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CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

ROOM TO BOOST EUROPEAN DIVIDEND YIELDS?

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Room to Boost European Dividend Yields?

Many firms in Europe currently have very fat wallets and have been under increasing pressure by shareholders in recent years to put this cash to productive use. Chief financial officers have many potential uses for their cash hordes. Mergers and acquisitions (M&A) have been one popular option. Investing in the business has been less popular. Distributing a massive special dividend to new private equity owners (either friendly or hostile) is becoming more common. Other firms return the money to common stockholders, either through a cash dividend (one-off or continuing) or via share repurchases. While dividends have increased in this environment, they have not kept pace with earnings growth, resulting in relatively low payout ratios.

The cash dividend yield (DY) on the MSCI U.K. Index is currently about 3.2%, compared to an average of 4.4% since 1970, while the MSCI Europe ex U.K. Index's cash DY is running at 2.6%, compared with a long-run average of 3.6% (Table A).[1] While cash DYs are lower in Europe outside of the United Kingdom, the percentage of profits paid out as cash dividends is comparable: 41.5% in continental Europe versus 43.3% in the United Kingdom, both below their average since 1970 of just over 50% (Table B).

These low payout ratios seem anemic, but are not unexpected—when profits are as high as they are today, a relatively small portion of earnings are necessary to maintain steady dividends. Given investor sensitivity to cuts in dividend payments, corporations are generally slow to increase dividends as profits increase, waiting until they feel secure that the increase will be sustainable. Historically, this has resulted in payout ratios falling when earnings growth is strong. However, corporations have been willing to pass dividends on to shareholders through buybacks. If dividends are a journey, buybacks are more like a spontaneous weekend jaunt, easily cancelled or deferred without much pain. Dividend policy shifts by management are not taken lightly. Buyback programs, in contrast, may turn out to be long-running or evanescent, but shareholders seem to heavily discount tomorrow's expected buybacks in calculating today's share prices.

Nonetheless, buybacks, like dividends, can benefit shareholders as an effective use of cash. When net share buybacks are added to cash dividends to calculate a more complete yield, the result has been a bit more satisfying in recent years.

Share buybacks are becoming an increasingly popular use of cash for European firms—particularly those in the United Kingdom. U.K. firms bought back an estimated £46 billion of shares last year according to Morgan Stanley, while distributing £62 billion in cash dividends. In all of Europe, the buyback total was $165 million, compared to $290 million in dividends.[2]

[1] While the current DYs of both indices are considerably lower than their long-run averages, this is part of an established downward trend, and today's yield is in keeping with averages over the past 15 years. As noted in our 2005 *U.K. Historical Capital Market Valuations,* DYs for the FTSE Composite Index have remained below their historical mean since 1992.

[2] "Strategy: Euroletter: Buybacks Good, Dividends Better," Teun Draaisma, Graham Secker *et al*, Morgan Stanley Research Europe, May 11, 2007, and "UK Strategy: Dividends Are More Effective than Buybacks," Graham Secker and Charlotte A Swing, Morgan Stanley Research Europe, May 8, 2007.

One significant caveat: the share buyback figures from Morgan Stanley above (and typically those cited in the news media as well) are *gross*, rather than net of new share issuance. Many firms buy back shares primarily to cover share-option exercise by executives, so reporting buybacks on a *net* basis is more useful. In 2003, for example, the firms in the FTSE All-Share repurchased £10 billion in shares, which sounds impressive until it becomes clear that they issued £11 billion in new shares that same year! *Net* buybacks were actually negative—firms overall issued more shares than they repurchased—for the United Kingdom and continental Europe for much of the period for which we have data (back to 1988 in the United Kingdom and 1997 on the Continent) each turning positive in 2004 (Tables C and D).[3]

While inclusion of net buybacks in DYs boosts these returns to shareholders, and buyback programs have been popular (38% of firms in the MSCI U.K. Index were net buyers of their own shares in 2005) the programs are relatively minor for the majority of companies. In the United Kingdom, for example, just three firms—Vodafone, BP, and Royal Dutch Shell—together accounted for 76% of the MSCI U.K. Index net buyback yield for 2005. Thus, a meaningful change in buyback habits by just one or two of these large firms could change the total dividend picture for the entire region.

The largest-capitalization firms have the highest cash DYs as well. This may not come as a surprise, since the prices of these firms' shares have not risen as fast as those of their smaller-cap cousins. The largest decile of the MSCI U.K. Index (incorporating about three dozen firms) has a current cash DY of 3.8%, compared with a cash DY of 3.0% for the index's remaining nine deciles. The top capitalization decile of the MSCI Europe ex U.K. Index has a cash DY of 3.2%, compared with 2.6% for the remaining nine deciles (Tables E and F).

Even as DYs have remained relatively flat over the last several years, cash dividend payments have risen. Since 2002 as earnings per share (EPS) were bottoming, cash dividends in euro terms for the MSCI Europe ex U.K. Index have increased 97%, while the relatively higher cash dividends for the MSCI U.K. Index increased by a more modest 65% in pound sterling terms.

Firms may still have room to increase total dividends further even if profit growth stalls (either in the form of cash dividends or buybacks). DYs are not uniform across Europe, as the cash dividend payout ratio in the United Kingdom and France is on the high end, with the FTSE 100 constituents paying out 43.7% of profits and CAC-listed French firms, 42.1%, compared to just 35.3% for the 30 largest listed German firms according to Frankfurt-based investment bank Helaba.[4] Should German companies increase their payout ratios to levels more comparable to those of other relatively large markets, the region's DYs could be significantly boosted.

While the popularity of buybacks in the current environment is likely related to their use as a means of passing on value to shareholders without the ongoing obligation to sustain these dividends, other benefits

[3] The repurchase and issuance figures are available for a majority, but by no means all, of the firms in each index for the time periods shown. For all time periods shown in Tables A and B, at least 80% of share issuers and repurchasers are represented.
[4] Helaba report cited in "Germans Fall Behind Peers on Dividends," Gerrit Weismann and Ivar Simensen, *Financial Times*, May 7, 2007.

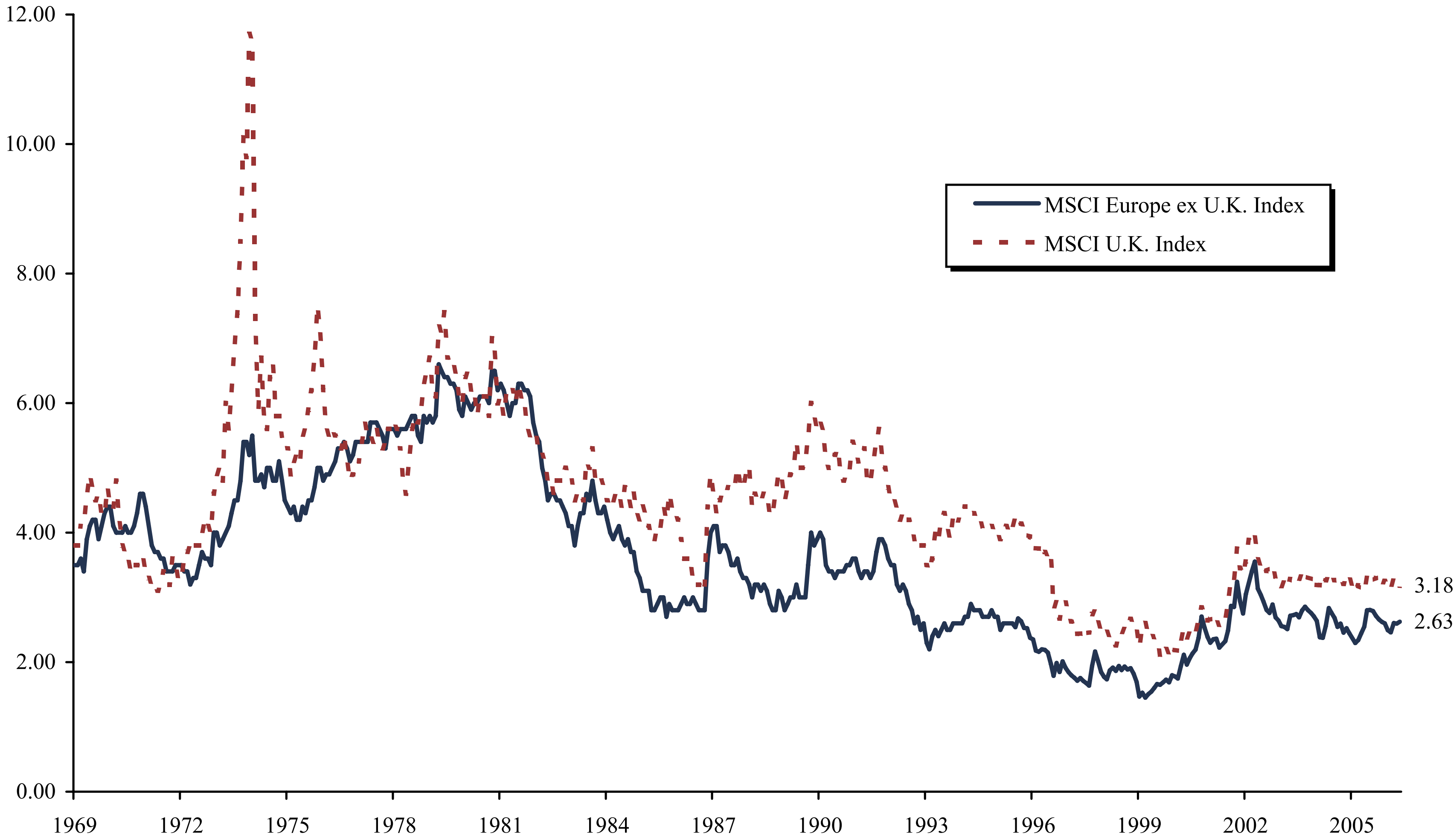
to corporate executives may not be in the best interest of shareholders. Buybacks are popular in part because they increase EPS (by reducing the share count), which is helpful to executives with compensation that is pegged to EPS or EPS-related targets. Option holders may also benefit from increased share price volatility that may be associated with buyback programs financed by increased gearing. Increased volatility may not be desirable for shareholders, but it may be attractive to option holders, since it increases the likelihood that an option will become exercisable.

Cash dividend increases are only one of multiple potential uses of corporations' bulging coffers. Companies have been relatively slow to commit to increasing dividends as profits have expanded, and would probably only do so if and when corporate managements feel confident that strong profits will continue. In the mean time, M&A and buybacks have been the primary uses of cash. If the M&A environment heats up further ($1.4 trillion in deals were announced in Europe last year, a 39% increase from the previous year), or if firms ramp up investment in technology or other neglected areas of their business, management's current enthusiasm for buybacks could go the way of the dodo and we could go back to looking at plain, old cash dividends, which have generated roughly one-third of the annualized U.K. and European equity returns since 1965 (and the reinvestment of those dividends in additional shares has accounted for the lion's share of the period's cumulative return) (Tables G and H).

Table A

DIVIDEND YIELD (%)

31 December 1969 - 30 April 2007

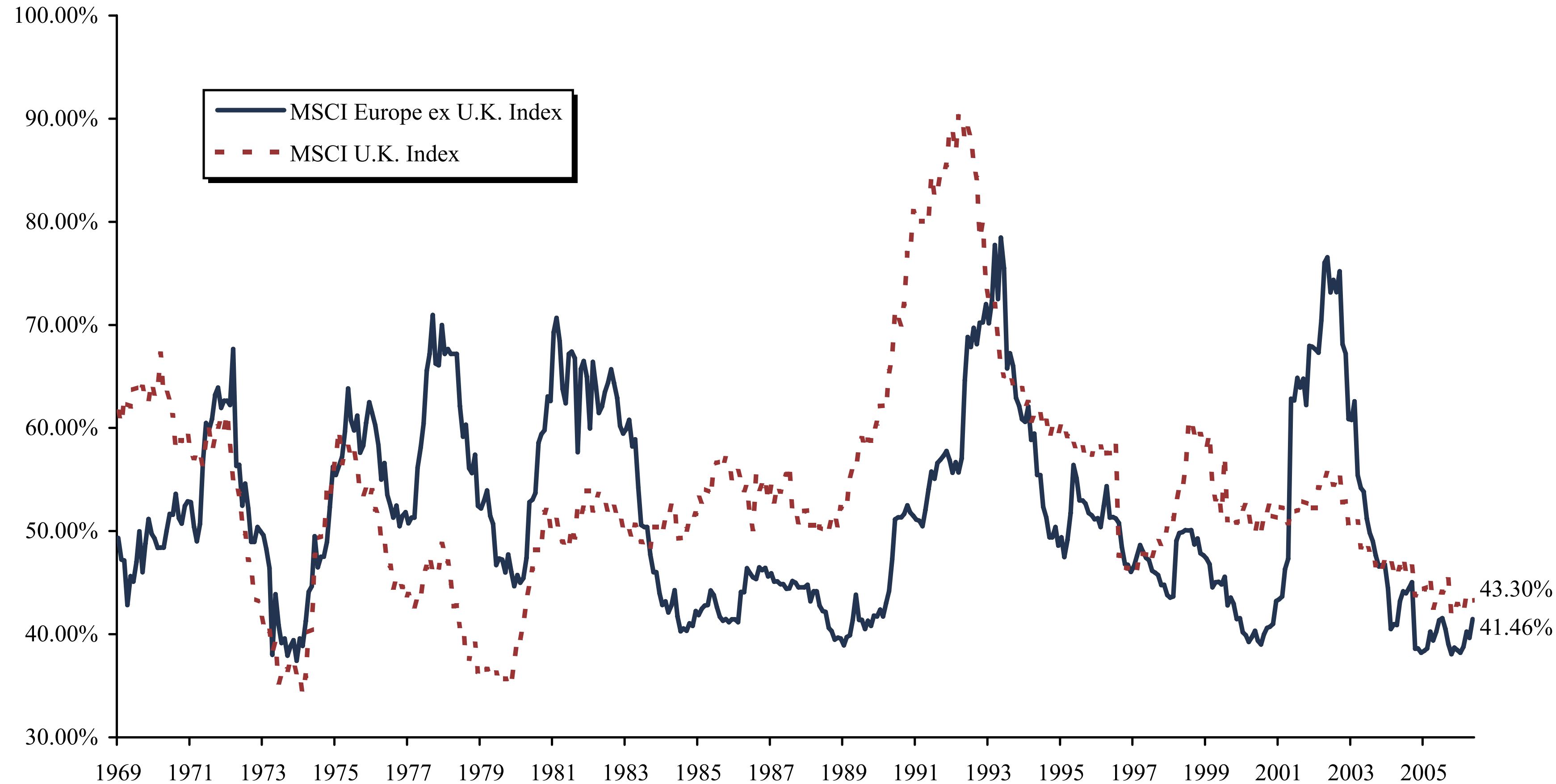


Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Table B

DIVIDEND PAYOUT RATIO

31 December 1969 - 30 April 2007



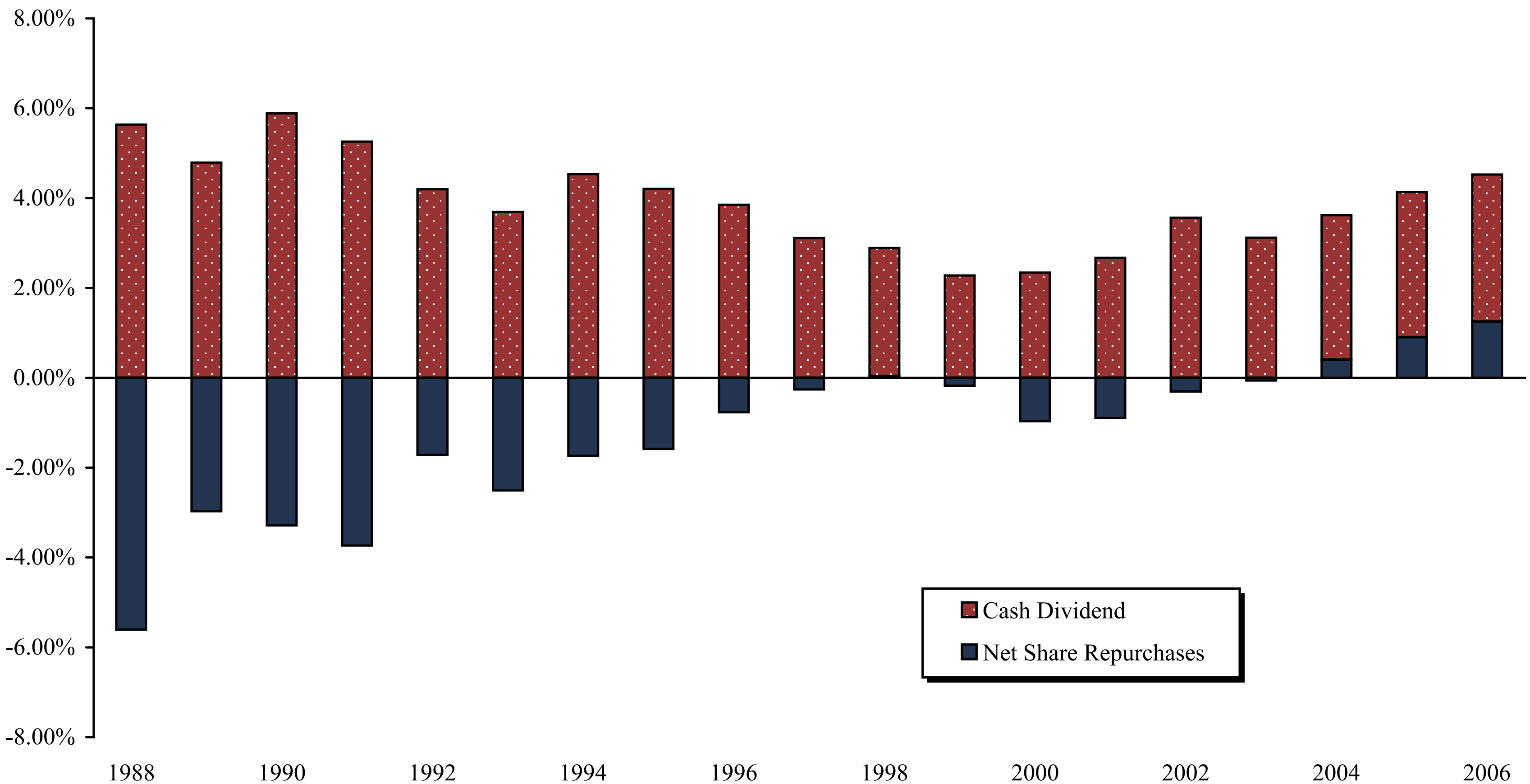
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Note: Dividend payout ratio is calculated by dividing the dividends per share by the earnings per share.

Table C

FTSE ALL-SHARE CASH DIVIDEND AND NET SHARE REPURCHASES

31 December 1988 - 31 December 2006



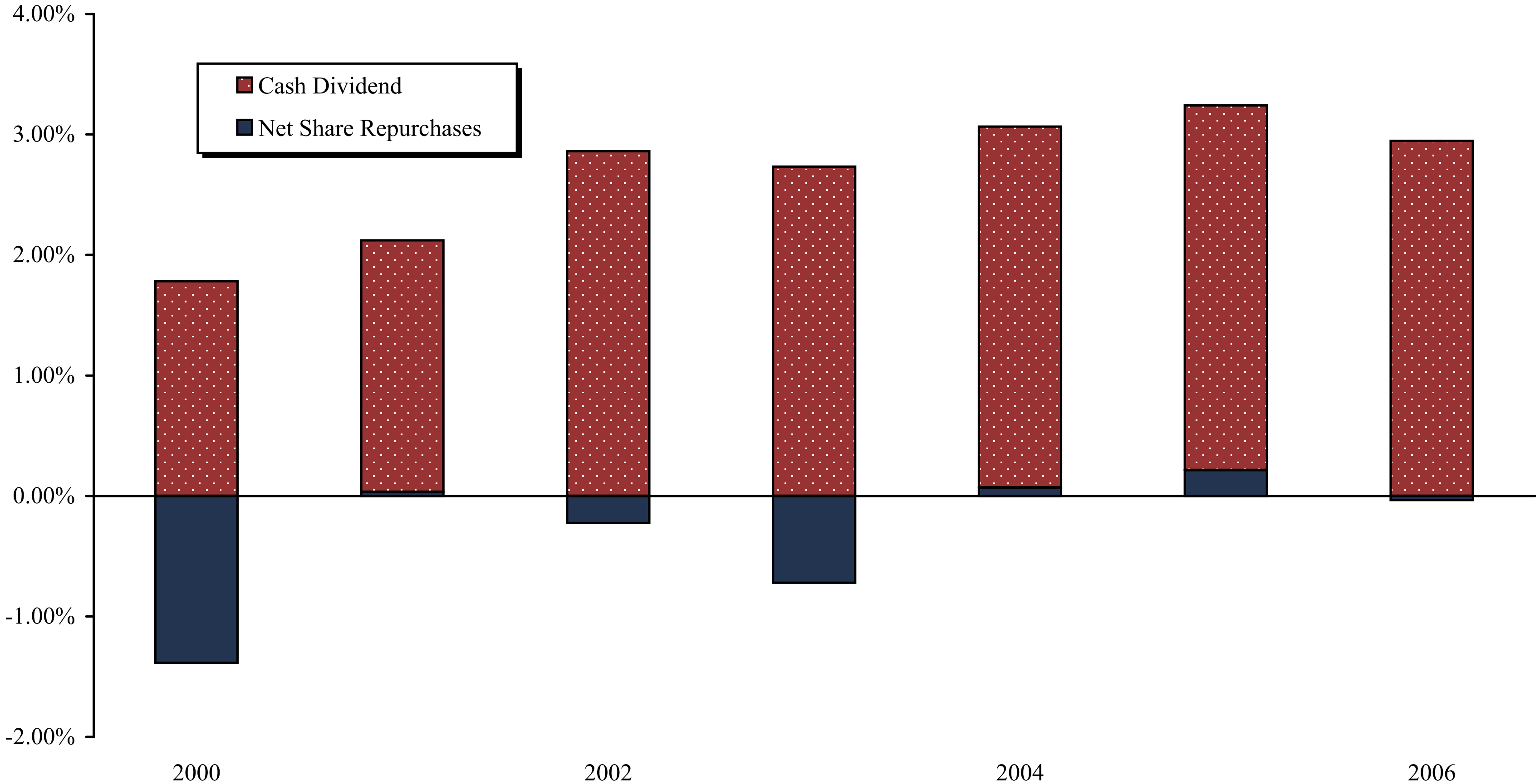
Sources: Factset Research Systems, FTSE International Limited, and Thomson Worldscope.

Note: Net share repurchases data for 2006 are represented by 56% of issuers of the FTSE All-Share as of May 25, 2007.

Table D

MSCI EUROPE EX U.K. CASH DIVIDEND AND NET SHARE REPURCHASES

31 December 2000 - 31 December 2006



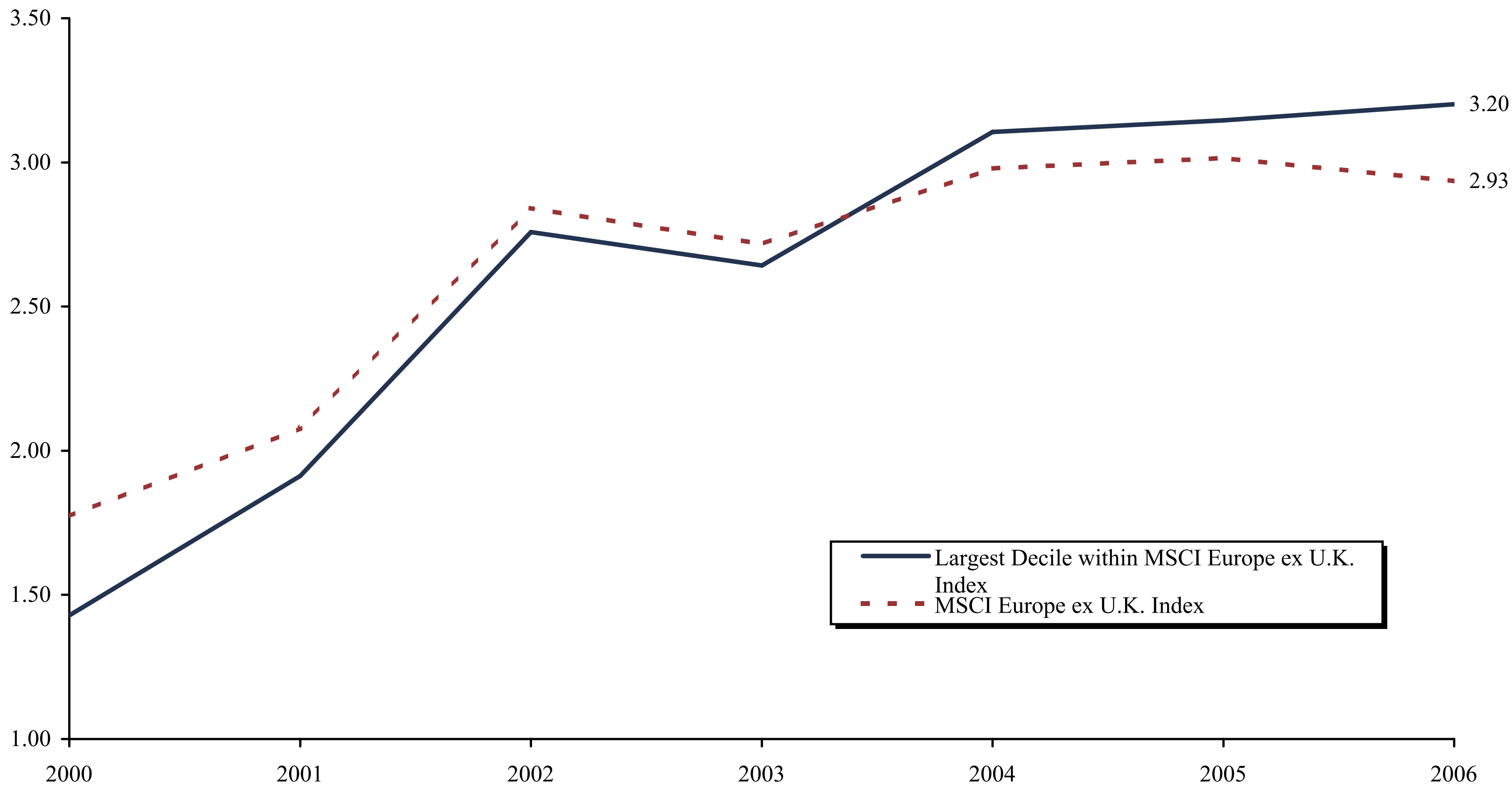
Sources: Factset Research Systems, Morgan Stanley Capital International, and Thomson Worldscope. MSCI data provided "as is" without any expressed or implied warranties.

Note: Net share repurchases data for 2006 are represented by 81% of issuers of the MSCI Europe ex U.K. as of May 31, 2007.

Table E

MSCI EUROPE EX U.K. INDEX DIVIDEND YIELD (%)

31 December 2000 - 31 December 2006



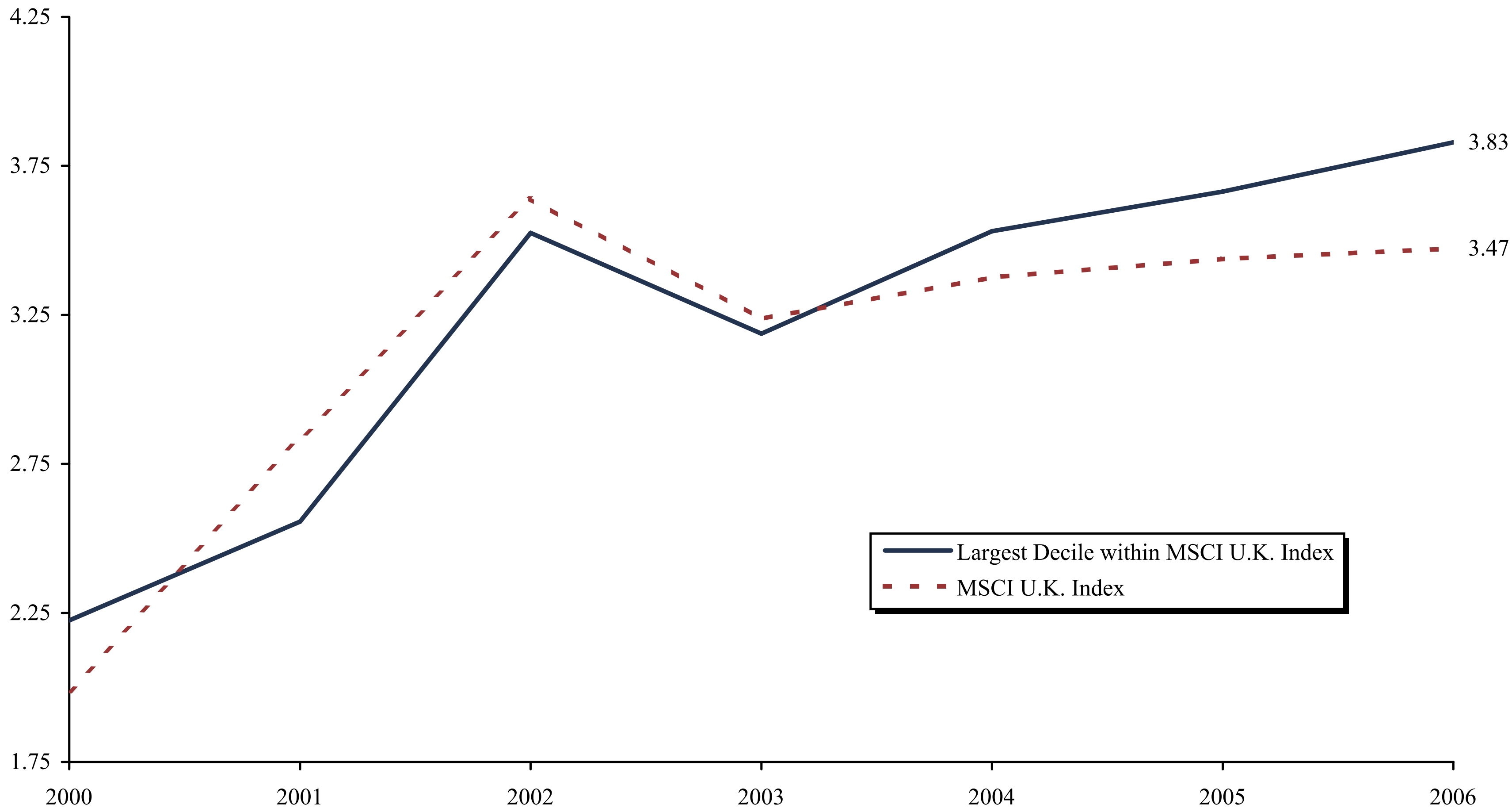
Sources: Factset Research Systems, Morgan Stanley Capital International, and Thomson Worldscope. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Dividend yields are calculated by using the weighted average on an annual basis. Deciles are ranked by market capitalization.

Table F

MSCI U.K. INDEX DIVIDEND YIELD (%)

31 December 2000 - 31 December 2006



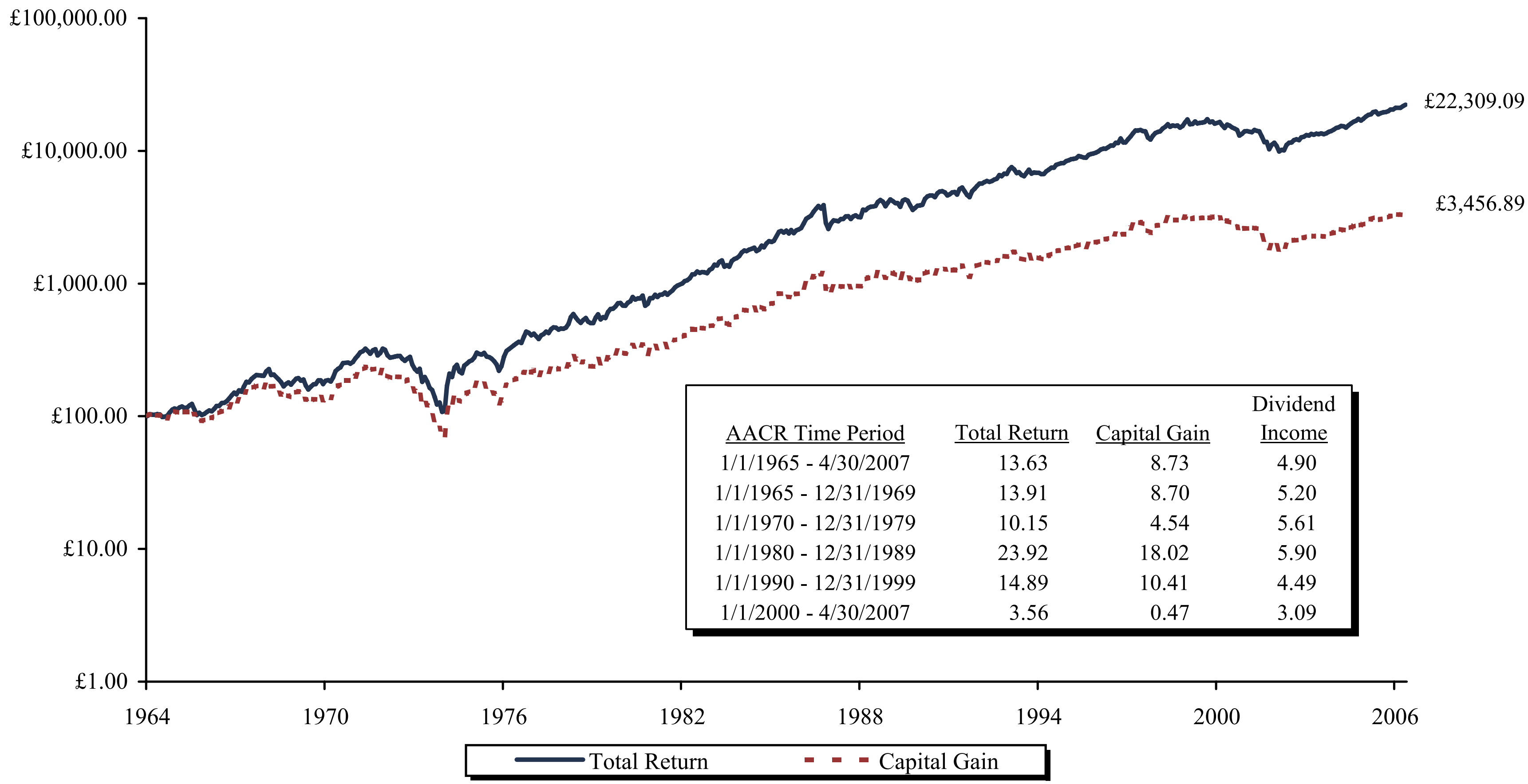
Sources: Factset Research Systems, Morgan Stanley Capital International, and Thomson Worldscope. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Dividend yields are calculated by using the weighted average on an annual basis. Deciles are ranked by market capitalization.

Table G

FTSE ALL-SHARE INDEX CUMULATIVE WEALTH

1 January 1965 - 30 April 2007
31 December 1964 = £100.00



AACR Time Period	Total Return	Capital Gain	Dividend Income
1/1/1965 - 4/30/2007	13.63	8.73	4.90
1/1/1965 - 12/31/1969	13.91	8.70	5.20
1/1/1970 - 12/31/1979	10.15	4.54	5.61
1/1/1980 - 12/31/1989	23.92	18.02	5.90
1/1/1990 - 12/31/1999	14.89	10.41	4.49
1/1/2000 - 4/30/2007	3.56	0.47	3.09

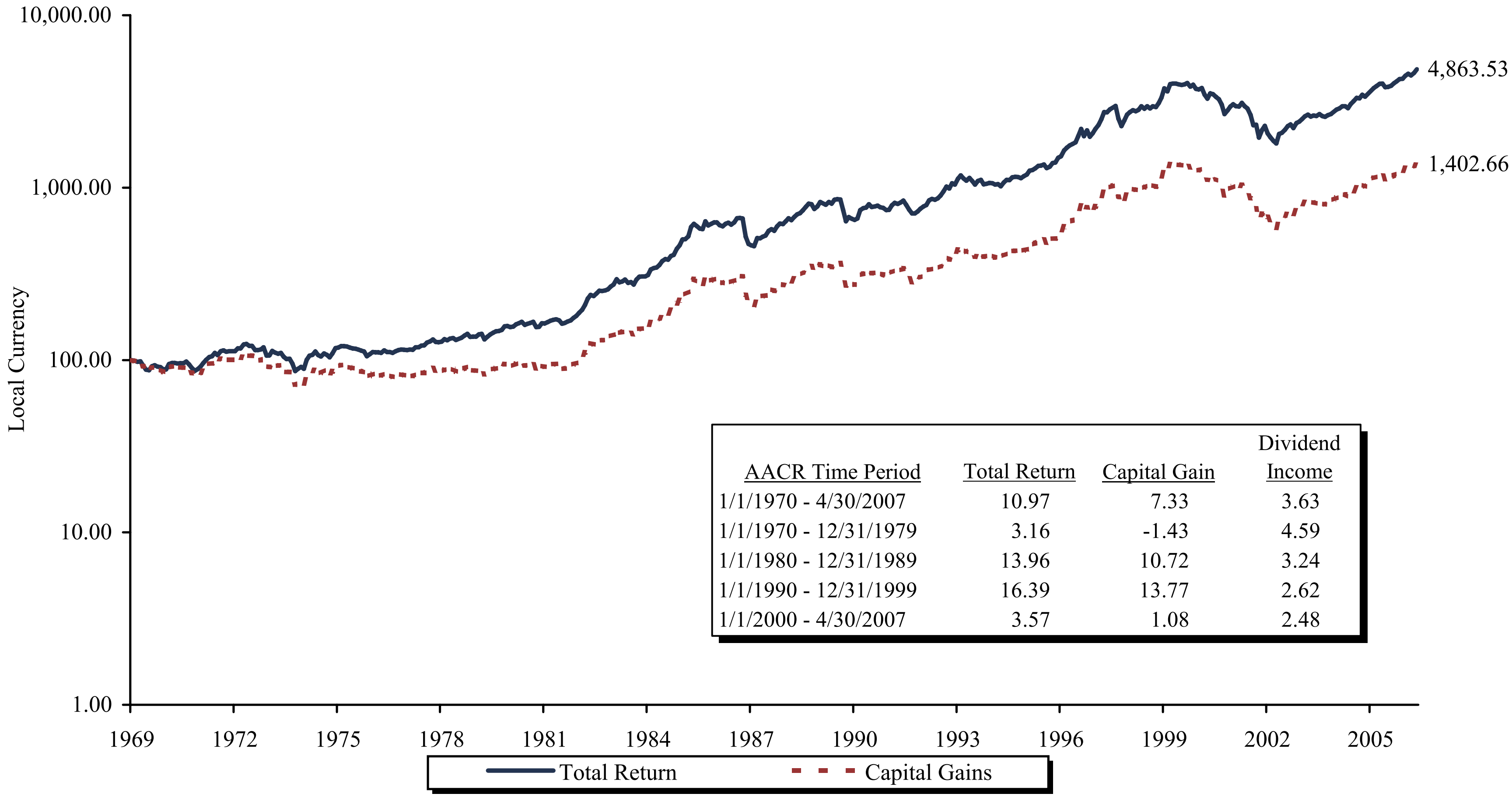
Sources: FTSE International Limited and Thomson Datastream.

Notes: Please note that total return series prior to 1985 are unofficial figures calculated by Thomson Datastream using price level and declared dividends. Data are represented on a logarithmic scale.

Table H

MSCI EUROPE EX U.K. INDEX CUMULATIVE WEALTH

1 January 1970 - 30 April 2007
(31 December 1969 = 100.00)



AACR Time Period	Total Return	Capital Gain	Dividend Income
1/1/1970 - 4/30/2007	10.97	7.33	3.63
1/1/1970 - 12/31/1979	3.16	-1.43	4.59
1/1/1980 - 12/31/1989	13.96	10.72	3.24
1/1/1990 - 12/31/1999	16.39	13.77	2.62
1/1/2000 - 4/30/2007	3.57	1.08	2.48

Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Notes: MSCI Europe ex U.K. total return index is calculated from gross returns. Data are represented on a logarithmic scale.