

Dividends Are Simply Divine

Profits are up, taxes are down, and more companies are making big payouts

AFTER TAKING OVER AS chief executive last year, James R. Cantalupo wanted to show that the turnaround at McDonald's Corp.—and its new commitment not to waste money—was real. So in September, he announced a 70% hike in the annual dividend, the burger giant's biggest increase in 25 years. The move committed McDonald's to passing out an extra \$200 million a year to shareholders, cash that otherwise might have gone toward ill-conceived expansion schemes. "It was," says Chief Financial Officer Matthew H. Paull, "a way of putting our money where our mouth is."

Moves like McDonald's have played out in scores of boardrooms over the past year. It's all part of a huge shift in corporate finance that began in December, 2002, when the Bush Administration began sounding out ways to cut taxes on dividends. Some 370 companies in the Standard & Poor's 500-stock index are now paying dividends, 19 more than in 2002. And last year these companies paid out \$161 billion, up 8.8% from the year before. This year, S&P expects payouts to rise by an additional 10.7%, the biggest increase since 1989. Among the first-timers joining the dividend bandwagon: Best Buy, Clear Channel Communications, Reebok International, and Microsoft. "Dividends are now back in play," says Howard

Silverblatt, equity market analyst at S&P.

The switch marks a sharp turning point after two decades in which companies handed out less and less of their profits directly to shareholders. But that period may have been an aberration, says Jeremy J. Siegel, professor of finance at the Wharton School of the University of Pennsylvania. Over most of the past century "it was considered essential to pay dividends," he says. They enhance the credibility of reported earnings and make executives think twice about how they use shareholders' money. This year's jump in payouts shows that corporations not only are making more money but also they're more confident they can keep the cash flowing, he says.

So why are dividends back in fashion?

The biggest reason may simply be the surge in corporate profits at the end of last year. So far, fourth-quarter earnings from continuing operations at S&P 500 companies have leaped 28%, compared with the year-earlier period. And the dividend-tax cut last year probably encouraged companies to share more of those profits. The cut reduced

government's slice of dividend payments to 15% from the 35% maximum federal rate on ordinary income. It also put dividend taxes on a par with those for capital gains, removing the disadvantage of dividends for individual investors. What's more, companies hoping to woo skeptical investors back to the market after several years of earnings games and financial



BACK IN FASHION

Companies are boosting dividends



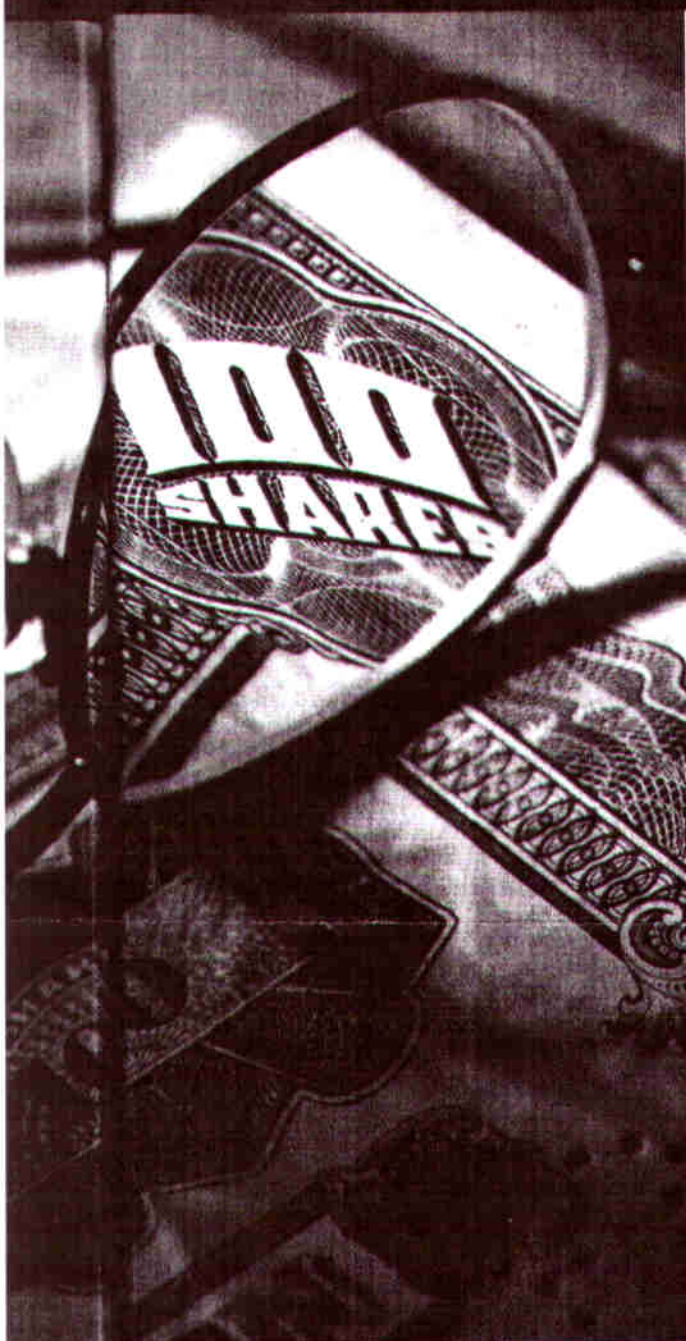
scandals may have used dividends to assuage doubts about corporate accounting. "There are very few ways a firm can fake it, year in and year out, when they're paying good dividends," says Siegel.

SPECIAL GIFTS

MORE EVIDENCE THAT chief financial officers are changing their minds on dividends piles up every day. On Feb. 9, 3M raised its quarterly payouts 9%, to more than \$1.1 billion a year. The money will come from the company's ample cash flow, which, thanks to cost-cutting and strengthening demand, jumped from \$3 billion to \$3.8 billion in 2003. Exelon

Corp., the
ny, anno
on Jan.
from a
com Gr
ing its c
a share
medica
mandat
payout,
compar
their d
Februa
all of F
The
ance c

WILLIAM WHITEHURST/CORBIS;
CHART BY ERIC HOFFMANN/BW



houses. They are paying out 34% more than last year, reflecting the rebound in the markets and the economy. Goldman Sachs Group and Citigroup raised their dividends by 108% and 94%, respectively, last year. Lehman Brothers has raised its dividend by 33% twice in the past 14 months.

Some companies are endearing themselves to shareholders even more with special cash dividends. So far this year, 58 companies, most outside the S&P 500, have declared such payouts. For instance, on Mar. 1, Renaissance Learning Inc. will make a one-time cash payment of \$2.15 a share, plus a new quarterly dividend of 4¢ a share. The company, which produces reading and math products for K-12 students, figures it can set aside some of its strong cash flow without tying its hands in the future.

THINKING TWICE

SO WHICH STOCKS perform better, those that pay dividends or those that don't? Dividend stocks generally beat broad market indexes from 2000 through 2002. In fact, with share prices plunging those years, dividends were essentially the only return investors got. The pattern reversed in 2003, with the comeback of tech stocks, few of which pay dividends. Dividend payers in the S&P 500 climbed 23% while nonpayers rose 54%, according to International Investment & Strategy Group Inc., a New York institutional broker. But, says finance professor Siegel, dividend-paying stocks have produced better returns

over the long run.

Either way, the renewed interest in dividends has one big payoff that's less easily measured: making executives and investors think again about how best to use corporate cash. Says Jason Trennert, chief investment strategist at ISI Group: "The fact that you can provide some return in the form of a dividend might give some companies a break from pursuing growth at any cost."

So why haven't tech companies jumped on the bandwagon? Of the 83 info-tech companies in the S&P 500, fewer than a third pay dividends. Most use any extra cash to buy back stock. In

Corp., the Chicago-based power company, announced its third hike in 12 months on Jan. 27, raising its dividend by 25% from a year ago. Marketing giant Omnicom Group Inc. joined the parade by lifting its quarterly dividend 12.5%, to 22.5¢ a share, on Feb. 17, the same day that medical-devices maker Guidant Corp. mandated a 25% raise in its quarterly payout, boosting it to 10¢. Already, 65 companies in the S&P 500 have raised their dividends this year through mid-February, nine more than in January and all of February last year.

The biggest payers are banks, insurance companies, and other financial

Sharing the Bounty

SECTOR	ANNUAL DIVIDEND* (BILLIONS)	INCREASE
Financials	\$51	34%
Consumer Staples	21	16
Health Care	20	6
Industrials	20	12
Energy	14	6
Telecom Services	12	11
Consumer Discretionary	11	5
Utilities	11	3
Information Technology	7	95
Materials	6	7

* For 2004, based on current dividend rates. Increase is over 2003 starting rates.

Data: Standard & Poor's

fact, while the sector accounts for 18% of the market value of the index, its dividends amount to just 4% of S&P 500 payouts. And that's after tech outfits doubled their payouts last year. "We're just not seeing the demand out there" from investors, argues Intuit Inc. CFO Robert R. "Brad" Henske.

Young tech outfits, in particular, insist that their investors are more interested in growth—and the stock appreciation that comes with it—than in dividends. Such companies say they attract investors who want them to find smart places to put their money. "We believe we should use our cash to invest in our own or new businesses first, since that's the greatest opportunity for growth," says Barry Diller, CEO of InterActiveCorp, parent of Expedia, Hotels.com, and Home Shopping Network. "Dividends will come when we've reached some level of maturity."

Even Microsoft's highly publicized decision to start paying a dividend is producing only a token payment of 16¢ a share—for a 0.6% yield. And its \$1.7 billion in annual dividend payments is tiny compared with its \$53 billion cash hoard and the roughly \$16 billion it pockets in annual cash flow. Microsoft executives have said it is prudent for them to keep a lot of cash as insurance against a pending private antitrust lawsuit and an investigation by European authorities. If the company overcomes these hurdles, investors have a suggestion on how it can celebrate: Raise its dividend! ■

—By Joseph Weber in Chicago and David Henry in New York, with Michael Arndt in Chicago, Timothy J. Mullaney in New York, and Jay Greene in Seattle

to as-
ating.
1 fake
: pay-

acial
n div-
9, 3M
more
y will
cash
3 and
m \$3
xelon

WILLIAM WHITEHURST/CORBIS;
CHART BY ERIC HOFFMANN/BW