The Copeland Review

First Quarter 2019

"We believe that stocks with sustainable dividend growth consistently outperform the market with less risk."

Tax Reform and the Trillion Dollar Question

"I feel good, I feel great, I feel wonderful…"

- Bill Murray as Bob Wiley in *What About Bob*, 1991

In our Fourth Quarter 2017 *Copeland Review* "Jelly of the Month Club," we discussed how the US Tax Cuts and Jobs Act (TCJA) was designed to substantially increase capital availability to American corporations in 2018 and beyond. We likened it to a gift that keeps on giving. At the micro level, we expected that most companies would realize a considerable upward step in earnings and cash flow from a lower tax rate. Combined with a new ability to repatriate offshore funds with limited tax consequence, we anticipated that this would provide additional flexibility and fodder for capital allocation. At the macro level, the objective was to make the US more competitive from a tax perspective in order to encourage increased domestic investment and thereby achieve faster economic growth.

As chronicled by countless headlines, corporate share repurchases surged last year. For example, S&P Dow Jones Indices reported that total S&P 500 stock buyback dollars increased 55% to $806 billion in 2018.[1] But what was the impact on other potential uses of capital, such as internal expenditures on capital equipment and research or external investment on acquisitions? Looking beyond buybacks, what of the other methods of returning cash to capital providers such as dividend increases and debt retirement? And what does this suggest about how companies feel about the future? After the TCJA's therapeutic boost, most companies are saying "I feel good, I feel great, I feel wonderful." However, we wondered if a deeper analysis of corporate activity would advise whether the boost was permanent or as short-lived and vulnerable as Bob's. *This is the trillion-dollar question*.

Now armed with a full year of financial information, we evaluated what transpired post tax reform for large cap and small cap companies. We observed, as detailed below, that all of these uses of capital appear to have benefited from tax reform. This includes dividend actions, which long time readers of the *Copeland Review* know are integral to Copeland's investment process and we believe are most indicative of management's confidence in the future. That said, the overall pace of growth in cash dividend outlays was – in aggregate – lackluster. In this *Review*, we share our full findings while highlighting the healthy growth profiles and reasonable valuations of Copeland's Dividend Growth strategies.

TCJA Refresher and Improved Incentive Structure

At the corporate level, the Tax Cuts and Jobs Act (TCJA) of late 2017 did three major things.

First, it reduced the statutory tax rate to 21% from 35%, moving the US from having the highest tax rate of all Organization for Economic Cooperation and Development (OECD) countries to a level more competitive with other markets.[2] In a globalizing economy, the previously high US corporate tax rate incentivized companies to relocate their headquarters abroad, shifting jobs and investment outside the US.[2,3]

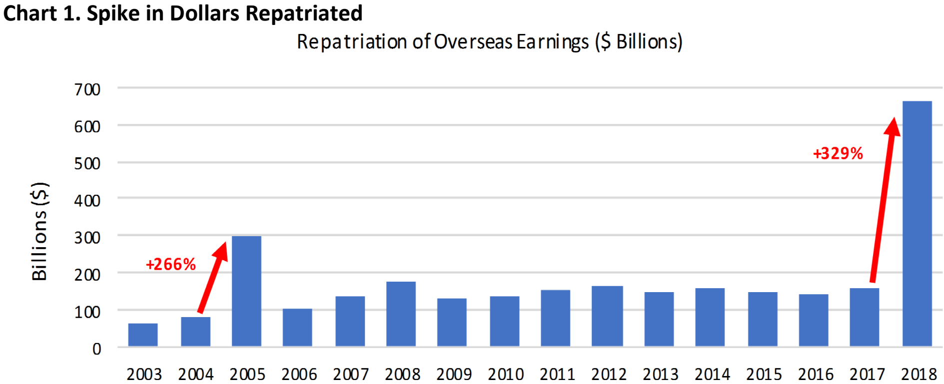
The second meaningful change was the level of taxation on foreign cash holdings and earnings. Prior to TCJA, foreign profits of US corporations that had already been taxed abroad were also subject to US taxes when brought into the US. As a result, corporations were incentivized to retain profits where they were generated, even if doing so was not optimal from a pre-tax capital allocation perspective. As explained by the Federal Reserve last September, the new tax law shifted the US to a system where profits are taxed largely where they are earned and are subject only to a minimal level of US taxes upon repatriation.[4] The Fed highlighted that, "as a transition to this new tax system, the TCJA imposed a one-time tax (payable over eight years) on the existing stock of offshore holdings regardless of whether the funds are repatriated, thus *eliminating the tax incentive to keep cash abroad*" (our emphasis). Further, the Fed calculated that, at year-end 2017, non-financial US enterprises "had accumulated approximately $1 trillion in cash abroad, held mostly in U.S. fixed-income securities." Thus, as a result of the tax law change, a significant amount of idle cash could efficiently be brought home.

Finally, the TCJA also enacted 100% bonus depreciation deduction for short-lived assets, fully for five years followed by a subsequent phase out over five years through 2026.[5] Instead of spreading deductions over many years, companies could deduct 100% of the cost up front. The goal was to encourage more capital spending to drive domestic capital formation and economic growth.

The Repatriation Boom…

Based on data from the US Bureau of Economic Analysis , corporations brought back $665 billion in 2018 or 67% of the Federal Reserve estimate of idle cash – more than four times the

Chart 1. Spike in Dollars Repatriated



Source: Bureau of Economic Analysis

$155 billion corporations repatriated in 2017, prior to tax reform (see Chart 1).[6] The chart shows that tax policy influenced corporate behavior much as it did following the American Jobs Creation Act of 2004, which also provided incentives for repatriation.

… and Immediate Bottom Line Benefits

To evaluate the changes to tax rates and the dollars allocated to share buybacks compared to other capital uses, we aggregated bottom-up financial data from FactSet for all current non-financial constituents of the S&P 500 Index and the Russell 2000 Index for the past four years. We omitted financial companies because of inherent business model differences that impact cash flow accounting.

Our bottom-up FactSet dataset revealed that effective tax rates declined materially for all sizes of companies. We found that the weighted average effective tax rate for S&P 500 companies declined to 18% in 2018 from 26% in 2016. Meanwhile for Russell 2000 companies the rate declined to 17% in 2018 from 25% in 2016. (We ignored the 2017 tax rate given the substantial charges and gains that were recorded as tax assets and liabilities were written off in accordance with the TCJA). Aided by lower tax rates, operating cash flow accelerated in 2018 for large and small companies.

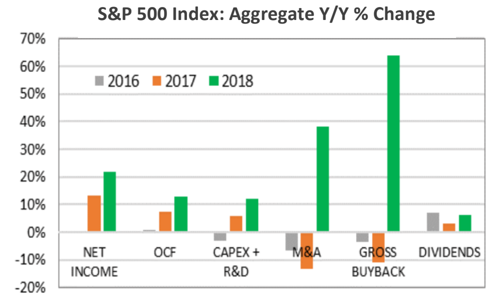
Chart 2a shows aggregate year over year percentage change for 2016 through 2018 for key financial statement items of S&P 500 Index constituents while Chart 2b shows the same for Russell 2000 Index constituents.

Trillion Dollar Answers

The charts tell the story. In addition to spurring earnings and cash flow growth, the data reveals that, as expected, the TCJA indeed influenced capital allocation meaningfully. Boosted by higher net income and operating cash flow, growth in each of the four major capital allocation buckets accelerated in 2018 versus 2017. Nevertheless, we find the breakdown broadly uninspiring, though perhaps unsurprising.

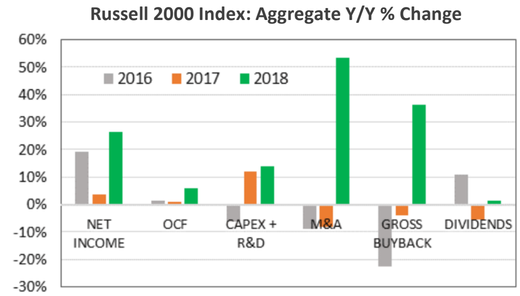
We believe the summation of capital expenditures (CAPEX) plus research & development (R&D) represents fairly the internal investment companies make in their business and have the greatest potential to lead to successful outcomes and future profit growth. These actions accelerated moderately in 2018 for both large and small cap companies, after lackluster spending in the years prior to reform.

Chart 2a. Trends in Large Cap Capital Allocation, 2016-2018A



Source: FactSet and Copeland Capital

Chart 2b. Trends in Small Cap Capital Allocation,



Source: FactSet and Copeland Capital

Meanwhile, the substantial surge in acquisition activity indicates a desire from management to quickly deploy new available capital into growth opportunities. However, while certain deals prove sensible and accretive, many transactions lead to "diworsification" and are ultimately value destructive.[7] With a sudden repatriation windfall and bottom-line boost after TCJA, some management teams may have pursued deals that fall further out on the risk spectrum than they otherwise would have considered. Time will tell.

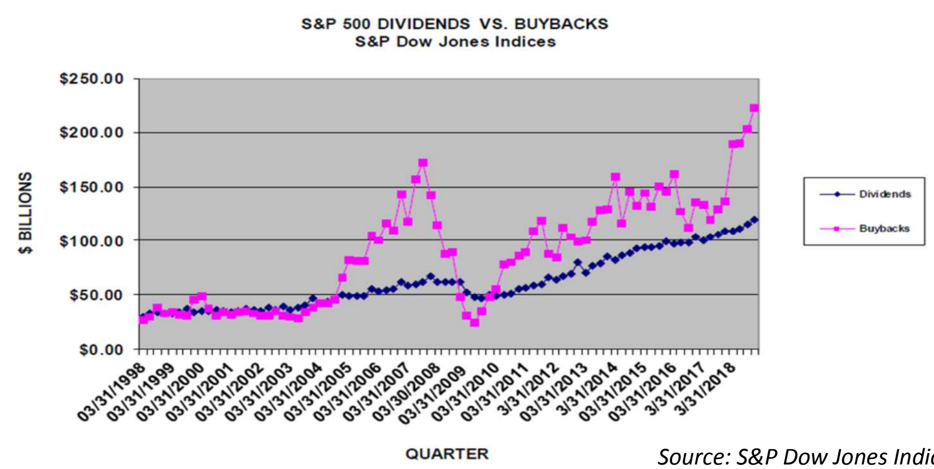
Regrettably, we attribute little such predictive value to the buyback boom. The significant increase in share repurchase activity makes sense on some level, as buybacks provide a flexible, periodic means to return excess capital to shareholders and the economy. As JPMorgan Chase & Co. CEO Jamie Dimon recently articulated in the company's 2018 Annual Report, "When companies buy back stock … the capital is redistributed to investors who can put it to good use elsewhere. It does not disappear."[8] That is, the funds are reallocated by the selling shareholders toward other investments and/or used for the consumption of goods and services.

Moreover, at the corporate level, a net reduction in shares outstanding lifts earnings per share and reduces the resulting dividend cash obligation, such that the per share pace of dividend growth can exceed the requisite change in dividend cash outlay. Indeed, even within Copeland's own Dividend Growth portfolios, many companies are consistent buyers of their own stock, so we don't inherently object to this decision. Given the flexible nature of buybacks, however, companies can just as easily decide NOT to repurchase shares in 2019 as they decided to purchase them in 2018.

Alternatively, in our experience, dividend decisions often offer significant insight into management's confidence in the future. Therefore, from Copeland's perspective, 2018's dividend growth was telling, at only 6% for large caps and 1% for small caps. This slow pace of dividend growth was markedly slower than the rapid pace of net income and cash flow growth during the year.

As we have noted before, boards of directors take great care before increasing the dividend. No board or management team wants to walk back or eliminate a dividend for fear of losing investor confidence or even their jobs. As a result, raising the dividend level indicates that management is confident that the business can

Chart 3. Dividends More Consistent than Buybacks



Source: S&P Dow Jones Indices

Table 1. Higher Earnings and Dividend Growth with Reasonable Valuation

Summary As of 03/31/19	Copeland Small Cap	R2000	Copeland SMID Cap	R2500	Copeland Mid Cap	RMID	Copeland Large Cap	SP500
1-Yr EPS Growth (Median)	21%	18%	19%	18%	19%	18%	23%	18%
1-Yr Dividend Growth Rate (Median)	10%	3%	10%	4%	11%	6%	14%	8%
NTM P/E Ratio	17.6x	17.4x	18.3x	17.1x	18.4x	16.5x	17.9x	16.4x
Dividend Yield (Weighted)	1.9%	1.3%	1.8%	1.5%	1.8%	1.6%	1.8%	1.8%

Source: FactSet and Copeland Capital

The table above shows the median dividend growth and median earnings growth for the Copeland Dividend Growth strategies and Indexes referenced for 1 year. There is no guarantee that investors will experience the type of growth reflected in the information presented. The portfolio characteristics of the Indexes may differ from other providers due to the source of the data and differences in calculation methodology. Historical data does not guarantee similar future results. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time. You cannot invest directly in an Index. For information on the Indexes shown above as well as other important information, please refer to the Disclosures below.

generate higher profits in the future in order to fully fund the increased dividend commitment. This is in stark contrast to share buybacks, which can ebb and flow from year to year without any investor uproar. Chart 3 displays the periodic spikes in corporate buyback activity alongside the more consistent trend in dividend growth over time. The ominous timing of previous buyback spikes in 2000 and 2007, just before steep market corrections, is just one more reason why Copeland is committed to following dividends as guide instead.

Copeland Finds Higher Growth and Reasonable Valuations

Those familiar with Copeland's investment philosophy know that we only invest in companies that demonstrate consistent year over year dividend growth. Further, it is those select dividend growers that effectively reinvest in their businesses for future growth that we prefer. Our rationale is that, when it comes to capital allocation, dividend growth companies that participate appropriately in all of the buckets – reinvesting in their businesses, growing dividends, repurchasing stock, servicing and paying down debt, and pursuing selective merger and acquisition opportunities, are most likely to be the best performing stocks over time. Reinvesting to sustain a high level of earnings growth enables elevated levels of dividend growth and drives capital appreciation. Importantly, we continue to find and own companies that are outpacing their relevant benchmarks in terms of both earnings and dividend growth (see Table 1), even post TCJA. To this, we can repeat over and over, like Bob Wiley, "I feel good, I feel great, I feel wonderful."

Of course, based on the year-to-date rally after a dismal fourth quarter, most investors seem to be repeating after Bob. *Barron's* even ran a cover story in early April, entitled, "Is the Bull Unstoppable – The Decadelong Rally Could Continue for Years, the Optimists Say."[9] We do believe that the increased incentive to invest capital domestically and ongoing repatriation should provide long-lived benefits to US corporations and the economy. Additionally, valuations are below historical median levels – at quarter-end, the S&P 500 Index was valued at 17.1x 2019 earnings versus a 30-year median P/E of 18.1x – not to mention that the Federal Reserve has shifted to a more accommodative stance.[10]

However, the trouble with robust growth is that year over year comparisons become more difficult in 2019 and some economic indicators are already slowing, such as the US Manufacturing PMI.[11] In addition, the same *Barron's* piece opened with a disclaimer that its cover story "could be a contrarian indicator signaling that the market has truly topped," a sentiment echoed by numerous pundits.

We'll avoid choosing sides, but we do know this: when a board decides to increase a company's dividend, it is publicly exhibiting confidence in the company's future ability to pay and maintain the higher dividend. In our experience, the higher bar sets these companies apart from the crowd and they tend to outperform with less risk over time. "I feel good, I feel great, I feel wonderful."

April 2019

[1] *S&P Down Jones Indices, March 25, 2018, https://www.prnewswire.com/news-releases/sp-500-q4-2018-buybacks-set-4th-consecutive-quarterly-record-at-223-billion-2018-sets-record-806-billion-300817734.html.*

[2] *"The Benefits of Cutting the Corporate Income Tax Rate," Tax Foundation, 14 April 2018, https://taxfoundation.org/benefits-cutting-corporate-income-tax-rate/.*

[3] *"Corporate inversions and economic performance," National Tax Journal, 1 December 2015, https://nyuscholars.nyu.edu/en/publications/corporate-inversions-and-economic-performance; see also "Tax Inversion," Bloomberg, 2 March 2017, https://www.bloomberg.com/quicktake/tax-inversion.*

[4] *"US Corporations' Repatriation of Offshore Profits," Federal Reserve, FEDS Notes, 4 September 2018, https://www.federalreserve.gov/econres/notes/feds-notes/us-corporations-repatriation-of-offshore-profits-20180904.htm*

[5] *IRS https://www.irs.gov/newsroom/new-rules-and-limitations-for-depreciation-and-expensing-under-the-tax-cuts-and-jobs-act and see also "The TCJA's Expensing Provision Alleviates the Tax Code's Bias Against Certain Investments," 5 September 2018, Tax Foundation, https://taxfoundation.org/tcja-expensing-provision-benefits/.*

[6] *US Bureau of Economic Analysis, "Table 4.2. U.S. International Transactions in Primary Income on Direct Investment," https://apps.bea.gov/iTable/iTable.cfm?ReqID=62&step=1 (accessed 18 April 2019).*

[7] *Lewis, Alan, and McKone, Dan. "So Many M&A Deals Fail Because Companies Overlook This Simple Strategy," Harvard Business Review, 10 May 2016, https://hbr.org/2016/05/so-many-ma-deals-fail-because-companies-overlook-this-simple-strategy.*

[8] *JP Morgan Chase & Co., 2018 Annual Report, https://reports.jpmorganchase.com/investor-relations/2018/ar-ceo-letters.htm.*

[9] *"Is the Bull Unstoppable," Barron's, 8 April 2019, https://www.barrons.com/magazine/20190408.*

[10] *S&P Dow Jones Indices, S&P 500 Index Earnings.*

[11] *TradingEconomics, United States Manufacturing PMI, https://tradingeconomics.com/united-states/manufacturing-pmi.*

About Copeland Capital Management — Copeland Capital Management is an employee owned, registered investment adviser with offices in Conshohocken PA, Wellesley MA and Atlanta GA. The firm specializes in managing Dividend Growth strategies for both institutions and high net worth individuals. For more information, please contact Chuck Barrett, Senior Vice President - Director of Sales and Marketing at (484) 351-3665, cbarrett@copelandcapital.com or Robin Lane, Marketing Manager at (484) 351-3624, rlane@copelandcapital.com.

Disclosure Section:

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Currency -Unless otherwise specified or disclosed, the currency used for data in the report is US Dollar (USD).

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Definitions

Gross Buybacks - The amount of cash paid by a company for buying back its common shares over the past year.

Capital Expenditures (CAPEX) - Capital expenditures, commonly known as CapEx, are funds used by a company to acquire, upgrade, and maintain physical assets such as property, buildings, an industrial plant, technology, or equipment.

Dividend Growth Rate -The annualized percentage rate of growth that a particular stock's dividend undergoes over a period of time.

Dividend Yield -The company's total annual dividend payments divided by its market capitalization, or the dividend per share, divided by the price per share.

EPS Growth – Earnings Per Share Growth illustrates the growth of earnings per share over a period of time.

Net Income – Net Income is equal to net earnings (profit) calculated as sales less cost of goods sold, selling, general and administrative expenses, operating expenses, depreciation, interest, taxes and other expenses. This number appears on a company's income statement and is an important measure of a company’s profitability.

NTM P/E Ratio - The Next Twelve Months Price-to-Earnings Ratio of a stock is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share.

Operating Cash Flow (OCF) - Operating cash flow is a measure of the amount of cash generated by a company's normal business operations. Operating cash flow indicates whether a company can generate sufficient positive cash flow to maintain and grow its operations, or it may require external financing to fund operations and capital investments.

Research and development (R&D) - The activities companies undertake to innovate and introduce new products and services. It is often the first stage in the development process. The goal is typically to take new products and services to market and add to the company's bottom line.

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