

## What future for dividends in Europe?

Topic Paper

Dividend Research

■ After a banner year, European companies will persist and prove again very generous towards their shareholders in 2006. Over the last two years, dividends have enjoyed a historical growth of **20% p.a.**, compared with 10% p.a. between 1994 and 2004.

■ Despite these historical levels, we remain very confident about the growth rate of European dividends for the years to come. Basically, our scenario is based on two strong arguments:

■ **1/ Companies will be able to maintain solid dividend growth in the long term.** According to us, European firms will, in the short run, benefit from the improvement their balance sheets that has been under way for two years and from factors supporting their earnings. In the longer term, they will be stirred by solid global growth that will be stirred by the US economy and emerging countries.

■ **2/ Companies are encouraged to pay out dividends.** In view of delusions sparked by the burst of the internet bubble, shareholders and managers now “prefer liquidity”. Far from reversing itself, this trend will persist and be fuelled, on the long term, by significant structural changes.

■ In the face of these favourable conditions, **we expect the average dividend growth of eurozone firms to reach 7.7% between 2007 and 2012**, vs. 11% on average over the past 15 years. We emphasise two subperiods.

■ **2006-2008: Dividends will rise in line with profits.** As a result, we expect Eurostoxx 50 dividends to rise +30% this year, +14% in 2007 and +9% in 2008.

■ **2009-2012:** The average earnings growth of stocks constituting EuroStoxx50 will be 5% on the period. As for dividend growth, it will be supported by the upturn in payout ratios and will reach **6% p.a. on average between 2009 and 2012.**

■ We suggest **prioritising the EuroStoxx50** index among all the European indices (economy, liquidity, methodology) and propose to **arbitrate the slope of the price curve** by selling short maturities (2007-2008) and buying medium-term ones (2010-2012). Indeed, although we believe short maturities are still undervalued, they still retain upside potential that is much more limited than longer maturities (2010-2012).

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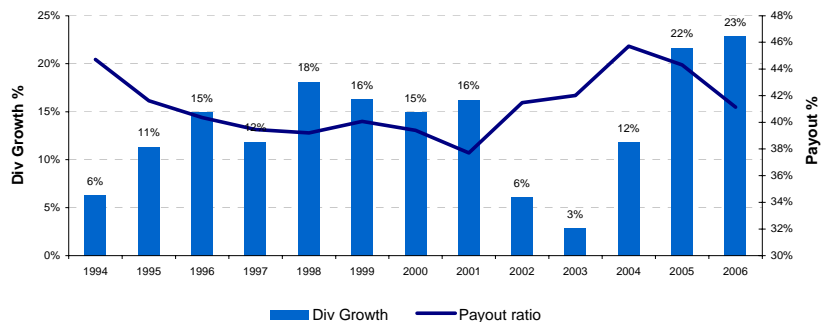
## 2005-2006: Two exceptional years...

**Dividends up by 50% in two years and payout ratio fully restored.**

After a banner year, European companies will persist and prove very generous again towards their shareholders in 2006. Indeed, bolstered up by increasing earnings, European companies distributed dividends up by 23% in 2006 (paid in 2006 on 2005 earnings). Over the last two years, dividends have enjoyed a historical growth of 20% p.a., compared with 10% p.a. between 1994 and 2004.

Since dividend growth has been inferior to profit growth over the period, companies have, in the meantime, significantly reduced the percentage of earnings paid to shareholders in the form of dividends. After sharply rising over the 2001-2004 period, European payout ratios went back to their average levels recorded between 1994 and 2004 (41%). Payout ratio reconstitution will be very supportive for dividends in the event of a market reversal.

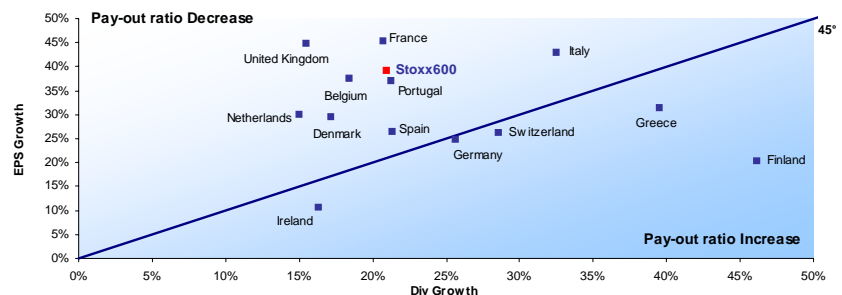
### Average growth of dividends and payout ratio in Europe\*



\* Reduced average calculated from the stocks constituting the Stoxx600  
Source – Thomson DataStream - BNP Paribas

British and Dutch companies have taken advantage of the solid results recorded over the past two years to lower their payout ratios significantly and rebuild their reserves. On the contrary, Finnish and Greek companies have proved very generous, offering dividend growth above results growth. Lastly, let us point to Italian companies that have been very dynamic, and to a lower extent, to German companies which are the main contributors to dividend growth in Europe.

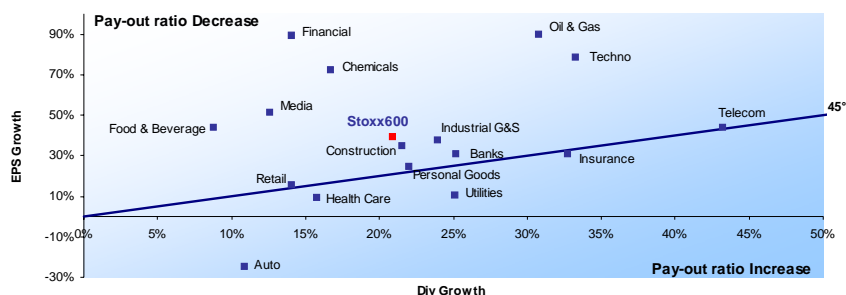
### 2 year average EPS & Dividend growth in Europe



\* Reduced average calculated from the stocks constituting the Stoxx600  
Source – Thomson DataStream - BNP Paribas

Sector-wise, Telecom stocks have benefited from solid results over the last two years and are one of the main drivers behind the rise in dividends in Europe. Energy and techno stocks proved less generous despite substantial cash flows and thus keep strong potential for the coming years. Lastly, the automotive sector, after two pretty dull years, has remained cautious regarding its dividend policy.

### 2 year average EPS & Dividend growth in Europe



\* Reduced average calculated from the stocks constituting the Stox600  
 Source – Thomson DataStream - BNP Paribas

### 2005-2006: Boom of the dividend swap market

Further to two outstanding years, the dividend swap market has enjoyed exceptional growth over the period. We observe several trends:

- **Steepening of the price curve.** We saw prices rise on all maturities. This trend, more pronounced on longer maturities, was mechanically accompanied by a steepening of the price curve. This movement can be observed on all the traded indices.
- **Rise in liquidity.** We can observe a strong and continuous rise in volumes over 2006 and 2005. Liquidity rose and was coupled with a narrowing of the Bid-Ask spread price.
- **Extension of proposed maturities.** Although the investment horizon was limited at 4 or 5 years at the beginning of 2005, it is now possible to trade dividend swaps on a longer horizon, i.e. over 10 years (even longer for the EuroStoxx50).
- **Multiplication of traded indices.** The EuroStoxx50 is by far the most traded European index; nonetheless, we also observed buoyant activity on the FTSE, CAC, AEX and SMI indices and, to a lower extent on the IBEX, SP/Mib and Epra indices.
- **Development of dividend swaps on single stocks.** Although the activity remains concentrated on few blue chips, it should further develop in the next years with the growing need for hedge products for dividend risk.

## What future for dividends in Europe?

Although dividends have enjoyed historically strong growth over the past two years, we remain very confident about the growth rate of European dividends for the years to come. Overall, our scenario is based on two strong arguments that we will develop later on in this paper:

- **Companies will be able to maintain solid dividend growth in the long term (section 1).** According to us, European firms will, in the short run, benefit from the improvement of their fundamentals that has been under way for two years on. In the longer term, they will be stirred by a favourable macro-economic environment.

- **Companies are encouraged to pay out dividends (section 2).** In view of delusions sparked by the burst of the internet bubble, shareholders and managers now favour generous dividend policies. Far from reversing itself, this trend will persist and be fuelled, on the long term, by significant structural changes.

These two trends will serve as powerful drivers for dividend growth in Europe in the next ten years.

# Companies will be able to maintain solid dividend growth in the long term

## Favourable macro-economic environment

In the medium term, global growth will be supported by two powerful drivers that have become increasingly independent:

**Global growth will be stirred by the US economy and emerging countries.**

■ **The good state of the US economy.** Although the US economy is likely to slow down in 2007 due to the contraction of the housing sector, it will in the medium term benefit from solid fundamentals (productivity, companies' financial state, ability to create new jobs, improvement of budgets).

■ **The energy of emerging countries (and notably China).** These countries will benefit from buoyant growth, first stirred by external demand, then progressively by internal demand generated by the emergence of a 'middle class'. Their fundamentals are outstanding and contagion effects we observed in the past, notably in 1997-1998, now belong to the past, notably as a result of greater flexibility in exchange rates and of investors' ability to discriminate risks.

**More stable growth over time.**

Global growth will also benefit from a more and more diversified profile. The contribution of emerging countries to global growth has increased from 50% in the 1980s to 66% in 2000-2006. Their weight in the global GDP is now 48% compared with 29% in 1980. Depending less on the US cycle, the world economy will display a more 'balanced' profile and thus offer a more stable growth in the future.

## Solid corporate fundamentals...

Although, per our core scenario, we expect the US economy to slow down in the short term, we still remain confident towards US corporate earnings growth. Let us point to two elements:

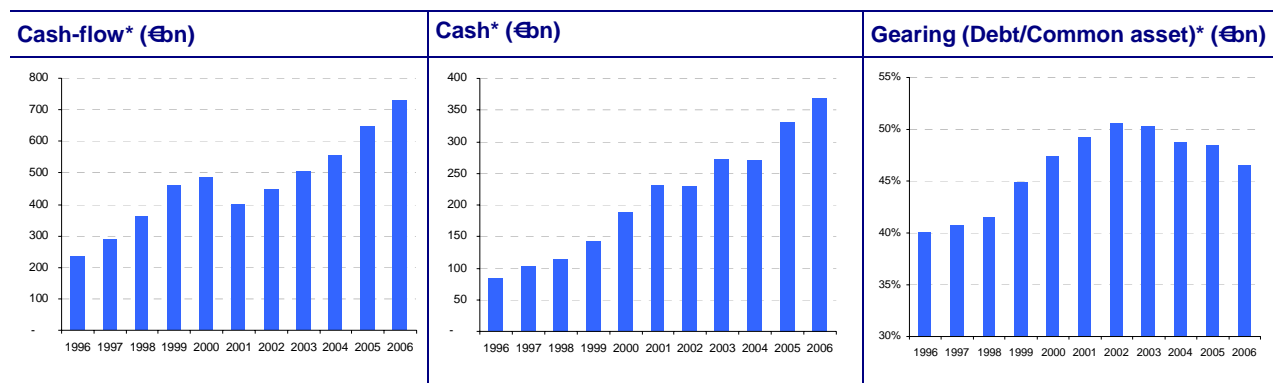
■ **Corporate balance sheets have been improved.** In view of the difficult economic environment of recent years, numerous companies have postponed their investment projects and now boast abundant liquidity. In the meantime, they have sharply reduced their debt levels and dedicate less and less cashflow to restore debt.

■ **Factors supporting earnings.** Although earnings growth rates are already at historical highs, several factors will support the profit growth of European companies in the medium term: 1/ the reduction of operating costs through the implementation of restructuring plans, 2/ synergies coming from a buoyant M&A activity. This effect will be all the stronger as shareholders prefer rapidly accretive operations, 3/ the acceleration of relocation announcements which will reduce production costs in the medium term, 4/ productivity gains - according to our analysts, the peak has not been reached yet, 5/ more favourable financial conditions.

## ... to finance investment needs

From a micro-economic point of view, investment is the main threat for dividend growth in the long term as cash-flows are divided between investments (M&A and Cap-Ex) and shareholders (buy-back and dividends). Given the still important concentration potential in numerous sectors, we expect the M&A activity to remain buoyant in Europe in 2007. However, this trend will have, according to us, only a limited impact on dividend growth. We put forward several reasons:

- First, in terms of M&A, European companies have long differentiated themselves from their American counterparts by using more cash (in relation to stocks) when financing an acquisition. Today, this difference is no longer apparent, the latest deals being mostly financed with stocks. This trend, which looks set to persist in the upcoming years, will limit the negative impact (due to the cash used) of M&A deals on dividend growth.
- In the most indebted sectors, the deleveraging cycle is coming to an end; however, the rise in gearings is not expected. Neither do we expect financial situations to deteriorate in the medium term.
- Contrary to what had been done some years ago, M&A deals must now rapidly appear as accretive in order to gain approval from shareholders. These M&A operations will stand out as very supportive for dividend growth in the long term.
- Sometimes (too) generous dividend policies hide a lack of strategic vision which, on the longer run, can prove dangerous for corporate profits, and thus for dividends. As a result, although investment can limit dividend growth in the short term, it is the only way the keep regular growth in a longer term. Investment is a growth driver for dividends in the long term.
- The strong dividend growth of the past few years has not substituted for investment, and, on the contrary, has gone hand in hand with a buoyant M&A activity, and, to a lesser extent, with renewed internal investment (Cap-Ex).



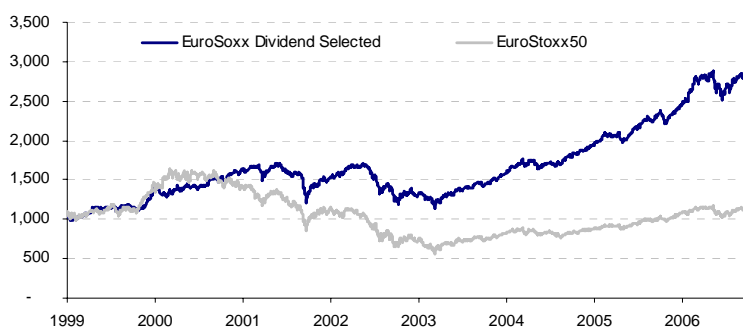
\* Calculated from the stocks constituting the EuroStoxx  
Source – BNP Paribas

## Companies are encouraged to pay out dividends

As we observed it, companies are now able to maintain solid dividend growth in the long run. This growth will be all the more marked in the years to come as several factors will encourage generous dividend policies.

■ **Investors focus on stocks with high dividends.** In view of the delusions sparked by the burst of the internet bubble, numerous investors have turned to mature companies that offer good visibility in terms of dividend policy. Now investors prefer to know precisely the dividend amount in the short term rather than being given a higher expected return in the medium term. As a result, companies paying a high level of dividends are valued on the basis of multiples that are higher than other companies, and have significantly outperformed the market since 1999. According to us, this trend is likely to persist over the next few years.

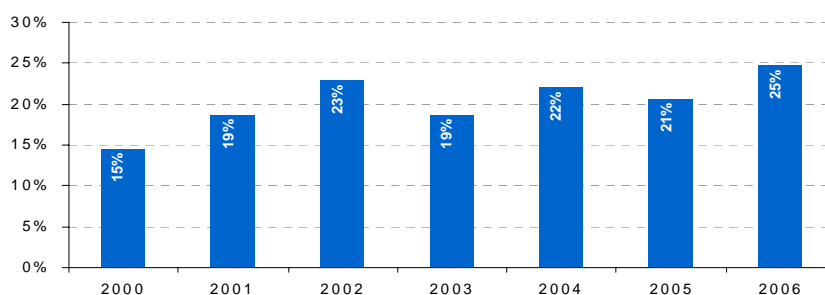
### EuroStoxx50 & EuroStoxx Selected Dividend Relative Performance



\* Calculated from the stocks constituting the EuroStoxx  
Source – Thomson DataStream - BNP Paribas

■ **Companies prioritise return to Shareholders.** Indeed, companies devote a growing part of their cash to pay shareholders: 15% in 2000 vs. more than 25% in 2006. This movement has gone hand in hand with the re-emergence of share buy-back programmes. Although we believe this trend will gain strength, it is nevertheless a threat for dividend growth. Indeed, paradoxically, these two options are strongly linked: for a few years now, we have observed that companies being generous in terms of dividend are also the most generous in terms of share buy-backs.

### Return to Investors (Div+Buy-Back) / Invest for Growth (M&A+Cap-Ex)



Source – Thomson DataStream - BNP Paribas

### Dividends, an important communication tool ...

According to the theory of market equilibrium, dividend policies are not very significant: the shareholder shows no preference between receiving a dividend and agreeing that the company reinvests this amount in assets at a rate he would have fixed. Indeed, his assets remain the same. In practice, dividends become, on the contrary, one of the most important communication tools between a company and its shareholders.

■ **... used by companies towards their shareholders (signal theory).** 1/ Although the financial information conveyed by companies towards investors are sometimes blurred (accounts manipulation, overemphasis of objectives, etc.), dividends have become an objective criterion used to assess a firm's financial state. Indeed, dividends require having cash. 2/ Dividend policies also enable the top management team to show its shareholders it has implemented a well-considered policy in terms of finance and development. 3/ Lastly, through its dividend policy, the company shows its ability to anticipate the future. If a company keeps its dividend level unchanged although its results decrease, it thus shows that the hard time is only temporary. Or, by paying a first dividend, a company lets the market know that it has reached a high maturity level.

■ **... used by shareholders towards their company (agency theory).** Dividends are increasingly used as a control tool by shareholders. Indeed, by constraining top management to pay out part of the achieved results, the dividend policy becomes a way to 'control' managers (thereby avoiding investments at a loss, etc.) and constrains them to integrate the shareholders' interests. For instance, pressurised by their shareholders, numerous companies try to give more and more precise medium-term (2-3 years) information. Companies are aware that if they fail to reach their targets, they will be strongly penalised. This behaviour, although it will artificially limit the rise in dividends in the short run, will nonetheless help the trend last.

### Structural reasons

■ **Dividends, a weapon against takeovers.** In view of the renewed M&A activity, dividends increasingly appear as a tool for the potential targets to stand up against the acquirers. Indeed, some companies, anxious about keeping their shareholders' support in the event of a hostile takeover bid, do not hesitate to pledge themselves to pay out substantial dividends over several years (Endesa, BPB, Bouygues).

■ **Population ageing will doubly benefit dividend growth:** 1/ Retired people prefer by far high-dividend stocks. Indeed, after saving money during all their working life, they tend to consume the accumulated capital in order to maintain their consumption level (although their revenues are smaller). Therefore, overall, retired people invest in companies boasting a generous dividend policy, which ensures them a quick and high return on investment, rather than a company prioritising investment, with a less regular return on investment. 2/ The growing part of the non-working population will inevitably deteriorate the profitability of pay-as-you-go systems (as well as national insurance systems). European households therefore will be increasingly

encouraged to adopt an additional pension scheme which will serve as a support for markets in the long run.

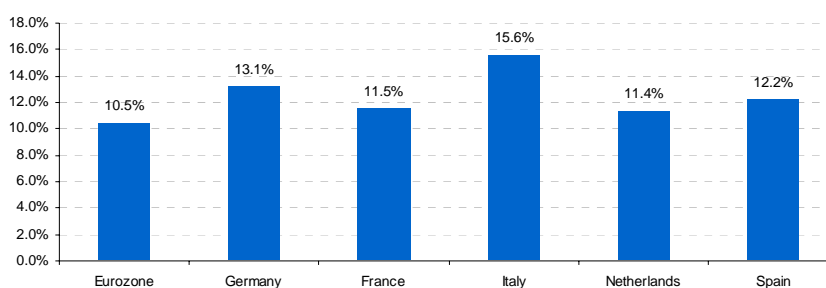
■ **A more favourable fiscal and legal environment.** Three favourable evolutions: 1/ the development of stock options has significantly limited dividend growth (which impacts prices negatively). As a consequence, the increasingly restricting legal environment for stock options should limit their development and favour dividend growth. 2/ dividends have long been penalised by a more restricting tax system than on capital gains. The recent tax relief in several countries will encourage generous dividend policies in the upcoming years. 3/ the harmonization of tax policies regarding dividends in the eurozone, which notably translates into the progressive reduction of withholding tax, will encourage competition between countries.

## Dividend Swap: What index to prioritise?

As we will see in the next section, the dividend swap market offers interesting opportunities on long maturities. The choice of indices remains nevertheless hard to make. We prefer the EuroStoxx50 index for several reasons:

- Economic growth in the eurozone displays, through its diversity, a more balanced profile, thus less sensitive to economic (political, social, etc.) shocks than a national economy.
- The EuroStoxx50 index is composed of the largest European market caps. Three consequences. 1/ these companies make a high proportion of their profits outside Europe. Therefore, they are better positioned to take advantage of buoyant global growth (stirred by the US and emerging countries) and thus offset the anticipated low activity in the eurozone. 2/ In addition, they benefit from high financing capacities enabling them to invest rapidly and massively in new growth shifts. 3/ given their size, these companies are subject to a thorough follow-up (financial analysts, press, etc.) in comparison to smaller-sized firms. Thus they give special importance to communication. Therefore, should their earnings decrease, they would tap into their reserves in order to keep their dividend unchanged, whereas a less exposed firm will not hesitate to cut its dividend.
- Given their geographical diversity, Pan-Euro indices pay out dividends that are more stable over time in comparison with country indices. Judging by past dividends, dividends on the Italian stocks vary far more than those on the other analysed indices.

### 10 Years “Volatility” of dividend paid by country indices



\*10-year standard deviation calculated on yearly change of dividend paid by Datastream country indices.  
Source – Thomson DataStream - BNP Paribas

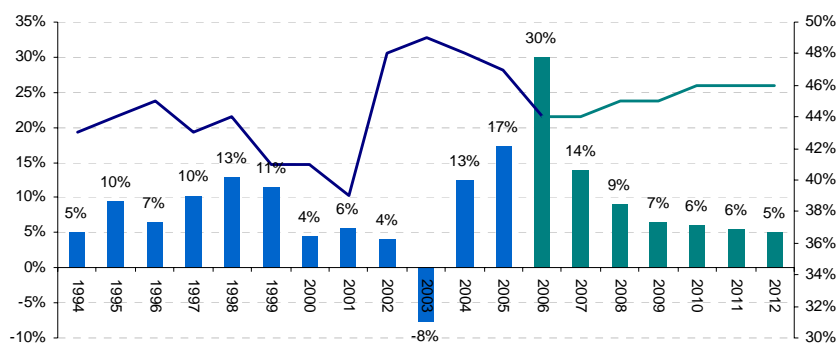
- By preferring EuroStoxx50, we also show mistrust toward the UK market. Two reasons: 1/ In relation to their eurozone counterparts, British stocks display significant exposure to the US economy. And the US economy will slow down in the short term, due to the housing sector downturn. Thus we prefer stocks of the eurozone since they depend more on the global economy, which will benefit from the aggressiveness of emerging countries. 2/ finally, our concerns towards British stock are also fuelled by the fact British companies seem to have difficulty financing their pension funds. Should these problems materialize, dividend growth in these firms will be impacted negatively.

- Liquidity is also a determining factor in our choice. We put forward three reasons: 1/ Dividend swaps on single stocks offer a perfect hedging tool suited to holders of dividend swaps on index. Nevertheless, their development remains limited and are currently concentrated on the big caps of EuroStoxx50. 2/ Liquidity, still low on national indices, does not match well with a Mark-to-Market management. 3/ Dividend swaps on EuroStoxx50 – index gathering the 50 largest caps of the eurozone – is being increasingly used as a ‘global hedging’ tool by teams that trade stocks. This trend will serve as an important liquidity factor for the European index.
- Large supply from structured products on EuroStoxx50 create arbitrage opportunity. Basically, when an investor purchases a structured product, he buys upside potential. In order to hedge this upside exposure, dealers buy long-dated forwards. Since there is an inverse relationship between forward price and implied dividend, these market operators have a negative impact on dividend swap prices. This effect systematically puts a sell-pressure on dividend swap prices. And, interestingly, volumes of structured products are mainly focused on EuroStoxx50.
- Lastly, we also prioritise Eurostoxx 50 since its methodology is more favourable to dividend swaps. Indeed, whereas exceptional dividends are systematically adjusted in indices managed by Euronext-Liffe (and thus with no impact on dividend swap prices), they can (depending on the funds’ origin) be partially adjusted among the Stoxx indices – which is positive for dividend swap prices. Far from being insignificant, these differences offer ‘free options’ to holders of dividend swaps on EuroStoxx50 (Eon or Endesa in 2006).

## Dividend Swap EuroStoxx50: What growth?

Given all the above, we expect the average dividend growth of eurozone firms to reach 7.7% between 2007 and 2012, vs. 11% on average over the past 15 years. We emphasise two subperiods.

### EuroStoxx50: Average Dividend Growth



Source – Thomson DataStream - BNP Paribas

### Marked downturn in the short term (2006-2008)

In the next two years, the US economy will record a sharp slowdown coming from the housing sector's contraction that will soon reach other economic activities. Although eurozone firms are weakly exposed to the US economy (only 20% of their results achieved in North America), the cyclical economic reversal will spark a marked slowdown in earnings. We forecast slower growth in the next two years (+14% in 2006 and +9% in 2007, vs. 30% the previous year).

As for dividends, they will drop in line with profits. Indeed, we expect pay-out ratios to remain stable over the next two years: 1/ payout ratios are now fully restored. Today they are below their long-term average. 2/ Companies display solid fundamentals enabling them to maintain generous dividend policies while guaranteeing their investment needs.

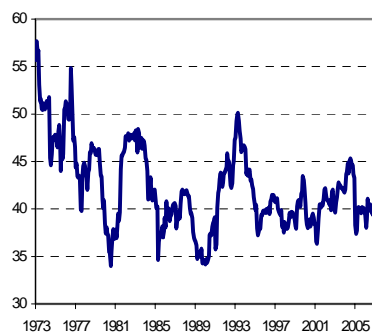
**All in all, dividends will in the short term rise in line with profits. As a result, we expect Eurostoxx 50 dividends to rise +30% this year, +14% in 2007 and +9% in 2008.**

### Stable growth in the long term (2009-2012)

In the longer term, corporate earnings in the eurozone will grow at a measured and stable pace. Earnings will be supported by the energy of the global economy and by the stabilising effect of payout ratios which have now been fully restored. In the meantime, dividend growth will be supported by numerous structural factors (see previous pages).

**By and large, the average earnings growth of stocks constituting EuroStoxx50 will be 5% between 2009 and 2012. As for dividend growth, it will be supported by the upturn in payout ratios and will reach 6% p.a. on average between 2009 and 2012.**

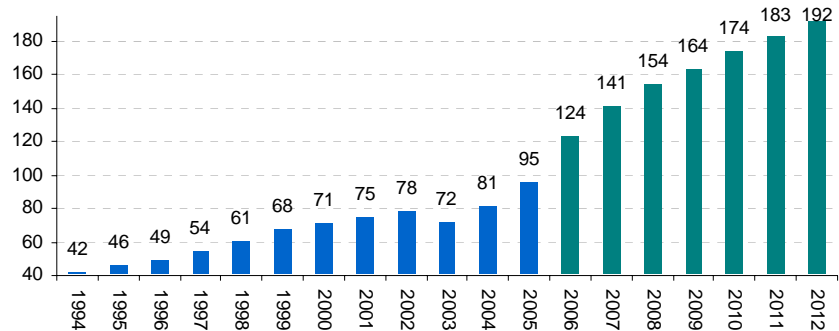
### Europe: Average Pay-out ratio



Source – Thomson DataStream - BNP Paribas

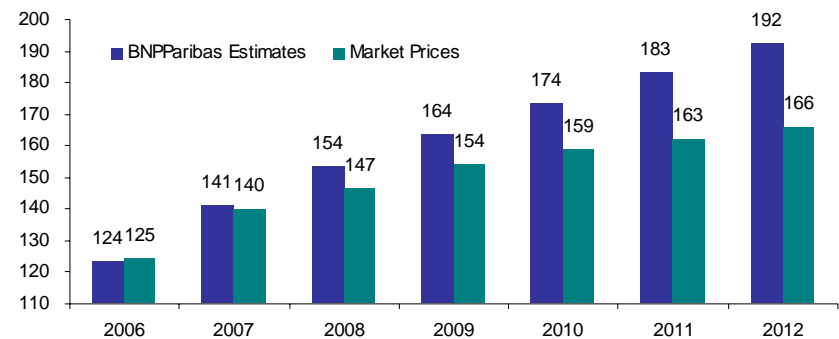
## Dividend Swap EuroStoxx50: What strategy?

**EuroStoxx50: Dividend Points (paid on earnings from previous year)**



Source – Thomson DataStream - BNP Paribas

**EuroStoxx50: Average Dividend Growth**



Source – Thomson DataStream - BNP Paribas

In view of our estimates, we propose here to trade the slope on the EuroStoxx50. Although it has steepened strongly, the price curve nevertheless remains conservative on its medium and long-term maturities. According to the market prices, the dividends should grow on average by 2% p.a. between 2010 and 2014, i.e. 5 points below the average levels observed in the last 10 years.

In this context, **we propose to arbitrate the slope of the price curve by selling short maturities (2007-2008) and buying medium-term ones (2010-2012)**. Indeed, although we believe short maturities are still undervalued, they still retain an upside potential that is much more limited than longer maturities (2010-2012).

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