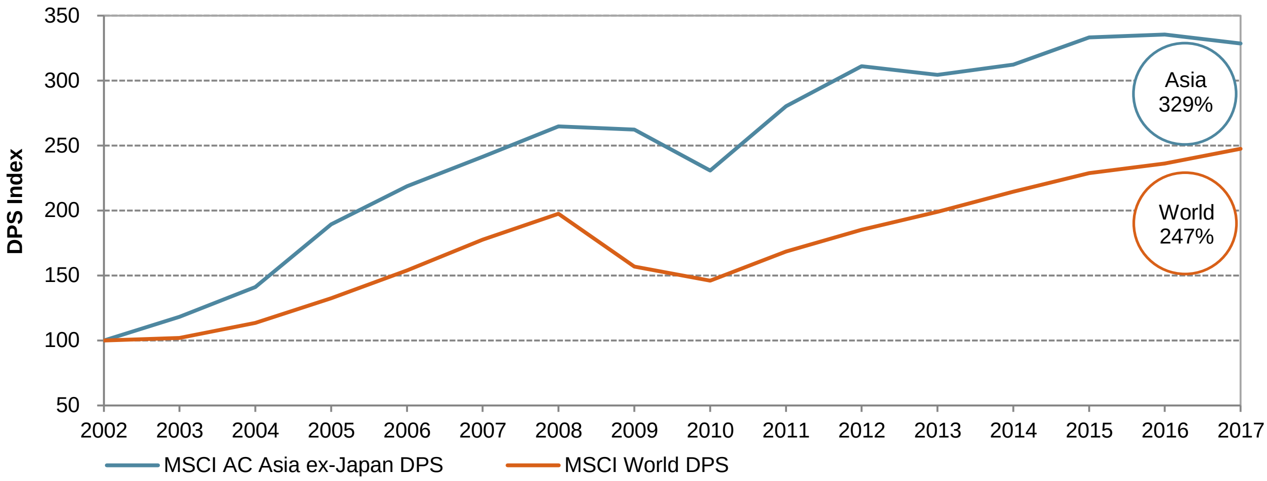


* MSCI World Index excludes Emerging Markets.

Source: CLSA, Global Microstrategy (Dividend wave 2017: Screening for surprises) March 2017, data Dec 2003 June 2017

Although Asian corporates do appear miserly compared to most other markets and regions, there does appear to be clear grounds for optimism, with a number of high profile bell weather stocks across the region announcing more generous distribution policies in recent times which have been warmly received by the market. Indeed as illustrated in Figure 8 below, over the last fifteen years Asian markets have typically delivered compound growth in dividends per share well in excess of that observed elsewhere.

Figure 8. Growth in dividends per share in Asia ex-Japan vs. the World*



* MSCI World Index excludes Emerging Markets.

Source: FactSet, annual data May 2002-2017

[11] FactSet, Data June 2017. Payout ratio calculated as Dividend Per Share divided by Earnings per Share

Stock example: Samsung Electronics

Korea's largest stock leading by example

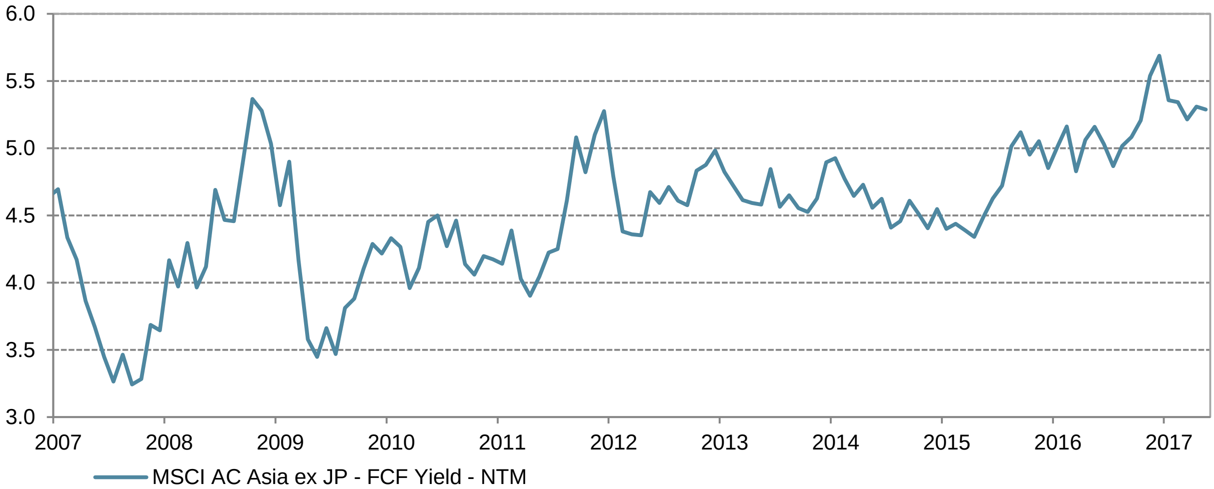
Of all the stocks showing signs of heeding the mantra of enhanced returns to shareholders, perhaps Samsung Electronics (Samsung), one of Asia's largest companies is the most surprising. For many years Samsung has frustrated investors with its ultra conservative approach to its capital management policies. As South Korea's largest company, it is not surprising that the South Korean market as a whole has historically been a sorry laggard among all Emerging Markets when it comes to divided distribution. Only the Philippines with its relatively punitive withholding tax regime has consistently maintained a lower payout ratio.

However after years of pressure from both domestic and international shareholders and ever rising cash on balance sheet, towards the end of 2015 Samsung articulated a new capital returns policy which was received very positively by the market. Over a 3 year to 5 year period, the company would return 30-50% of free cash flow to shareholders via dividends and buybacks. This new course for the company saw a marked increase in returns which had been lagging its international peers. With some 70 trillion Won (US$60bn) in net cash residing on its balance sheet and a dividend payout ratio of barely 10% over the last several years, such frustration was clearly warranted. Although the initial dividend increase was a relatively modest increase, it was coupled with a significant US$10bn buyback. Encouragingly, this trend has continued with its decision to increase 2016 dividends by 36% on the prior year along with another US$8bn buyback.

Improving free cash flow and earnings outlook

Another fundamental tenant of support for increased distributions across Asia is premised on the noticeable improvement in free cash flow evident across the region in recent years (see Figure 9). Both better capital discipline and an improved earnings outlook are conspiring to increase the free cash flow yield evident across the Asia ex-Japan region. This is an important development serving to encourage companies across Asia to be more generous with respect to their capital management policies. Historically the corporate mantra has been focussed almost exclusively on growth and a desire to expand capital expenditure at the expense of dividends and other capital management initiatives. As earnings recover, the scope for management teams to reward shareholders appears far greater than what has been observed historically.

Figure 9. Free cash flow yield forecasts* increasing in Asia

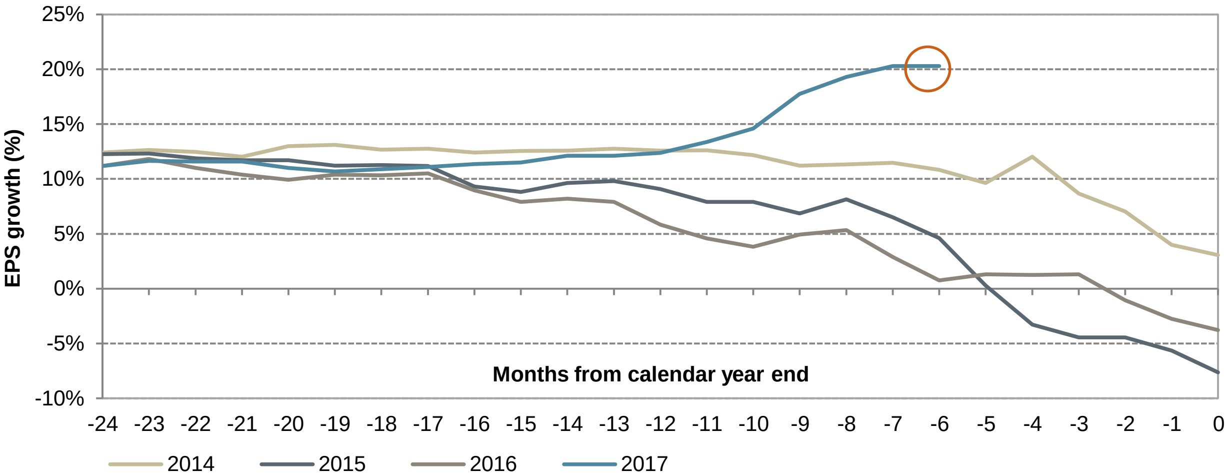


*Forecasts for next 12 months at any point in time during the data period
Source: FactSet, data January 2007 – May 2017

Underpinning the improving cash flow performance is a corresponding uplift in the bottom up earnings outlook for the region. After several years of cyclical contraction, Asia offers one of the most prospective earnings recovery stories across the global equity universe.

Figure 10 shows the 24 month forward EPS growth forecast for the market over the past several years (i.e. '2014 EPS' forecast is tracked from the beginning of 2013 through to the end of 2014). Analyst over-enthusiasm about forecast growth is a well-documented phenomenon and over the past several years growth has indeed disappointed relative to initial expectations. For example, at the beginning of 2013, consensus was expecting 2014 EPS growth of around 12% however as time progressed actual growth in 2014 EPS was far more moderate at around 3%. What is different thus far in 2017 is that unlike in previous years, expectations for earnings growth are being revised upwards with the best outlook for growth forecast for many years.

Figure 10. Asia is growing again with EPS growth forecasts improving



Source: FactSet, FactSet Market Aggregates (USD), data Dec 2012-June 2017

Conclusion

The importance of dividend income to total long term returns cannot be ignored. In Asia, as is the case elsewhere in the world, the long term return from equities is approximately evenly shared between income and capital growth.

High yield strategies on their own are not necessarily a successful strategy, with the highest yielding sectors in Asia ex-Japan typically underperforming the broader market of that region over the long term[12] with scant statistical evidence to support its relevance as a single factor strategy.

Asia ex-Japan is uniquely placed to offer investors exposure to upside in dividend growth by virtue of its recovering earnings trajectory and an apparent willingness to accept an increasing payout profile.

Strong balance sheets, an improving earnings outlook combined with a modest but growing payout ratio are important factors in providing increased confidence to boards across the region to enhance dividend returns to shareholders.

[12] FactSet. Data relates to MSCI AC Asia ex-Japan Index over a 10 year period (May 2007-May 2017). The GICS sectors with the highest 10 year average dividend yields were Telecommunication Services (3.56%) and Energy (2.89%). Both sectors underperformed the MSCI AC Asia ex-Japan Index over the same 10 year period.