



Hunting for Large Dividend Increases

QUARTERLY REPORT 3Q 2022



“How am I doing?”

It's a natural question for any investor to ask. We would all like assurances that we are on the path to achieving our long-term financial goals, but sometimes it can be difficult to have confidence given the day-to-day swings in the markets. We have written extensively about the performance of high-yield dividend stocks over long holding periods:

- **High-yield stocks, held for rolling 10-year holding periods, have averaged 12.1% compound annual returns versus the S&P 500 Index's 10.3% over the past 50 years.**

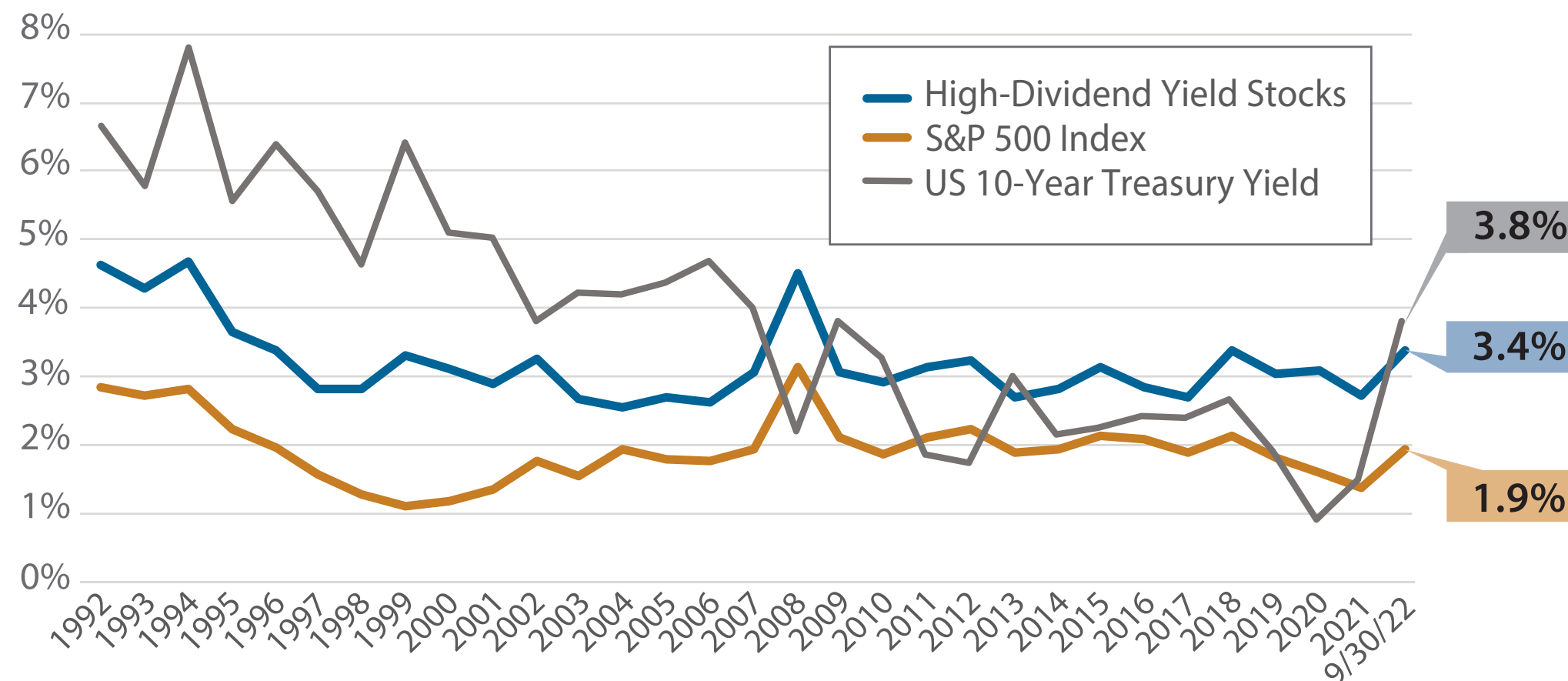
(See Miller/Howard 1Q 2022 Quarterly Report.)

- **High-yield stocks, held for rolling 10-year holding periods, have outperformed the S&P 500 and bonds in every decade going back to the 1960s.**

(See Miller/Howard 2Q 2021 Quarterly Report.)

Investors who ride out periods of equity market volatility have been well rewarded by sticking with high-yield stocks. Yet, “How am I doing?” remains a fair question from savers. With gyrating stock prices, there is no easy answer, and the question becomes more pointed as interest rates rise. As the quarter closed, the interest rate on a 10-year US Treasury bond was 3.8%. An investor might reasonably be tempted to lock in that return for the next 10 years rather than worry about the swings of the equity market. A simple rebuttal to this plan would be that over past 50 years, there were only two 10-year holding periods in which high-yield equities produced compound average returns of less than 3.8%, albeit still positive. (See Miller/Howard 1Q 2022 Quarterly Report.)

Bond Yields Have Improved



Data as of September 30, 2022.
Source: Bloomberg; Miller/Howard Research & Analysis.
High-Dividend Yield Stocks consists of Decile 7, 8, and 9 (where decile 10 is the highest yielding members and decile 1 the lowest) of a universe of US dividend paying common stocks with a market capitalization equal to or greater than \$1 billion.

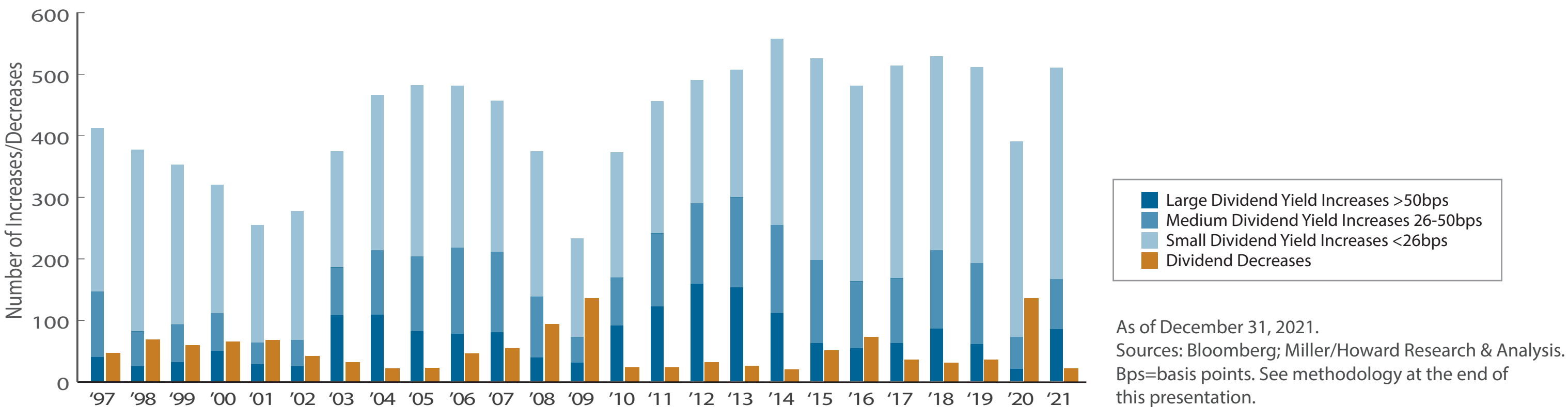
But there is no guarantee that history will repeat itself. The argument for equities is easiest when the dividend yield is well above the bond yield, such as we saw during 2020. With that set up, even dismal equity markets with flat dividends and stock prices over a 10-year period would lead equities to outperform bonds.

As interest rates rise above dividend yields, it becomes more important to income investors that dividends grow.

The good news is that dividend increases are common and much more frequent than decreases.

Looking at the stocks in the Russell 1000 Index over the past 25 years, 427 companies increased their dividend each year on average, while only 52 cut their dividend. And this is not ancient history—last year, 509 companies in the Russell 1000 raised their dividend while only 23 decreased. Naturally, there are more decreases during difficult years such the end of the Internet Bubble (2000-2001), the Global Financial Crisis (2008-2009) and the pandemic (2020). But even in these challenging years, increases still strongly outpaced decreases.

Dividend Increases/Decreases of Russell 1000 Index



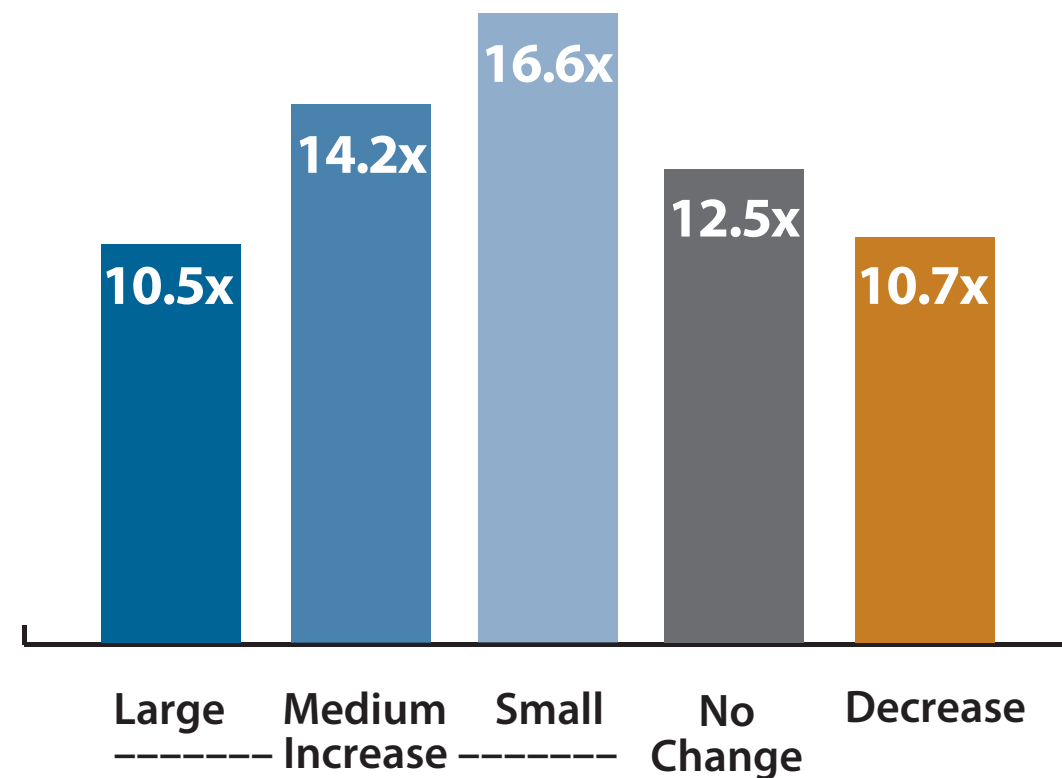
At Miller/Howard, we are dedicated to increasing the income our clients earn from their portfolios. Evaluating the impact of dividend hikes on portfolio income reveals the importance of large increases. Many companies brag about increasing their dividend year after year, but if a dividend is only rising by 1%, that will not generate the income growth we are after. More subtly, sometimes large-sounding increases are not so big after all. If a stock selling at \$100 raises its dividend from one cent per quarter to two cents, that may lead to headlines touting a doubling of the dividend, but it's only a 0.04% increase in the annual yield—hardly worth mentioning.

In an effort to learn what factors have led to sizable dividend increases, we analyzed the dividend changes in the Russell 1000 over the past 25 years, focusing on the companies that were paying a dividend in the preceding year. We have separated all dividend increases into three categories: large (greater than 0.50% increase in dividend yield, as measured by the percentage point difference between ending and starting yield), medium (0.26-0.50% increase in yield) and small (less than 0.26% increase in yield). There is no grade inflation in this class—over time, only 17% of dividend increases have been big enough to meet our definition of “large.” Small dividend increases have accounted for 61% of the increases.

The percentage of large and medium increases has fluctuated over the years, primarily going up as market recoveries age. The increase in 2003 can also be attributed to a reduction in the income tax on dividends. The most important point is that every year offers opportunities to find large increasers, so **what characteristics are associated with the companies announcing the largest hikes?**

Valuation Versus Dividend Changes

Price/Earnings Ratio



As of September 30, 2022.

Sources: Bloomberg; Eikon; Miller/Howard Research & Analysis. Increases: Large >50bps; Medium 26-50bps; Small <26bps.

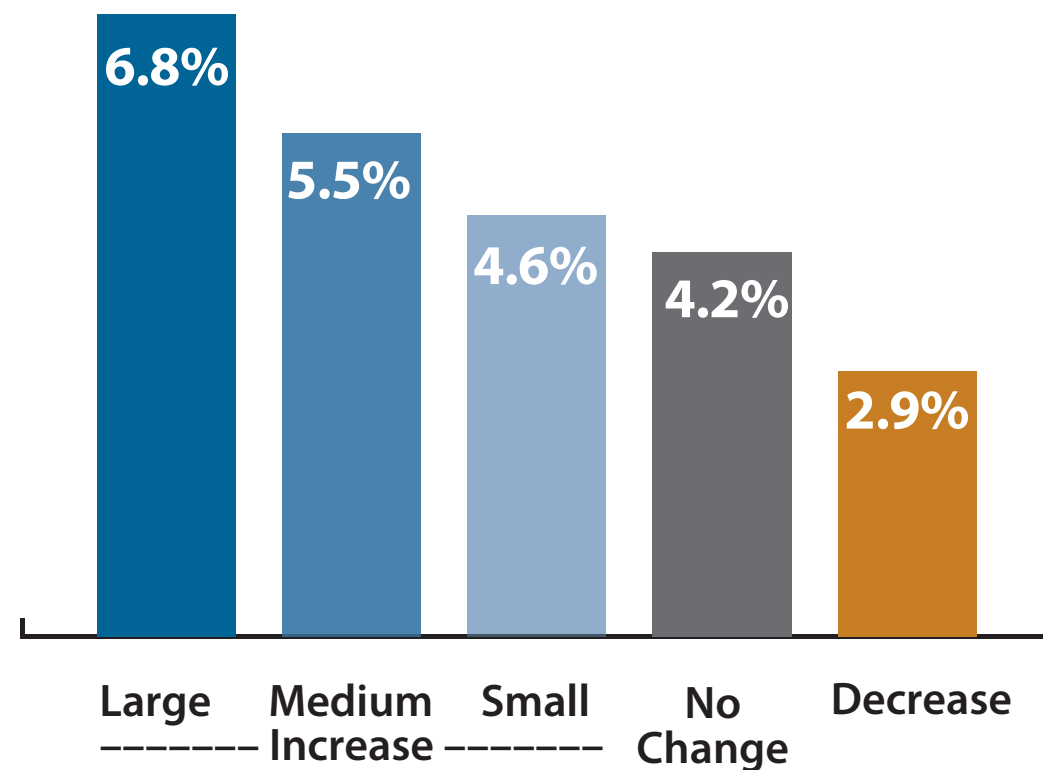
NOTE: Price/Earnings (P/E) Ratio is calculated using the universe of the earnings yield as of calendar year end selection dates for dividend payers in the Russell 1000 Index. Members with negative earnings have been excluded. See methodology at the end of this presentation.

Value is a natural place to start our hunt for large dividend increasers. After all, a company with a \$100 stock and \$10 of earnings per share has a lot more firepower to raise its dividend by 50 cents than a company with the same stock price and one-tenth of the earnings.

Looking at roughly 16,000 dividend decisions in the Russell 1000 over 25 years, the evidence on using price-to-earnings ratios to identify large increasers is mixed. Among companies raising their dividend, there is an unambiguous relationship between value and the size of the increase—lower price/earnings ratios are associated with larger dividend increases. The weakness of price/earnings as a prediction tool is that it does not do a good job distinguishing between likely increasers and potential dividend cutters. In fact, the average price/earnings ratio for the largest increasers is roughly equal to the ratio for dividend cutters.

Valuation Versus Dividend Changes

Free Cash Flow Yield



As of September 30, 2022.

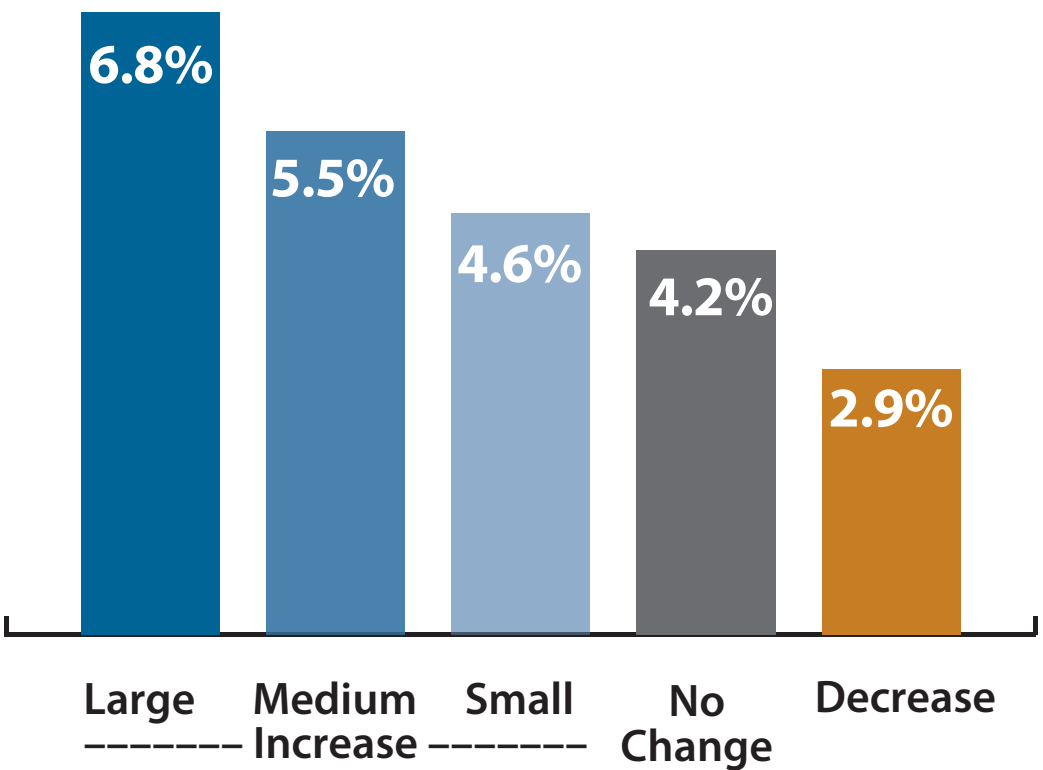
Sources: Bloomberg; Eikon; Miller/Howard Research & Analysis. Increases: Large >50bps; Medium 26-50bps; Small <26bps.

NOTE: Free Cash Flow (FCF) Yield is calculated using the trailing 12-month FCF and price as of end of calendar year selection dates for dividend payers in the Russell 1000 Index. For FCF Yield, financials, real estate, and utilities (as defined by Eikon) are excluded as it is not a meaningful metric for those sectors. See methodology at the end of this presentation.

Our view is that earnings can be a lagging indicator of the health of a business. Accrual accounting fails to sufficiently penalize companies for red flags on the cash flow statement such as rising inventories or increased capital spending. For the core of the market (which excludes financials, real estate, and utilities, where free cash flow is not a useful metric), we prefer free cash flow yield, defined as cash flow from operations less capital spending, divided by market capitalization. Free cash flow represents the actual cash that is available to pay dividends, reduce debt, or buy back shares. Accountants have good reason for creating accruals to adjust for items such as changes in working capital or capital spending, but ultimately, dividends must be paid out of cash flow, not earnings.

Valuation Versus Dividend Changes

Free Cash Flow Yield



As of September 30, 2022.

Sources: Bloomberg; Eikon; Miller/Howard Research & Analysis. Increases: Large >50bps; Medium 26-50bps; Small <26bps.

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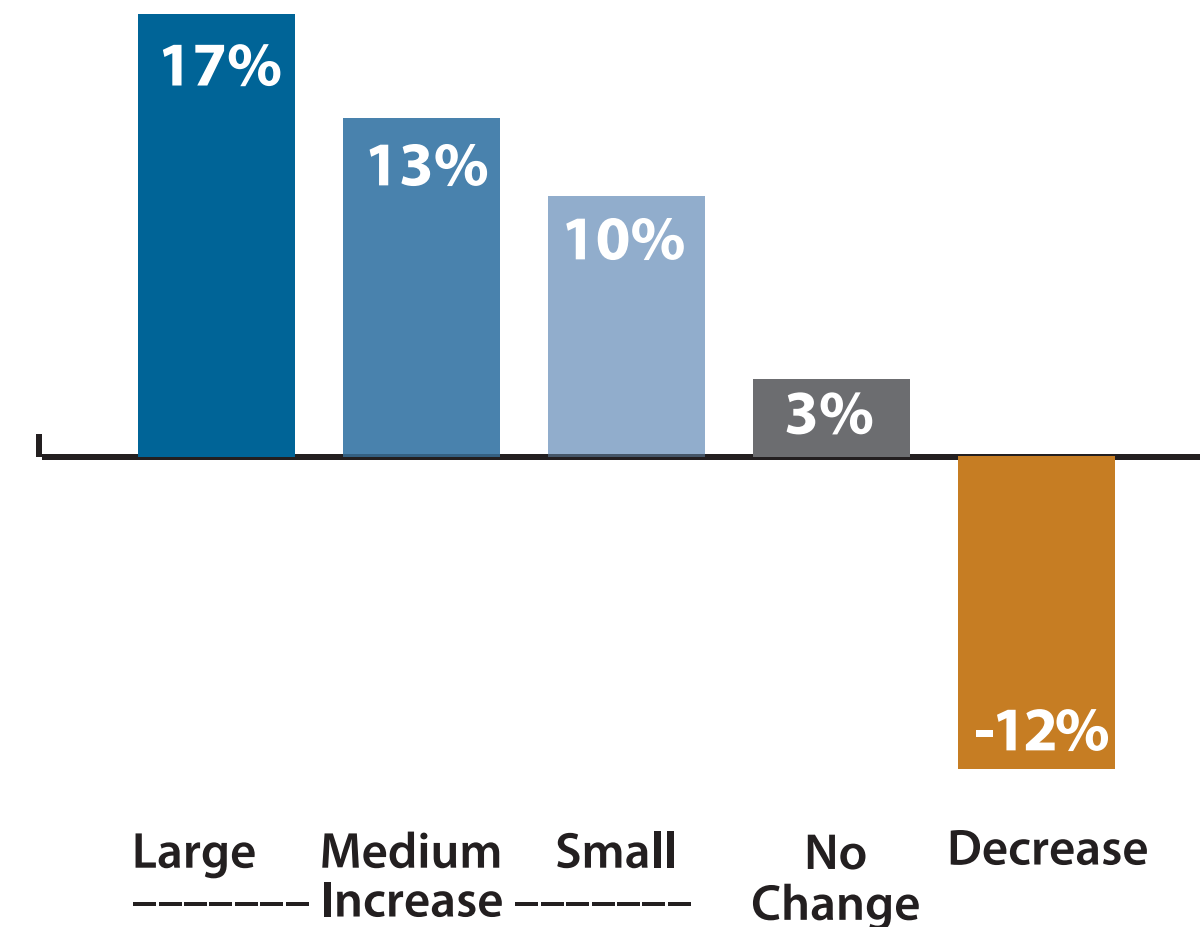
In fact, a direct relationship between free cash flow yield and the size of a dividend increase holds true across our categories. When we examine our database of Russell 1000 dividend decisions, we see that the largest dividend increasers had the highest average free cash flow yield in the preceding year. Dividend cutters had the lowest average free cash flow yield in the preceding year. Overall, we view free cash flow yield as the best value metric when hunting for large dividend increasers.

One of the key tenets of income investing is that dividends are dependable because management teams are loath to cut dividends. We have seen that dividend decreases do occur every year, but they are typically outnumbered by increases by roughly eight-to-one. In general, management teams are doing a good job of looking ahead, and largely avoiding increases that have to be reversed in a future year. One possible way management teams can avoid dividend cuts is by raising dividends only when their business is actually growing. **We researched three measures: earnings per share (EPS) growth, free cash flow growth, and sales growth.**

Examining EPS growth for the over 16,000 dividend decisions in our database, we conclude that large dividend increases are associated with rapid EPS growth. Companies that raised their dividend yield over 0.50% on average grew EPS by 17% in the year prior to the large dividend increase. Those announcing increases that raised yields by 0.26-0.50% also had high trailing growth in EPS at 13%. Even companies making small dividend increases had trailing EPS growth of 10%, well above the 3% EPS growth for companies holding their dividend flat. In contrast, dividend cutters averaged -12% EPS decline in the year before the cut.

Growth Versus Dividend Changes

Earnings Per Share Growth

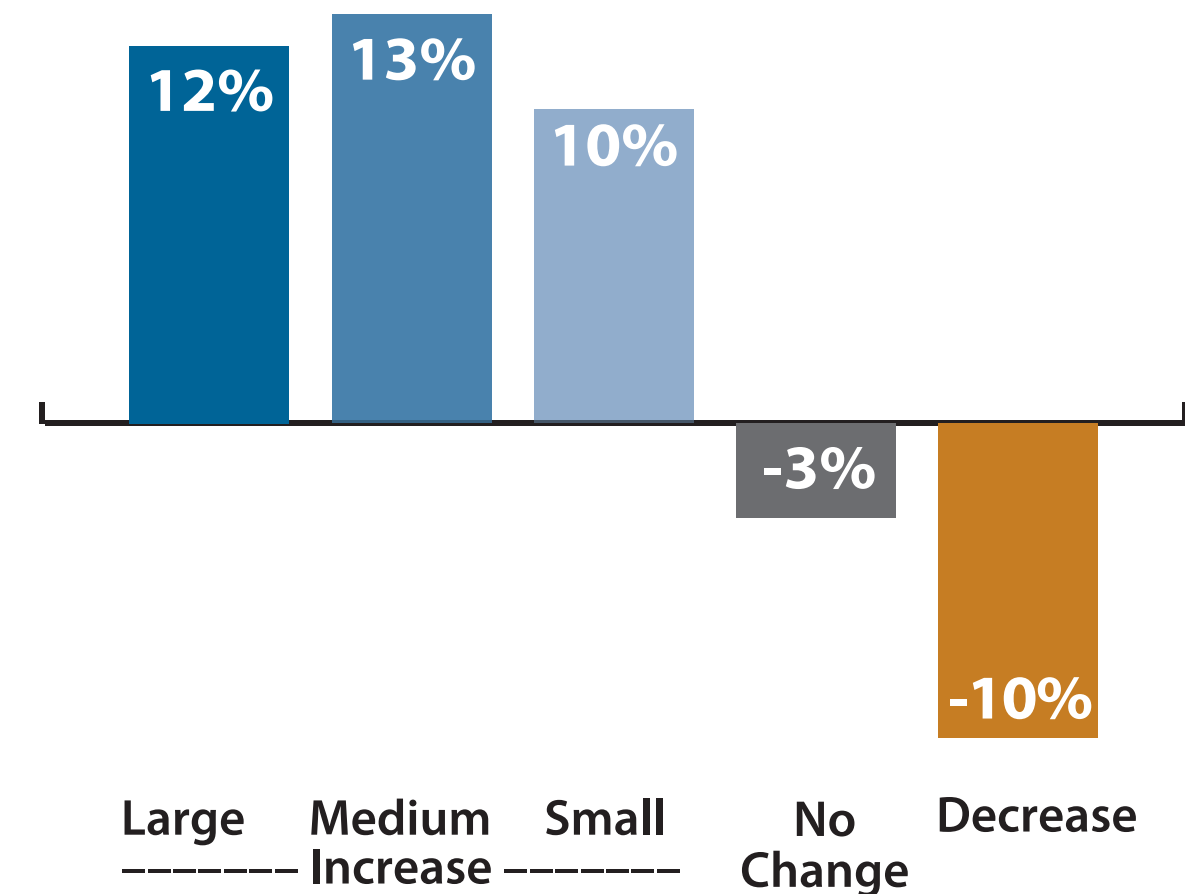


As of December 31, 2021. Sources: Bloomberg; Miller/Howard Research & Analysis.
Increases: Large >50bps; Medium 26-50bps; Small <26bps.
Outliers with growth values exceeding +/-100% are winsorized. See methodology at the end of this presentation.

Growth Versus Dividend Changes

High free cash flow growth was also associated with dividend increases while companies that held their dividend flat averaged -3% free cash flow decrease in the prior year. Dividend cutters averaged a drop in free cash flow of -10%. While useful for predicting dividend increases, free cash flow growth is less useful than EPS growth in predicting the size of the dividend increase. One explanation for why EPS growth works better than free cash flow growth is that the latter tends to be noisy while EPS data is smoothed by construction. It appears that using the smoother data series works better when constructing growth factors.

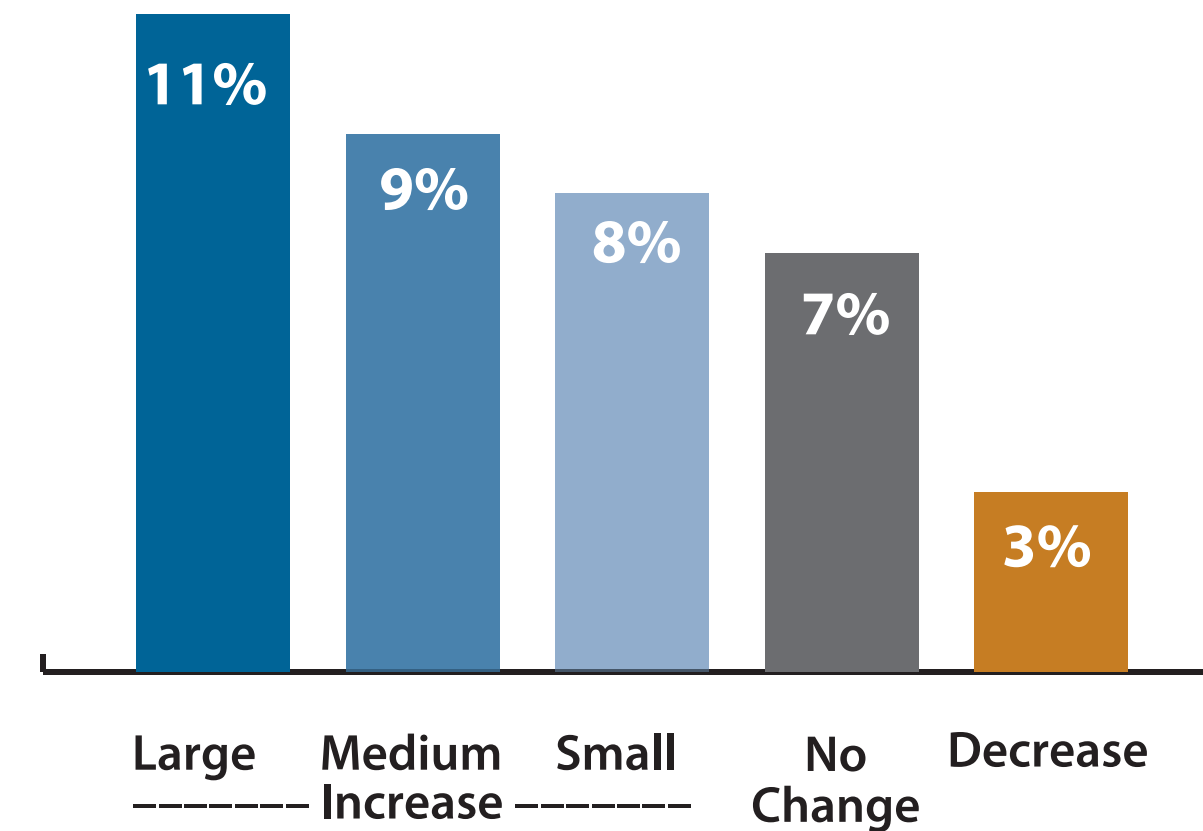
Free Cash Flow Growth



As of December 31, 2021. Sources: Bloomberg; Miller/Howard Research & Analysis.
Increases: Large >50bps; Medium 26-50bps; Small <26bps.
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Growth Versus Dividend Changes

Sales Growth

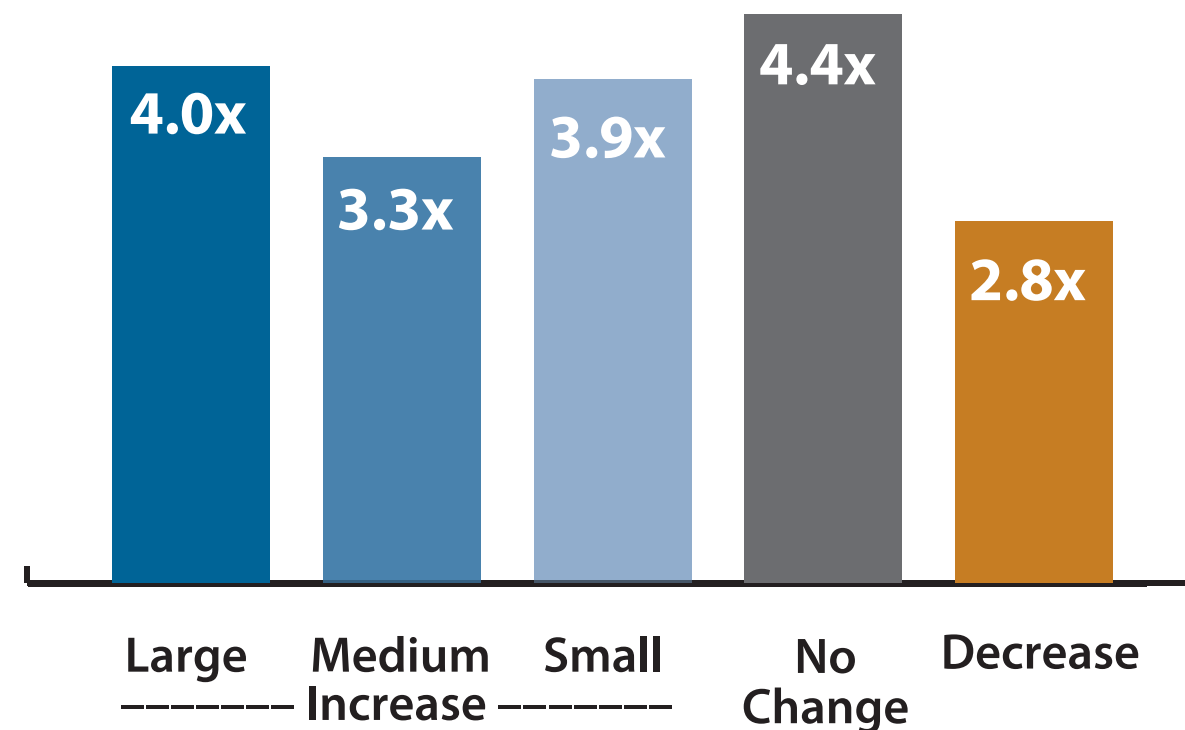


Sales growth proved to be a useful variable for predicting dividend increase size, with higher growth associated with larger dividend increases. Dividend cutters averaged only 3% sales growth in the preceding year, well below the 7% average for companies holding their dividend flat.

As of December 31, 2021. Sources: Bloomberg; Miller/Howard Research & Analysis.
Increases: Large >50bps; Medium 26-50bps; Small <26bps.
Outliers with growth values exceeding +/-100% are winsorized. See methodology at the end of this presentation.

Dividend Coverage Versus Dividend Change

Earnings Coverage



As of September 30, 2022.

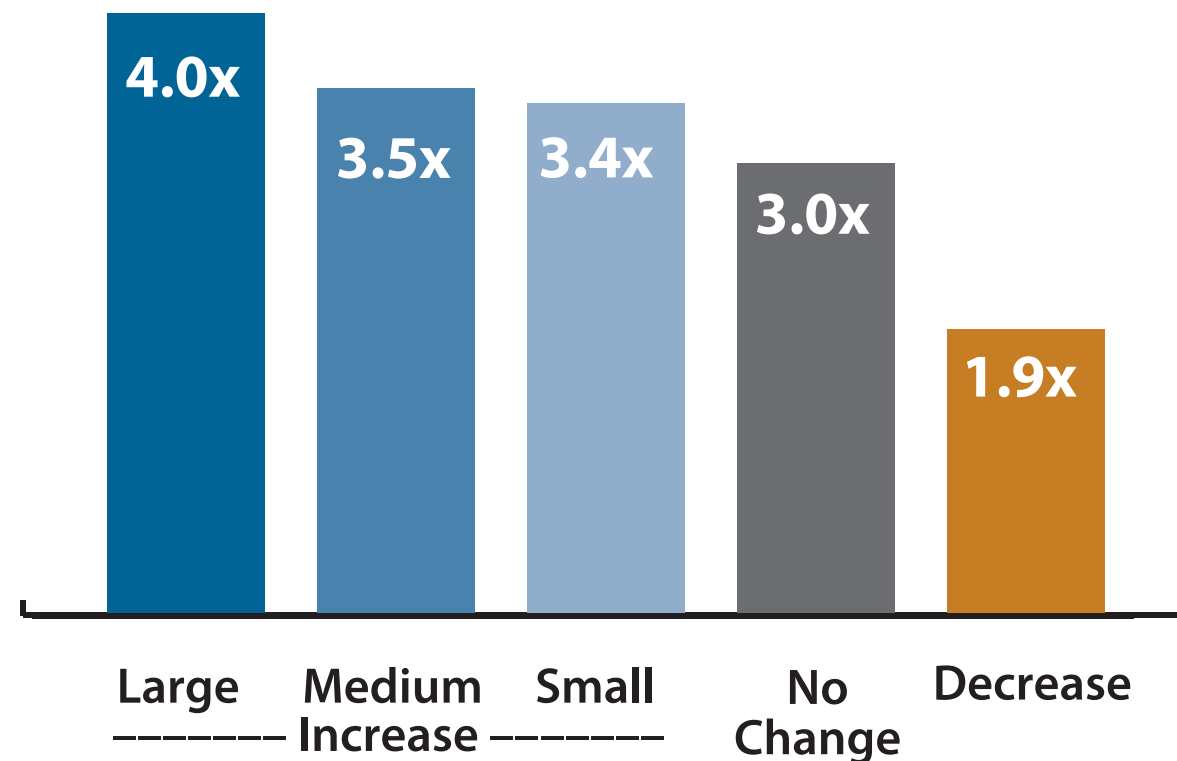
Sources: Bloomberg; Miller/Howard Research & Analysis.

Note: Earnings Coverage is calculated using the trailing 12-month earnings per share in relationship to the indicated annual dividend per share as of the calendar year end selection date. Members with negative earnings have been excluded. Increases: Large >50bps; Medium 26-50bps; Small <26bps. Coverage exceeding +/-25x are winsorized. See methodology at the end of this presentation.

Traditionally, high earnings coverage has been viewed as an indication of dividend safety. But does a high ratio of earnings to dividends portend large dividend increases? Our study indicates that earnings coverage does not help identify large increasers. In fact, the earnings coverage was actually highest for companies keeping their dividend flat. Consistent with conventional wisdom, the coverage ratio for dividend cutters was lower than for companies either increasing the dividend or holding it flat.

Dividend Coverage Versus Dividend Change

Free Cash Flow Coverage



As of September 30, 2022.

Sources: Bloomberg; Miller/Howard Research & Analysis.

Note: Free Cash Flow Coverage is calculated using the trailing 12-month FCF in relationship to the trailing 12-month dividends paid as of the calendar year end selection date. Coverage represented is for dividend payers in the Russell 1000 Index as of calendar year end selection dates. For free cash flow coverage, sectors financials, real estate, and utilities are excluded. Increases: Large >50bps; Medium 26-50bps; Small <26bps. Coverage exceeding +/-25x are winsorized. See methodology at the end of this presentation.

In contrast to earnings coverage, free cash flow coverage (the ratio of free cash flow-to-dividends) is much more useful in identifying large increasers.

For free cash flow coverage, the relationship holds across our five decision categories:

- **large increasers** have the highest average free cash flow coverage,
- followed by **medium increasers**,
- then **small increasers**,
- then companies holding their **dividend flat**,
- with **dividend cutters** having the lowest ratio of free cash flow to dividends.

Why would free cash flow coverage work better than earnings coverage?

Accrual accounting goes through many machinations to match revenue and expenses in the correct time period. For many uses this makes sense, but it can miss the point when it comes to measuring the ability to write large dividend checks. For example, large capital expenditures are clearly costs that can be matched to revenues far in the future, but they drain the ability of a company to pay dividends *now*.

How does indebtedness affect dividend-paying behavior?

It turns out that the ratio of net debt/EBITDA is not helpful in predicting the size of dividend increases, but it is highly useful in separating likely dividend increasers from companies at risk of cutting their dividend.

For companies levered less than 2x EBITDA, 68% increased their dividend while only 5% cut. In contrast, companies levered over 3x increased their dividend only 39% of the time and cut 15% of the time. These results are for the entire 1997-2021 time period, but debt is more dangerous in troubled times. Looking at the results only for the Global Financial Crisis period, 2008-2009, we see that the most levered companies cut their dividend 26% of the time. In our opinion, any equity income portfolio that has roughly a quarter of its holdings cut the dividend would generate very disappointing results.

High Debt Makes Dividend Increases Less Likely

Russell 1000 Dividend Changes

Net Debt/EBITDA	1997-2021				Net Debt/EBITDA	Case Study Global Financial Crisis: 2008-2009			
		Dividend Increase	Flat Dividend	Dividend Decrease			Dividend Increase	Flat Dividend	Dividend Decrease
	>3x	39%	46%	15%		>3x	23%	51%	26%
	2-3x	57%	34%	9%		2-3x	40%	37%	23%
	<2x	68%	27%	5%		<2x	54%	40%	6%

As of December 31, 2021. Sources: Bloomberg; Eikon; Miller/Howard Research & Analysis. Note: We examined the period of 2008-2009 to see the impact of leverage on company dividends during a major recessionary environment. Net Debt to EBITDA is calculated as total debt minus cash dividend by EBITDA as of the calendar year end selection date. Sectors financials, real estate, and utilities have been excluded for net debt/EBITDA calculations. See methodology at the end of this presentation.

It can be easy for investors to talk themselves into buying levered companies. If sales forecasts come true, profit can zoom because interest payments do not rise with revenue. “Everything will work out fine” might actually be true most of the time. The problem is that, when setbacks occur, overly indebted companies are fragile and something has to give—frequently leading to a dividend cut.

At Miller/Howard, we want our clients to get paid for holding stocks, even in rocky times. For this reason, we focus on companies with strong balance sheets.

Do Prior Dividend Changes Predict Future Changes?

Prior Year Change			Dividend Increase			Dividend Increase Subtotal	Flat Dividend	Dividend Decrease
			Large	Medium	Small			
	Dividend Increase	Large	29%	24%	19%	72%	20%	8%
		Medium	11%	39%	32%	82%	12%	5%
		Small	3%	10%	70%	84%	11%	5%
	Flat Dividend		6%	6%	14%	26%	61%	12%
	Dividend Decrease		12%	7%	11%	30%	50%	20%

As of December 31, 2021.
Sources: Bloomberg; Eikon; Miller/Howard Research & Analysis. Numbers may not sum due to rounding. For the above, we screened for dividend paying members of the Russell 1000 Index by calendar year end-date. Increases: Large >50bps; Medium 26-50bps; Small <26bps. See methodology at the end of this presentation.

Some might argue that looking for dividend decision patterns using company fundamentals is unnecessary—perhaps we can just study past behavior. It turns out there is some truth to this, but it is most useful for identifying companies that will make small increases or no change to the dividend.

For companies that made a small increase in the previous year, there was an 84% chance that they would increase the dividend again, but the vast majority of the time it was only another small hike. For companies holding the dividend flat in the preceding year, 61% of the time they held it flat again.

But our hunt is for sizable dividend increases. Companies making a large dividend increase decided to make another large increase the second year 29% of the time. Those are better odds than you would get from companies that did not make a large increase last year, but it's still far from a sure thing. Our conclusion is that trailing behavior is useful, but it is best combined with fundamental factors.

Dividend behavior is tightly linked to strong fundamentals—a high free cash flow yield, growing EPS, growing sales, and low debt. In essence, the companies in a good equity income strategy are healthy, growing businesses. They have to be in order to meet their dividend commitments.

When evaluating performance, dividend increases offer a useful window into the long-term income potential of a portfolio.

Dividend increases reflect management's confidence in their ability to pay dividends far into the future. Wall Street veterans often accuse corporate leaders of having overly optimistic forecasts. In our view, dividend decisions strip away much of the hubris and give investors a more honest assessment from management. This occurs for two reasons. First, paying dividends involves writing actual checks—not happy talk. Secondly, management teams understand that the market punishes cutters, forcing more than a modicum of conservatism into their dividend decisions. Overall, dividend increases outnumbering decreases by eight-to-one is the strongest evidence that dividend increases are a solid signal of future cash generation.

Methodology for Charts on pages 5-21:

We screened for members of the Russell 1000 Index by Calendar Year end-date beginning in 1997. Among dividend paying members of the resulting universe, an annualized dividend was calculated for both the year and the prior year based on the fourth quarter dividend paid for year one and year minus one (fourth quarter dividend multiplied by 4). To calculate the change in yield, the calendar year end date price was used. For example: For 2021 data, we screened for members of the Russell 1000 Index as of 12/31/2020. For each dividend payer in the resulting universe, the 2021 Q4 dividend was multiplied by 4 as well as the previous period dividend (2020 Q4). The formula to calculate change in basis points was $((2021 \text{ Q4 dividend} \times 4) - (2020 \text{ Q4 dividend} \times 4)) / 2020 \text{ calendar year end price}$. For annual payers, the annual dividend and prior annual dividend were compared. For semi-annual payers, the second dividend paid was multiplied by 2 rather than 4. Specials were excluded from all calculations. Calendar Years 2012 and 2013 were modified to adjust for dividend actions taken by companies in response to changes in tax laws around dividends.



DISCLOSURE

Miller/Howard Investments Inc. is an independent, research-driven investment boutique with over three decades of experience managing portfolios for major institutions, mutual funds, and individuals in dividend-focused investment strategies. The firm is 100% employee-owned through an Employee Stock Ownership Plan (ESOP).

We continue to evolve and develop strategies that strive to provide investors with various levels of current income and dividend growth. Our objectives are to generate total returns in line with the broad equity market and provide a high and rising stream of income with the lower volatility that an investor might seek from bonds or other income alternatives. With a primary goal of reliable income and long-term returns, coupled with a belief that investors can play an important role in securing a sustainable future, our shareholder advocacy efforts include environmental, social, and governance (ESG) research and/or screening, direct engagement with companies, filing shareholder resolutions, proxy voting, coalition building, and public policy involvement.

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DEFINITIONS:

S&P 500 Index® widely regarded as the best single gauge of large-cap US equities and serves as the foundation for a wide range of investment products. The Index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Price-Earnings Ratio (P/E)—The ratio of a company's share price to its earnings per share. The ratio is used as a valuation tool and can help determine whether a company is overvalued or undervalued.

Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)—A non-GAAP measure used to provide an approximation of a company's profitability. This measure excludes the potential distortion that accounting and financing rules may have on a company's earnings; therefore, EBITDA is a useful tool when comparing companies that incur large amounts of depreciation expense because it excludes these noncash items, which could understate the company's true performance.

High-Dividend Yield Stocks consists of Decile 7, 8, and 9 of a universe of US dividend paying common stocks with a market capitalization equal to or greater than \$1 billion.

Net Debt to EBITDA—A measure that computes the company's ability to pay off its debt by utilizing the earnings before interest, taxes, depreciation, and amortization (EBITDA).

Russell 1000 Index® measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000 Index® and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 Index® represents approximately 92% of market capitalization of the US market.

US Treasury 10-Year Yields are yield to maturity and pretax. Indexes have increased in precision as of May 20, 2008, to 4 decimal places. The rates comprise Generic US Government on-the-run government bill/note/bond indexes.

For more information and to request materials: Visit www.mhinvest.com or contact our Internal Sales Desk, email internals@mhinvest.com or call (845) 679-9166.

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Notification to Clients: Contact your Advisor with any material changes to your financial profile that would impact your appropriateness for investment.

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