Miller Howard
INVESTMENTS

Is Your Money Working for You or Corporate Management?

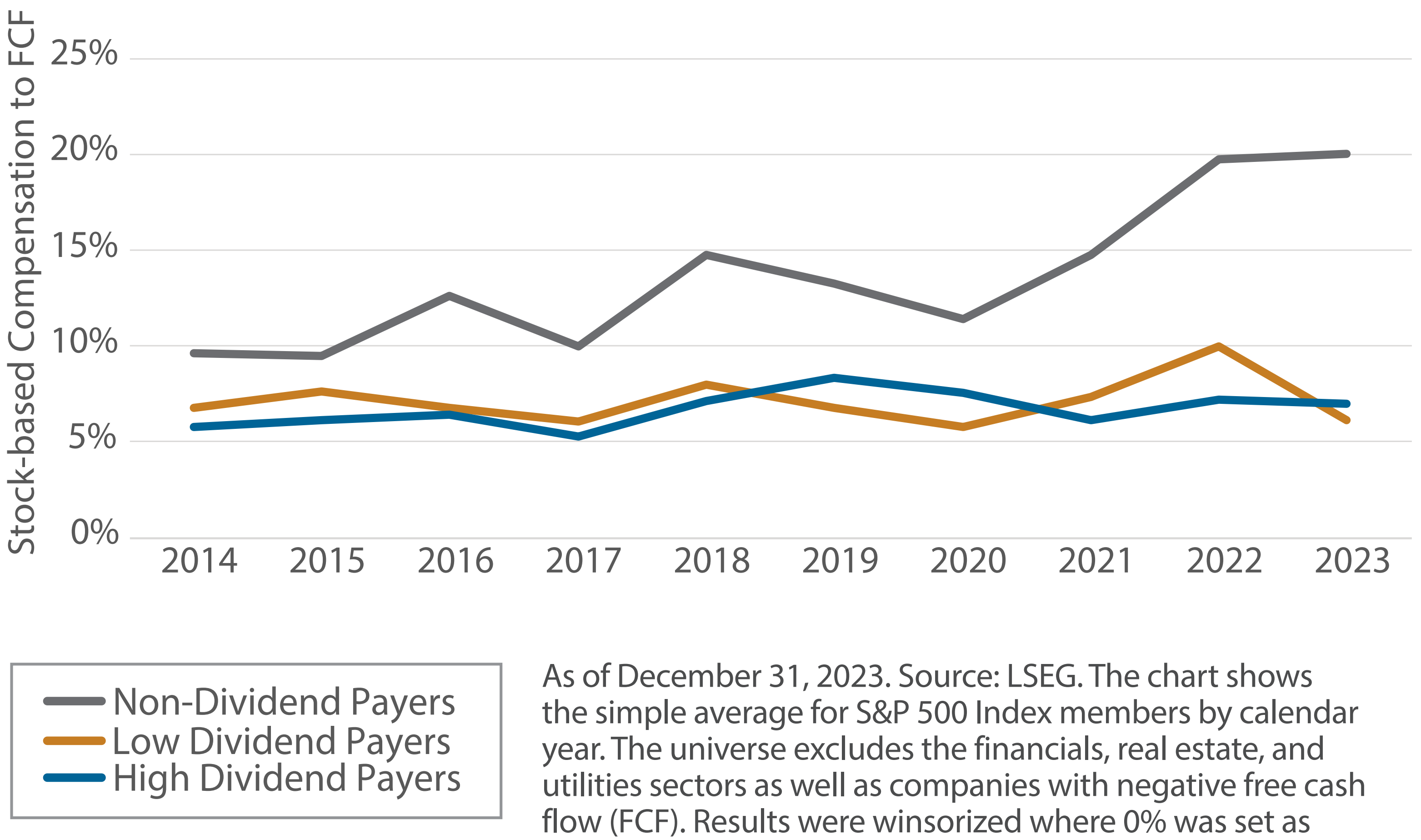
QUARTERLY REPORT 2Q 2024

The investment world has been smitten with picking stocks based on free cash flow (FCF, defined as cash flow from operations minus capital expenditure) over the past decade. The basic idea of this approach is to favor capital-light business models or companies in "harvest mode," meaning that capital investments have been made and now cash flow is plentiful. At Miller/Howard, we largely embrace this viewpoint, but our research-driven culture demands that we examine the quality of free cash flow. Looking under the hood, one issue leaps out—high levels of non-cash executive compensation at many companies, particularly non-dividend payers.

The use of stock or option-based compensation schemes is common across all industries. Accountants estimate the expected value of the awards and treat it as a cost when calculating net income. **When it comes to cash flow, the cost of stock and option compensation is *added* back to net income because these awards have no *current* cash costs. For investors, it's not that a check is in the mail—in contrast, a bill is coming.** The ultimate cost of non-cash compensation will be higher the better a company does, taking the shine off the upside.

The good news is that cash flow statements tell us exactly how much of free cash flow is coming from companies using non-cash compensation rather than salaries and cash bonuses. Looking at the S&P 500 Index's core members (leaving out financials, real estate and utilities for which free cash flow is not a useful metric) over the past 10 years, **companies without regular dividends have increasingly sourced their free cash flow from non-cash compensation.** For the last two years, these nondividend payers had roughly one-fifth of free cash flow come from using non-cash compensation. In contrast, regular dividend payers consistently sourced much less of their free cash flow from stock-based compensation. In our opinion, with their more judicious use of non-cash compensation, dividend-paying firms are sending a clear signal that they are managing their businesses for the benefit of shareholders.

Non-Dividend Payers Have Increasingly Sourced Free Cash Flow from Non-Cash Compensation



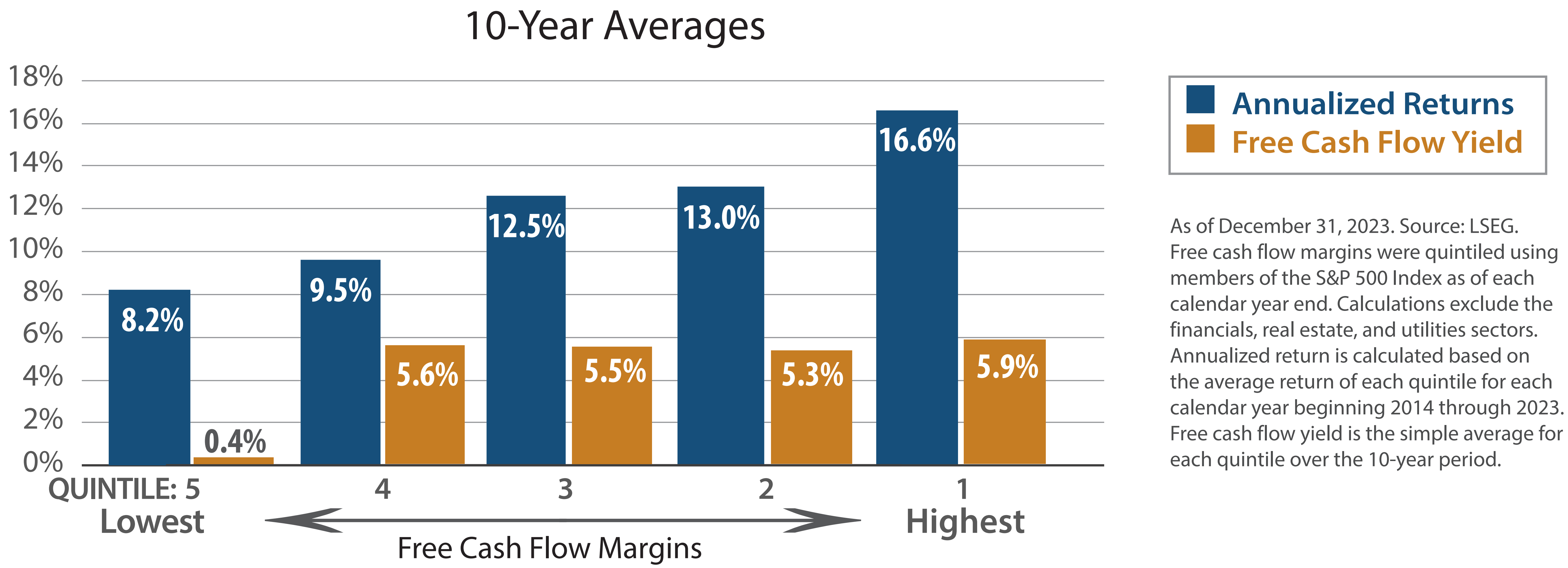
As of December 31, 2023. Source: LSEG. The chart shows the simple average for S&P 500 Index members by calendar year. The universe excludes the financials, real estate, and utilities sectors as well as companies with negative free cash flow (FCF). Results were winsorized where 0% was set as the lowest value and 100% as the highest value. Dividend groups are constructed based on indicated yield at the beginning of each calendar period, with Low Dividend Payers being the bottom half of the results, and High Dividend Payers being the top half.

The Free Cash Flow Story

Before we analyze how investors may be missing the potential problems with heavy use of noncash executive compensation, let's first review why investors have focused on free cash flow in recent years. From a stock-picking perspective, free cash flow ***margin,*** defined as free cash flow per dollar of revenue, has been an excellent predictor of total returns over the past 10 years. Stocks in the highest quintile of free cash flow margins have had more than double the returns of stocks in the lowest quintile.

High free cash flow margins suggest that firms can reliably convert revenue growth into higher levels of free cash flow. The key assumptions are that free cash flow margins will remain high, revenue will grow, and most importantly, valuation does not matter given that free cash margins are entirely independent of stock prices.

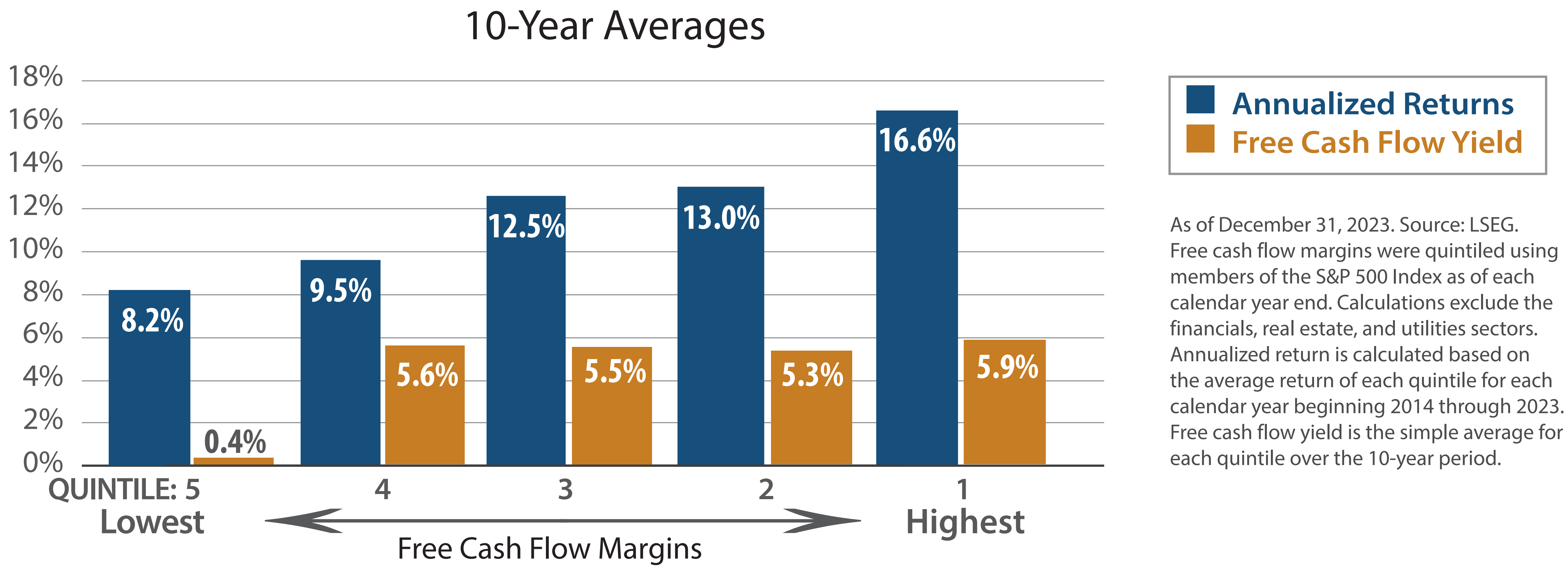
Higher Free Cash Flow Margins Outperformed Without Runaway Valuations



As of December 31, 2023. Source: LSEG. Free cash flow margins were quintiled using members of the S&P 500 Index as of each calendar year end. Calculations exclude the financials, real estate, and utilities sectors. Annualized return is calculated based on the average return of each quintile for each calendar year beginning 2014 through 2023. Free cash flow yield is the simple average for each quintile over the 10-year period.

Free cash flow ***yield***, defined as the amount of the free cash flow per dollar of market capitalization, is a useful valuation metric. The quirk of the trailing decade is that the top four quintiles of free cash ***margins*** averaged roughly the same valuation, between 5-6% free cash flow ***yield***, allowing investors to tilt towards high free cash flow ***margins*** without having to compromise too much on valuation (meaning free cash flow ***yield***).

Higher Free Cash Flow Margins Outperformed Without Runaway Valuations



As of December 31, 2023. Source: LSEG. Free cash flow margins were quintiled using members of the S&P 500 Index as of each calendar year end. Calculations exclude the financials, real estate, and utilities sectors. Annualized return is calculated based on the average return of each quintile for each calendar year beginning 2014 through 2023. Free cash flow yield is the simple average for each quintile over the 10-year period.

Let’s see how the free cash flow story intersects with dividend investing.

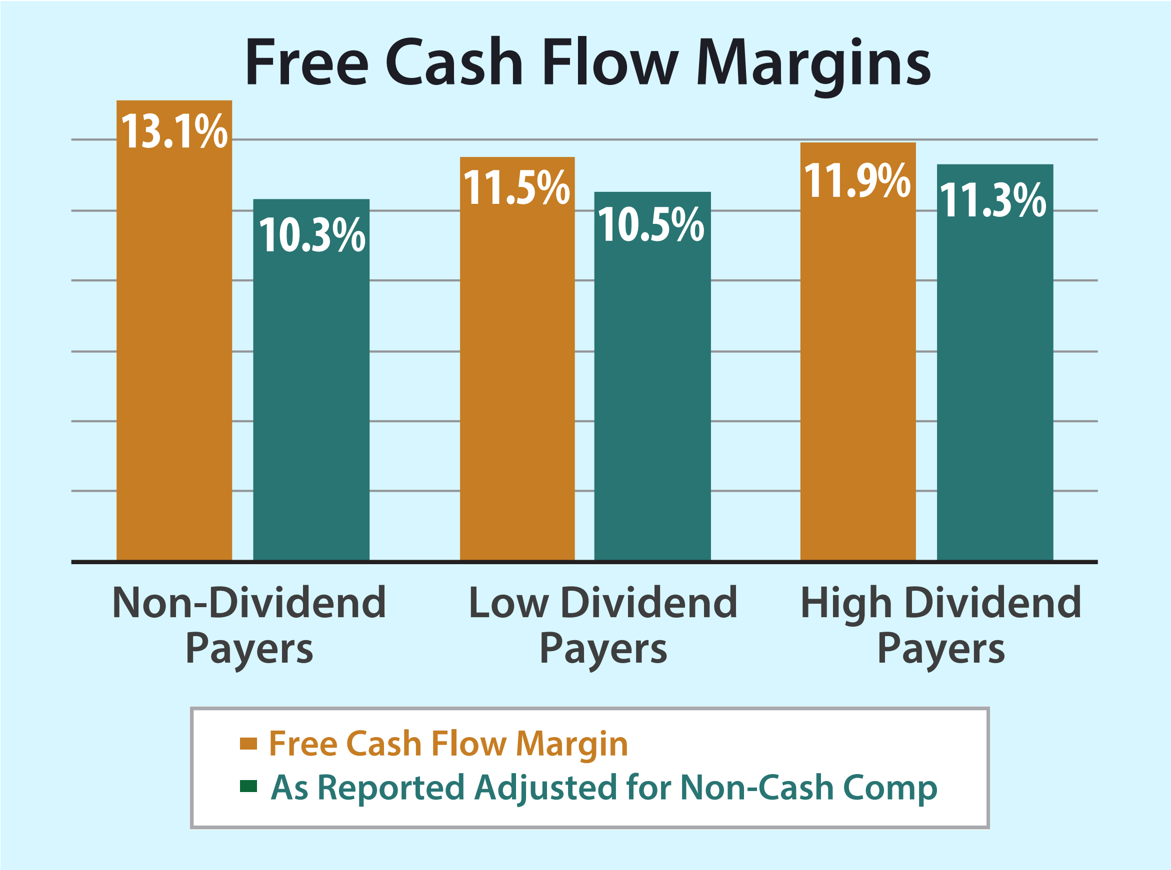
Dividend Investing Through the Free Cash Flow Lens

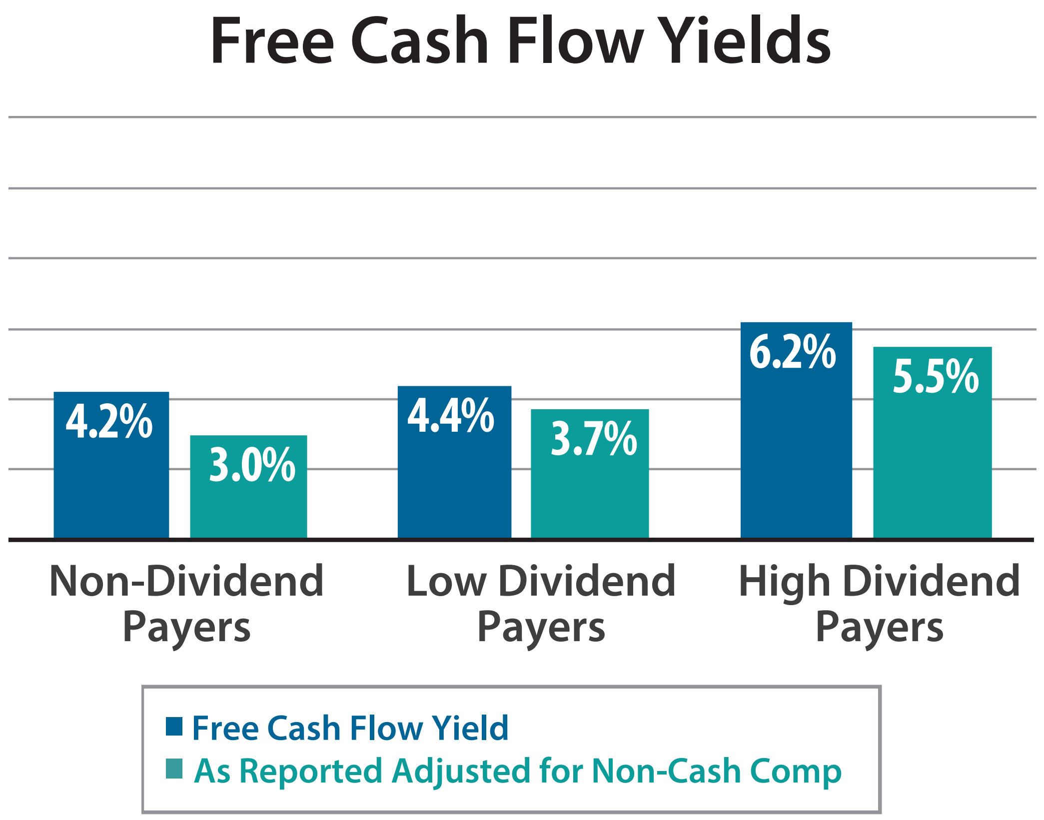
As we have discussed in our past Quarterly Reports, total returns for dividend-paying stocks have trailed non-dividend payers over the past decade despite having a better long-term return record. Looking at the core of the S&P 500, nondividend payers have outperformed dividend payers by 1.7% on an annualized basis over the last 10 years.

Through the free cash flow lens, the outperformance of non-dividend payers makes sense—free cash flow margins have been higher for non-dividend payers. This seems to be a good description of how the market has operated, but does it make sense? As discussed above, non-dividend payers have sourced a larger portion of their free cash flow from the use of stock-based compensation. **In our view, generating more free cash flow by loading management up on restricted stock units and options rather than cash bonuses masks the very real costs of high executive compensation.**

When Will Investors Recognize the Impact of Non-Cash Compensation?

10-Year Averages



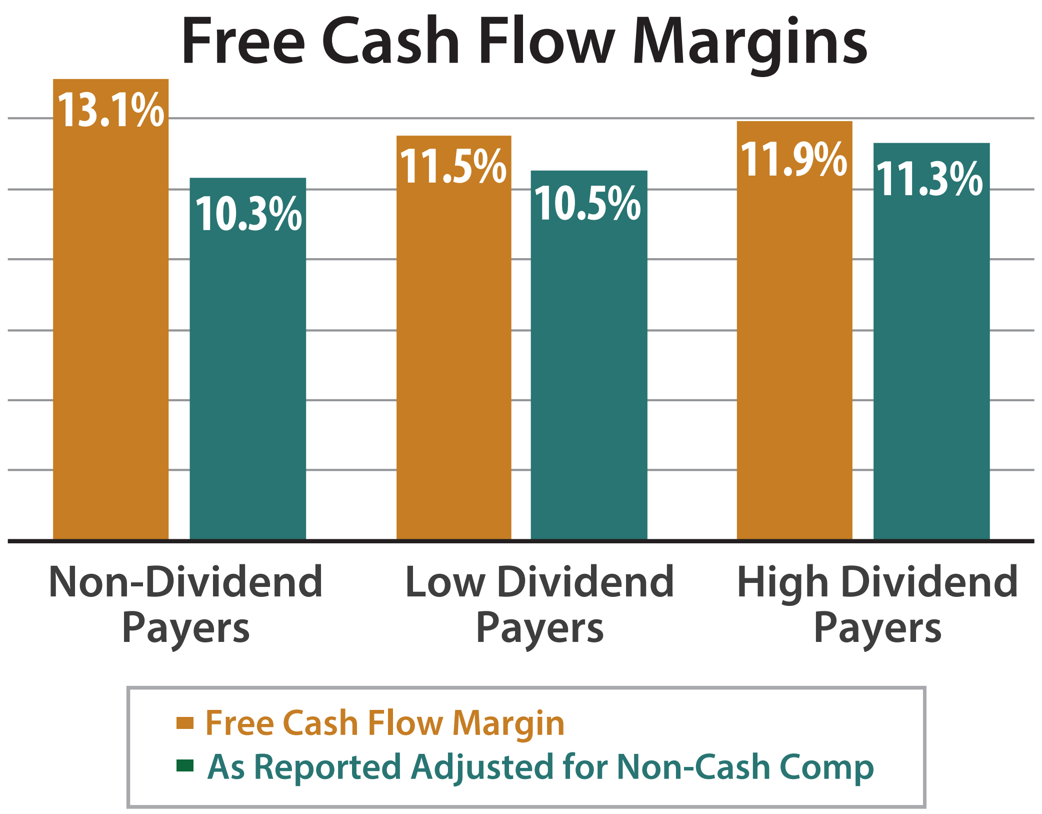


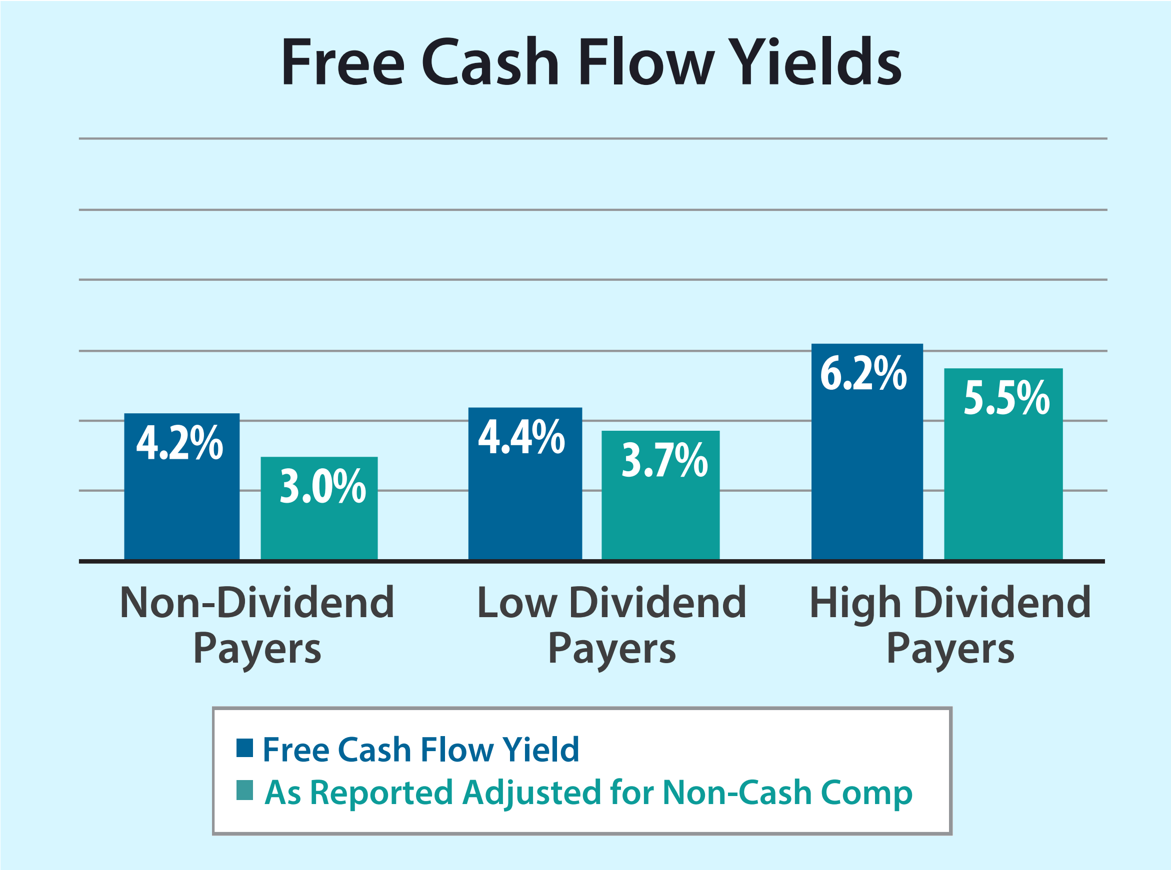
As of December 31, 2023. 10-Year average (2014-2023). Source: LSEG. Dividend groups within the S&P 500 Index are constructed based on indicated yield at the beginning of each calendar period. Dividend groups are constructed based on indicated yield at the beginning of each calendar period, with Low Dividend Payers being the bottom half of the results, and High Dividend Payers being the top half. Averages are based on constituent groupings and are equal-weighted.

If we back non-cash compensation out of free cash flow, the picture changes significantly—high dividend payers have the best free cash flow margins after adjusting for stock-based compensation. Non-dividend payers may have benefitted over the past 10 years as the market focused on free cash flow margins without considering the quality of those cash flows.

When Will Investors Recognize the Impact of Non-Cash Compensation?

10-Year Averages



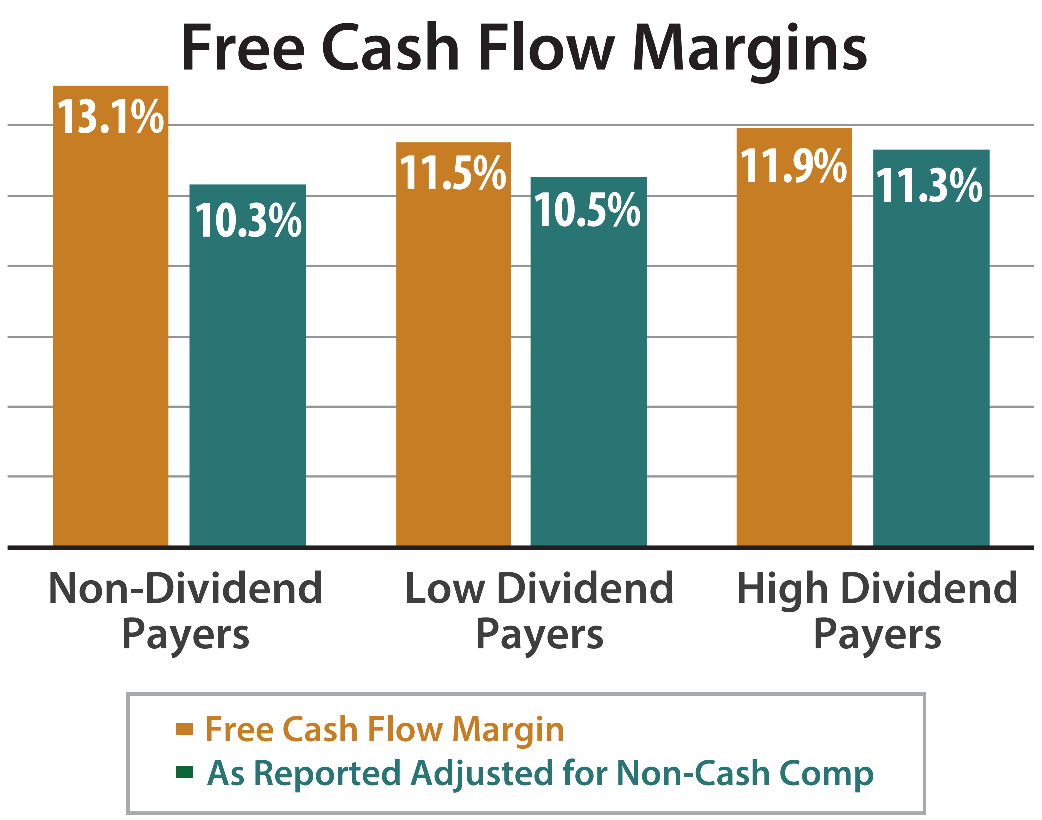


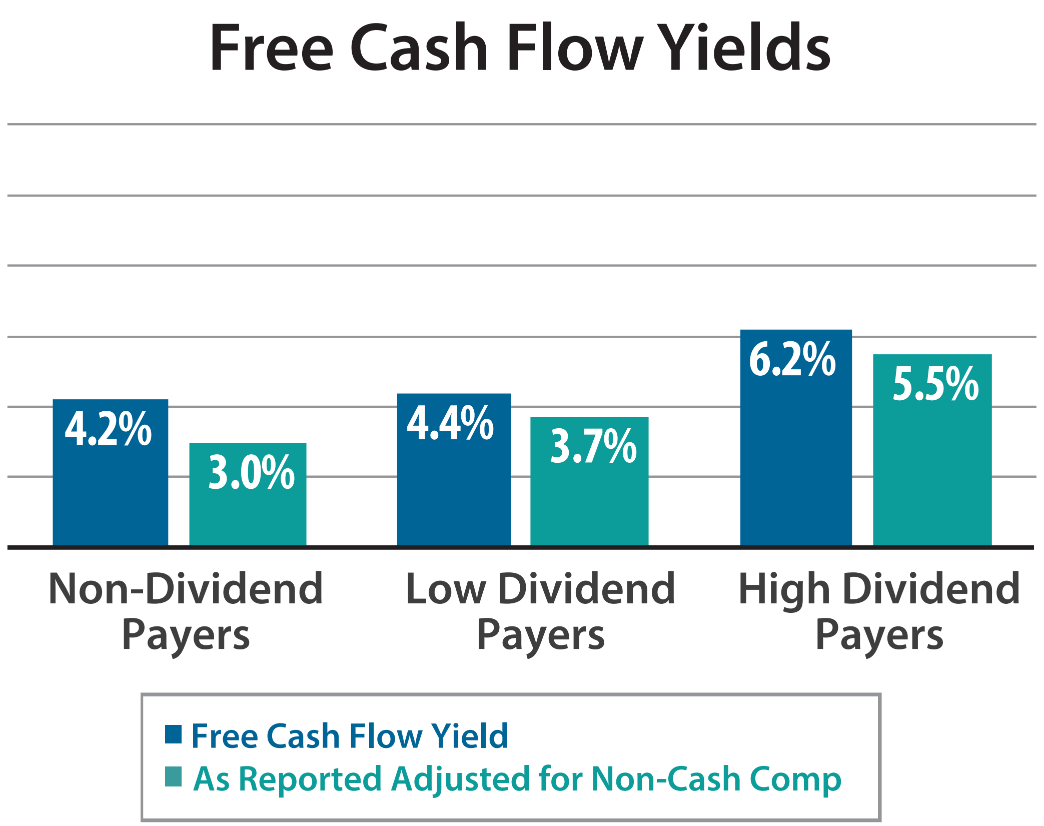
As of December 31, 2023. 10-Year average (2014-2023). Source: LSEG. Dividend groups within the S&P 500 Index are constructed based on indicated yield at the beginning of each calendar period. Dividend groups are constructed based on indicated yield at the beginning of each calendar period, with Low Dividend Payers being the bottom half of the results, and High Dividend Payers being the top half. Averages are based on constituent groupings and are equal-weighted.

From a valuation perspective, stocks in the top half of dividend yields had much higher free cash flow yields, both before and after pulling out the impact of stock compensation. Subtracting non-cash executive compensation from free cash flow for all stocks flips the entire story in favor of higher dividend yield stocks—both free cash flow *margins* and free cash flow *yield* are better for stocks with the high dividend yields. **The impact of stock-based executive compensation continues to rise as a percentage of free cash flow for non-dividend payers, so at some point, we expect the market to wake up to this growing issue.**

When Will Investors Recognize the Impact of Non-Cash Compensation?

10-Year Averages





As of December 31, 2023. 10-Year average (2014-2023). Source: LSEG. Dividend groups within the S&P 500 Index are constructed based on indicated yield at the beginning of each calendar period. Dividend groups are constructed based on indicated yield at the beginning of each calendar period, with Low Dividend Payers being the bottom half of the results, and High Dividend Payers being the top half. Averages are based on constituent groupings and are equal-weighted.

“Magnificent 7” Through the Free Cash Flow Lens

Returns for the broad market have recently been dominated by the Magnificent 7: Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla.* These mega-cap tech stocks have had high free cash flow margins, fitting with current investor preferences. Not surprisingly, on a valuation basis the stocks are expensive, with free cash flow yields well below the average for the core S&P 500.

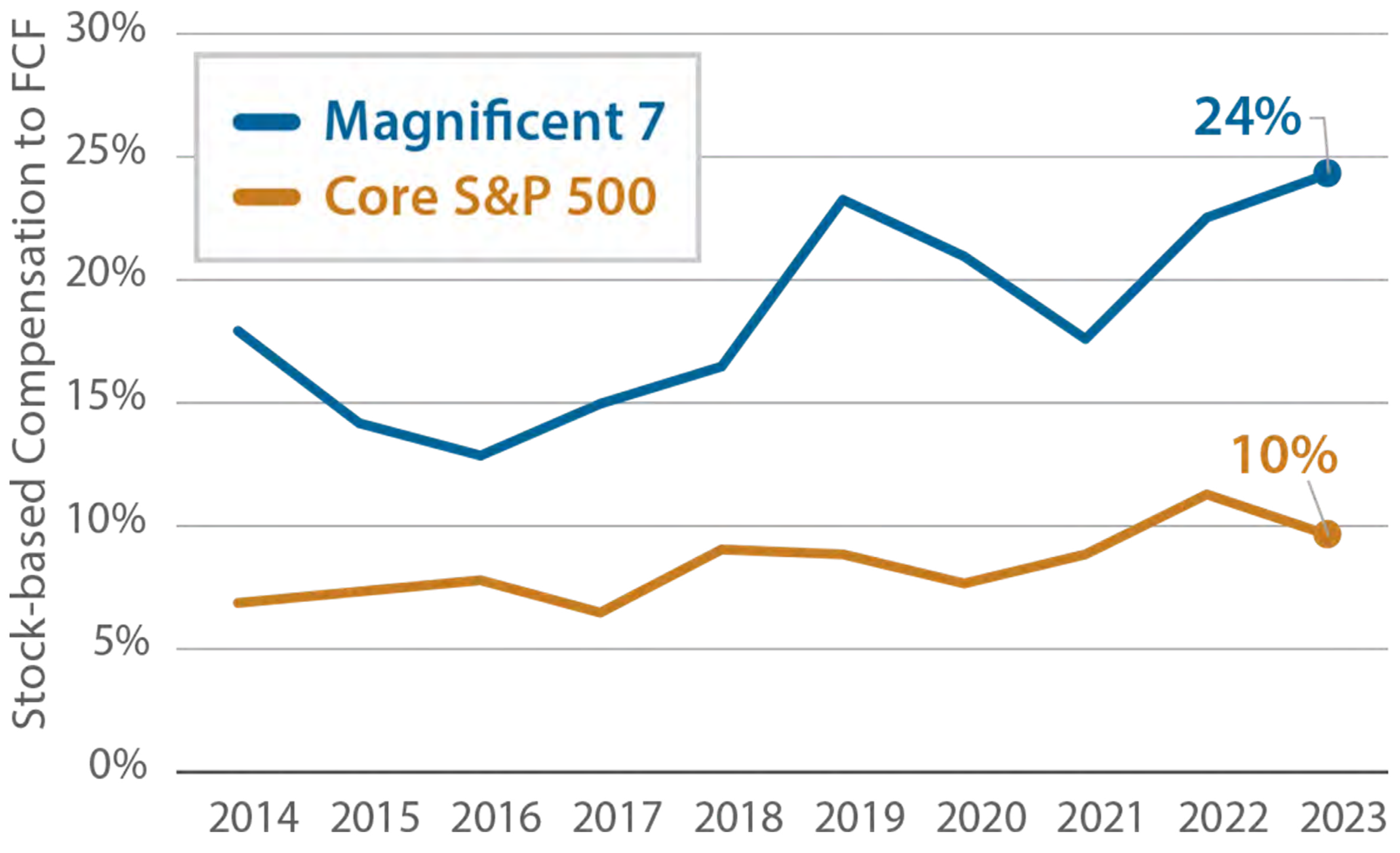
*Magnificent Seven= Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla (not held, except, as of June 30, 2024, Tesla was held in a Miller/Howard portfolio that is not yet available to investors).

From a dividend perspective, the Magnificent 7 are underwhelming—five have regular dividends that are each well below 1% and two (Amazon and Tesla) are non-dividend payers.

As exciting as the Magnificent 7 businesses may be, investors should note that non-cash executive compensation represents a high and rising fraction of free cash flow. **By using non-cash compensation in an era that's focused on free cash flow, it's likely that the companies are sidestepping the market consequences of high executive pay.**

Magnificent 7 Non-Cash Compensation:

High and Rising Fraction of FCF

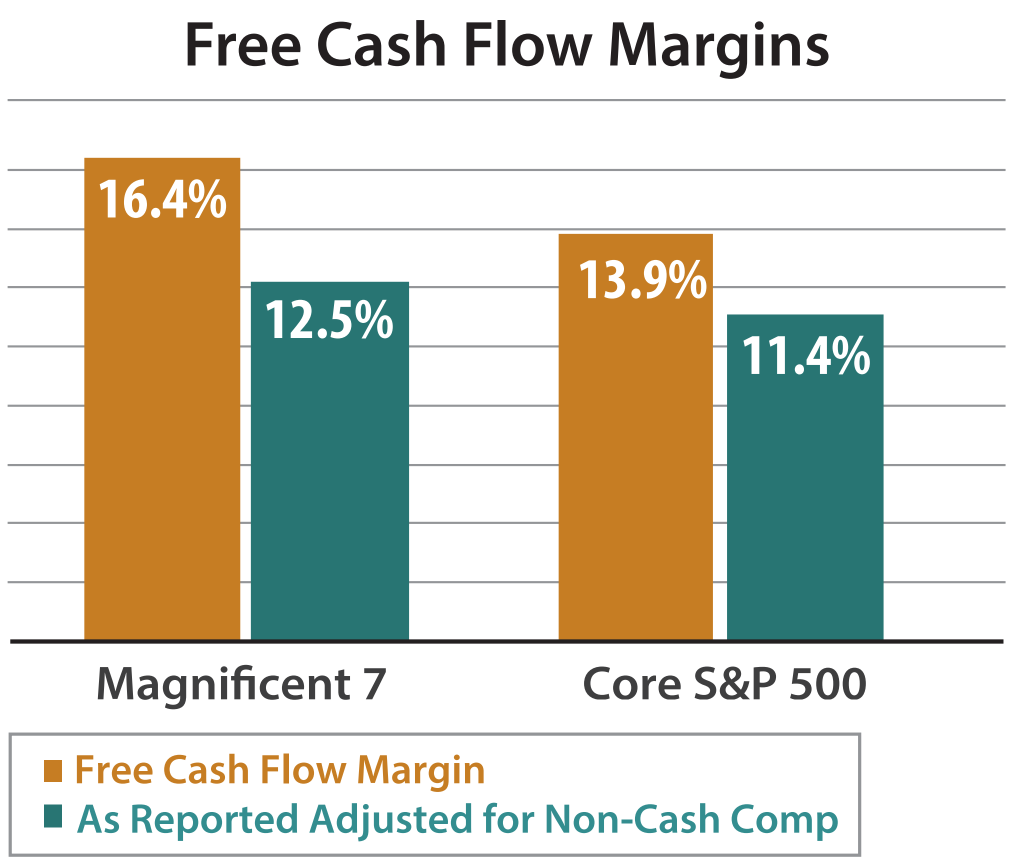


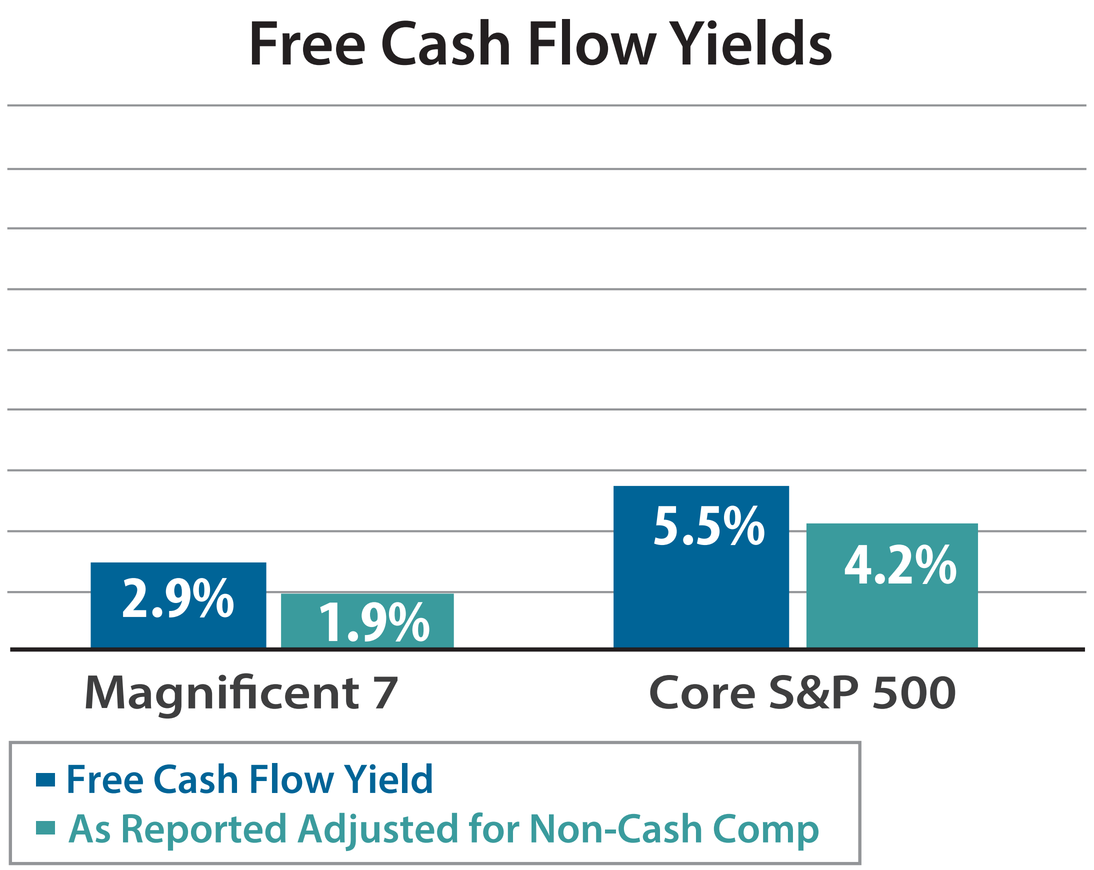
As of December 31, 2023. Source: LSEG. *Magnificent Seven= Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla (not held, except, as of June 30, 2024, Tesla was held in a Miller/Howard portfolio that is not yet available to investors). S&P Core is all members of the S&P 500 Index excluding financials, real estate & utilities. S&P Core is reconstituted at each calendar year end. Stock-based compensation net of tax. FCF=Free cash flow.

Backing out non-cash executive compensation, the free cash flow margins for the Magnificent 7 drop significantly, closing much of the gap with the core S&P 500. From a valuation perspective, removing stock-based executive compensation from free cash flow makes this group of high-flyers even more expensive relative to the core S&P 500.

Adjusting for Non-Cash Compensation, the Magnificent 7's Advantage Fades

2023 Averages



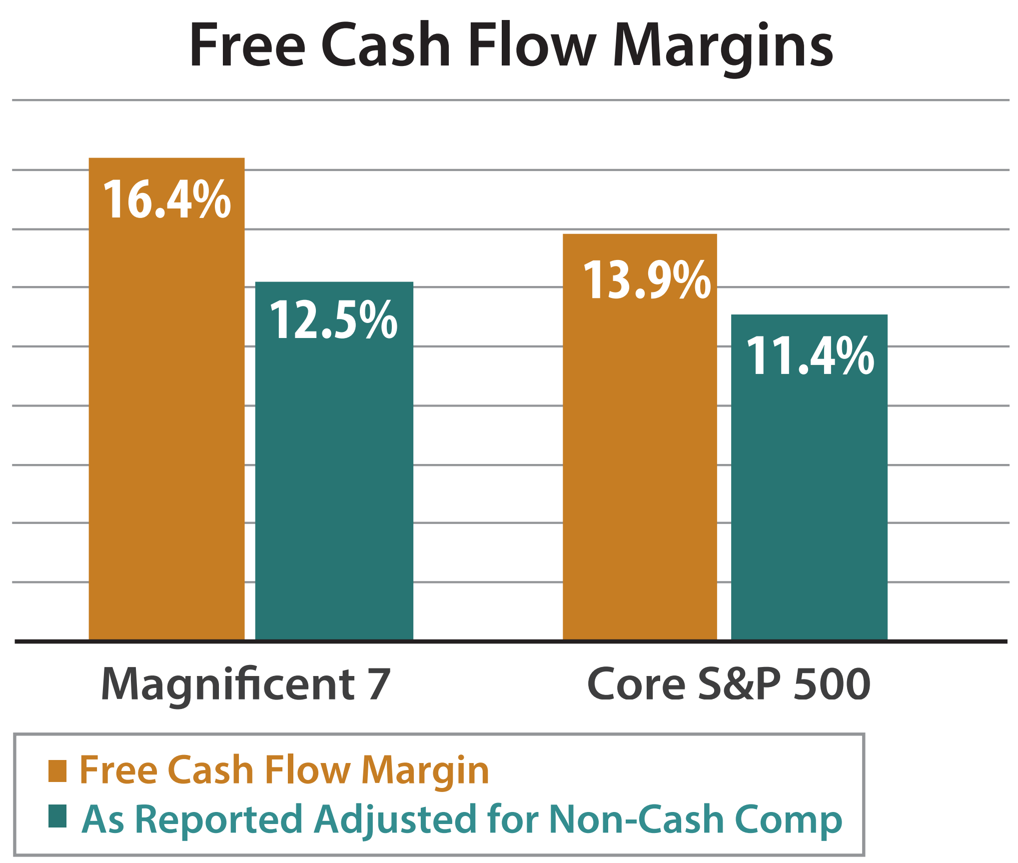


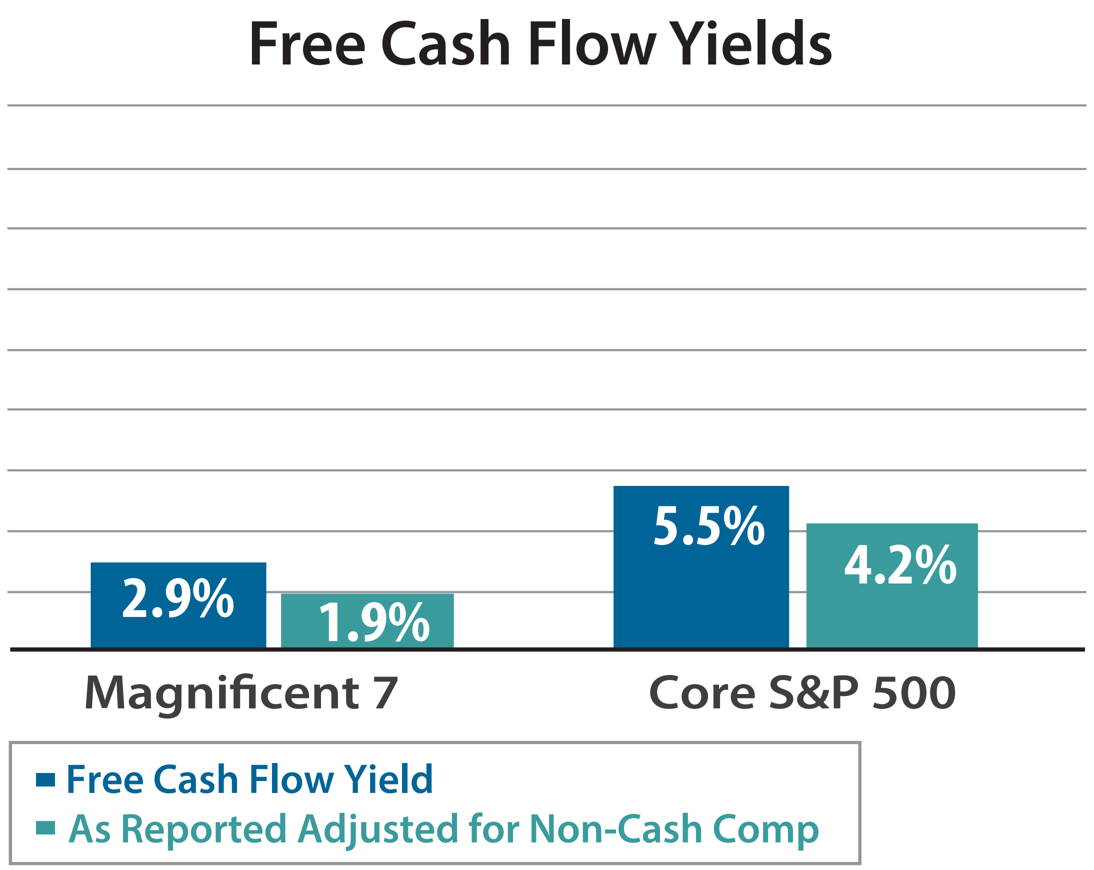
As of December 31, 2023. Source: LSEG. Magnificent Seven= Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla (not held, except, as of June 30, 2024, Tesla was held in a Miller/Howard portfolio that is not yet available to investors). S&P Core is all members of the S&P 500 Index excluding financials, real estate & utilities. S&P Core is reconstituted at each calendar year end. Stock-based compensation net of tax.

For the Magnificent 7, the portion of free cash flow coming from non-cash executive compensation is trending up, driving a larger and larger wedge between total free cash flow and the cash flow that could possibly fund dividends sometime far down the road.

Adjusting for Non-Cash Compensation, the Magnificent 7's Advantage Fades

2023 Averages





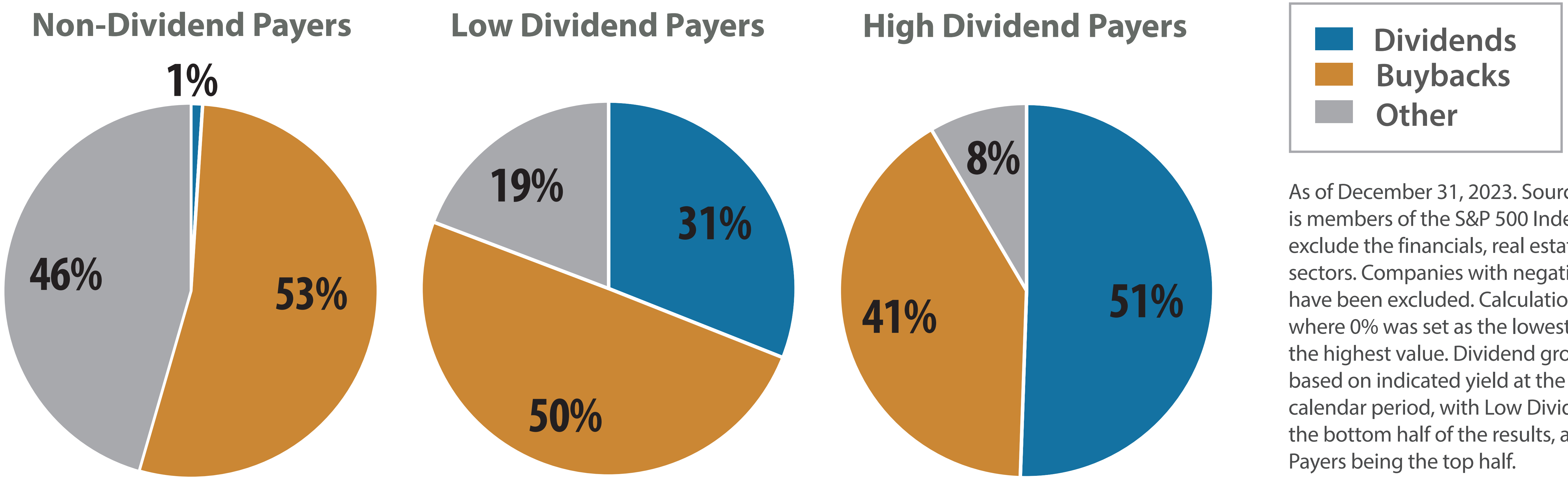
As of December 31, 2023. Source: LSEG. Magnificent Seven= Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla (not held, except, as of June 30, 2024, Tesla was held in a Miller/Howard portfolio that is not yet available to investors). S&P Core is all members of the S&P 500 Index excluding financials, real estate & utilities. S&P Core is reconstituted at each calendar year end. Stock-based compensation net of tax.

Use of Free Cash Flow: Dividend Payers vs. Non-dividend Payers

In addition to having higher-quality free cash flow, companies with regular dividends return more of their free cash flow to shareholders in the form of dividends and stock buybacks.

Companies Have Varying Uses of Free Cash Flow—**We Prefer Dividends**

10-Year Averages



As of December 31, 2023. Source: LSEG. Universe is members of the S&P 500 Index. Calculations exclude the financials, real estate, and utilities sectors. Companies with negative free cash flow have been excluded. Calculations were winsorized where 0% was set as the lowest value and 100% as the highest value. Dividend groups are constructed based on indicated yield at the beginning of each calendar period, with Low Dividend Payers being the bottom half of the results, and High Dividend Payers being the top half.

In the past 10 years, firms with the top half of dividend yields returned on average 91% of their free cash flow to shareholders through dividends and buybacks. In contrast, firms without regular dividends return an average of 53% of free cash flow in buybacks and 1% in the form of special dividends or dividend initiations. Firms in the bottom half of dividend yields return 81% of free cash flow, on average, to shareholders in terms of dividends and buybacks.

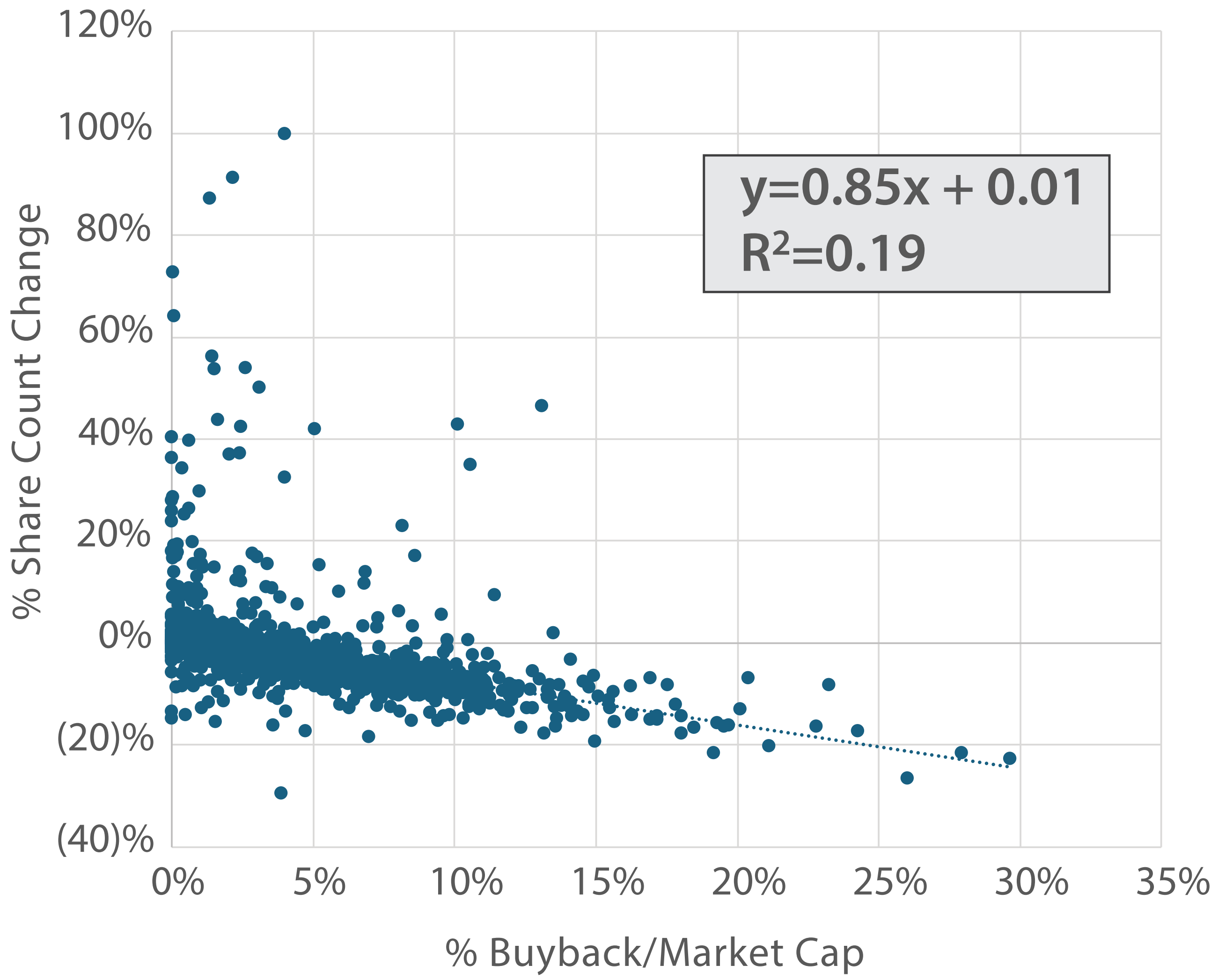
If free cash flow is not used for dividends or buybacks, where does it go? Some uses are positive, such as building cash or paying off debt. The other main use is making acquisitions. At Miller/Howard, we are wary of acquisitions, particularly large acquisitions with lines of business outside the acquiror's core competencies. Sometimes these deals can work out, but frequently, sellers are proven to understand the situation better than buyers. Classic examples of terrible deals include the AOL/Time Warner merger and the 2018 purchase of Time Warner by AT&T. Naturally, some deals create value, but our view is that investors are typically better served when free cash flow is returned to shareholders in the form of dividends or buybacks. Dividends are easy to understand, but let's examine how buybacks benefit investors.

Do Stock Buybacks Help Investors?

It would be hard to find a subject with more muddled thinking than share buybacks. Some observers view buybacks as a waste, as if the money actually disappears. Others see buybacks as a trick to "artificially" boost earnings per share. At Miller/Howard, we are skeptical of both large acquisitions and excessive capital spending, so we view buybacks as a sensible way for companies to return capital to investors so that the market can allocate it to better uses.

Holding everything else equal, share buybacks cause buy-and-hold investors to own a growing percent of the company. In addition, dividend increases become easier to afford because dividends are paid on a reduced share count. The caveat is that "holding everything else equal" potentially hides mischief. Share counts change for many reasons, but the two most important are using stock to make acquisitions and the fallout from executive compensation programs.

Management Mischief: Buybacks Don't Always Result in Fewer Shares

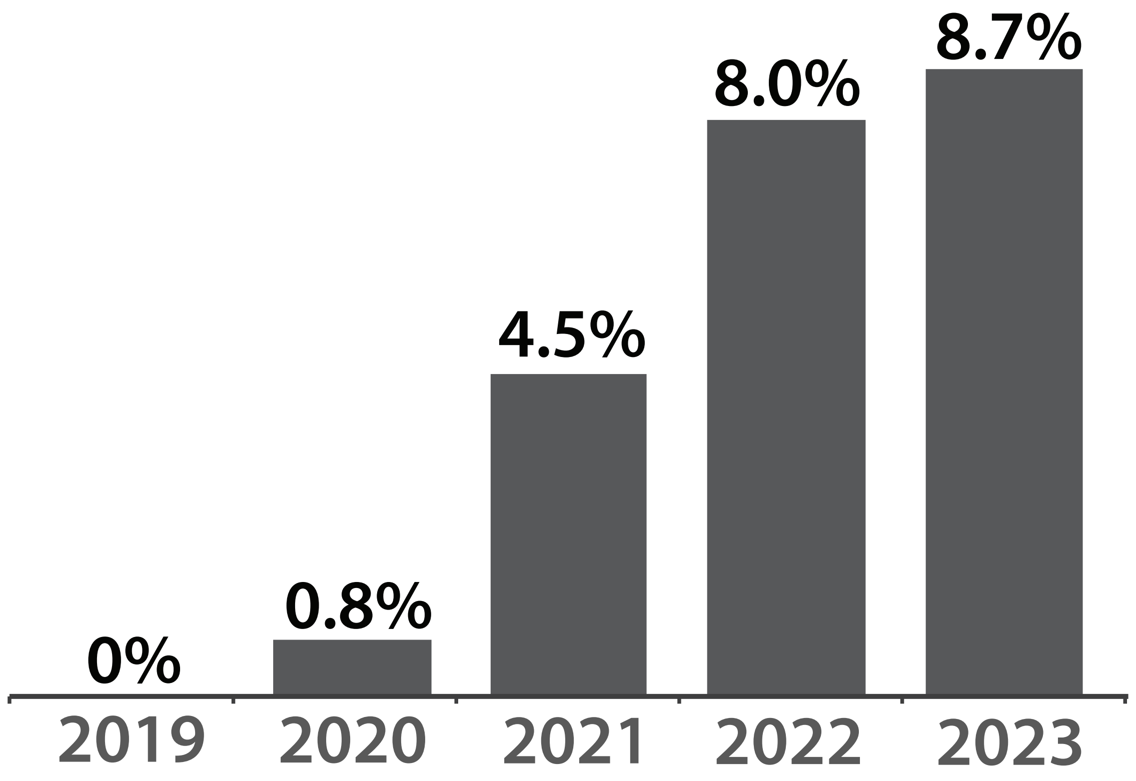


As of December 31, 2023. Source: LSEG. Universe is members of the S&P 500 Index as of calendar year end beginning 12/31/2013 through 12/31/2022.

Looking at the entire S&P 500 over the past 10 years, buybacks on average have reduced the number of shares with 85% efficiency, meaning that a buyback of 1% of the market cap, instead, had an average reduction in market cap of 0.85%. Given all the sources of leakage, the 85% average is not bad. But the regression line explains less than one-fifth of the variability, meaning that acquisitions and stock-based compensation are much more important in determining the diluted share count.

Non-Cash Compensation Can Trigger Massive Dilution

Musk's Stock Awards as a Percentage of Diluted Shares Outstanding



As of June 30, 2024. Sources: Tesla, Inc. proxy statements, annual reports, and quarterly reports; Miller/Howard Research & Analysis. Based on cumulative shares awarded to Elon Musk as part of Tesla's 2018 CEO Performance Award divided by Tesla's total diluted shares outstanding yearly. As of June 30, 2024, Tesla was held in a Miller/Howard portfolio that is not yet available to investors.

Elon Musk's 2018 Pay Package

Elon Musk's controversial pay package illustrates how difficult it can be to control the share count using buybacks. Musk's compensation hinges on Tesla's stock price, revenue, and profitability. The conditions set out in 2018 were not met in 2019, so no shares were added to the diluted share count in 2019. Times were better for Tesla in 2021 and 2022, and many of the conditions were met, triggering massive dilution—much bigger than Tesla could possibly have offset even if it had directed all of its free cash flow to buybacks. **Besides the magnitude of the dilution, the key takeaway from this example is that the impact of compensation programs can come with significant and unpredictable lags.**

Are Dividends Better Than Buybacks?

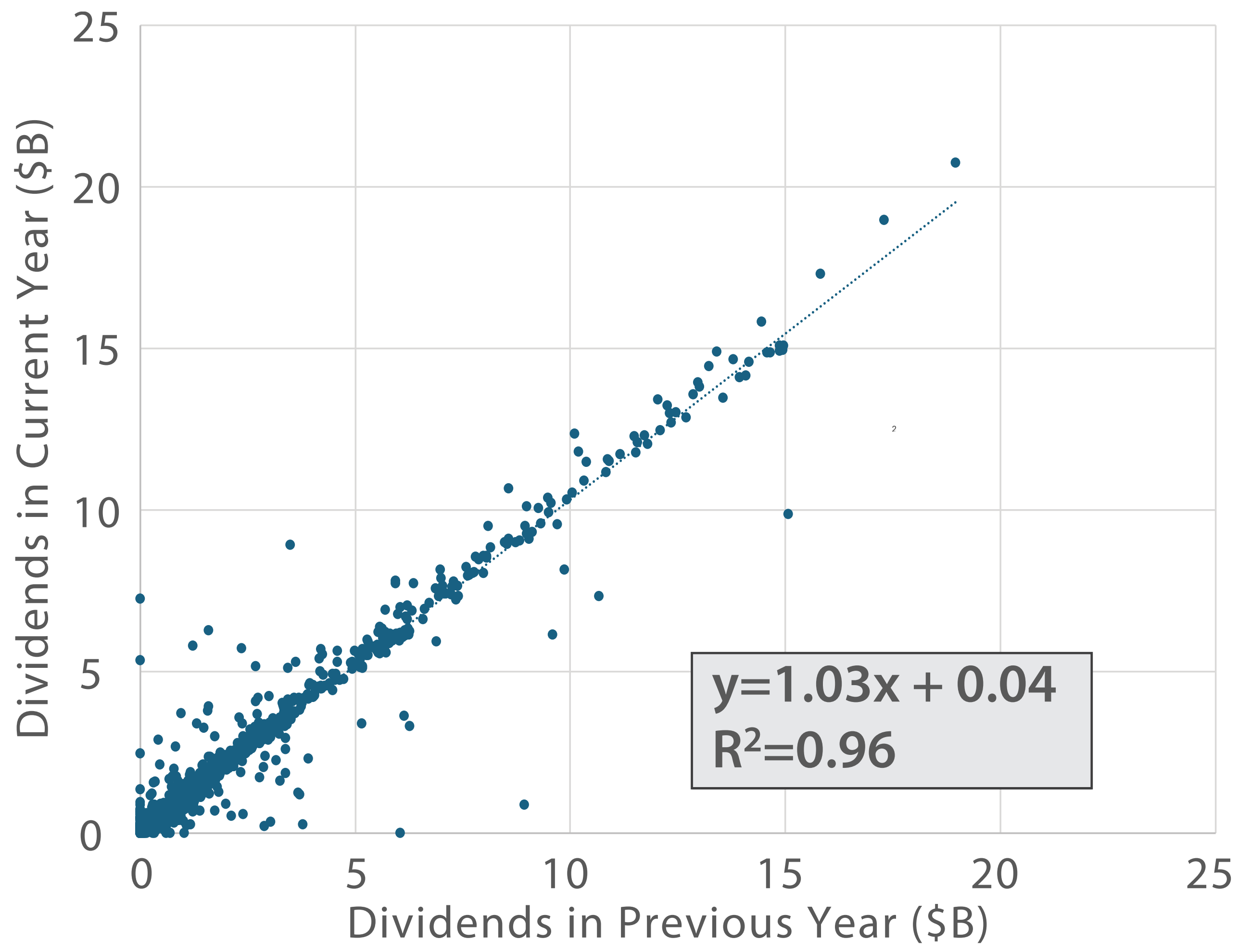
Both corporate executives and investors often ask whether we at Miller/Howard prefer dividends or buybacks. In speaking with corporate executives, we stress that a regular dividend is a commitment. The market punishes dividend cutters, so a commitment to a regular dividend must be based on conservative forecasts of future earnings and free cash flow. In contrast, one-off events such as the sale of a business unit, a favorable legal settlement or even an unusually good year can generate extra cash that is probably best returned to shareholders via a buyback rather than hiking the regular dividend.

When investors ask the question, the script is flipped. We know that corporate executives are loathe to risk a dividend cut, so a high regular dividend is a signal that management believes future profitability will be resilient, even in a changing environment. From the investor standpoint, regular dividends are preferable to buybacks, in our view, because they are more likely to continue.

One way to test our thesis is to examine how well dividends and buybacks in one year predict dividends and buybacks, respectively, in the subsequent year. The resulting regressions lead to two strong conclusions in favor of dividends:

- *Dollars spent by a firm on dividends are highly predictive of dividend spending in the subsequent year, with 96% of the variation explained. Buybacks are less predictive of future buybacks.*

Past and Future Dividends Are Highly Correlated...

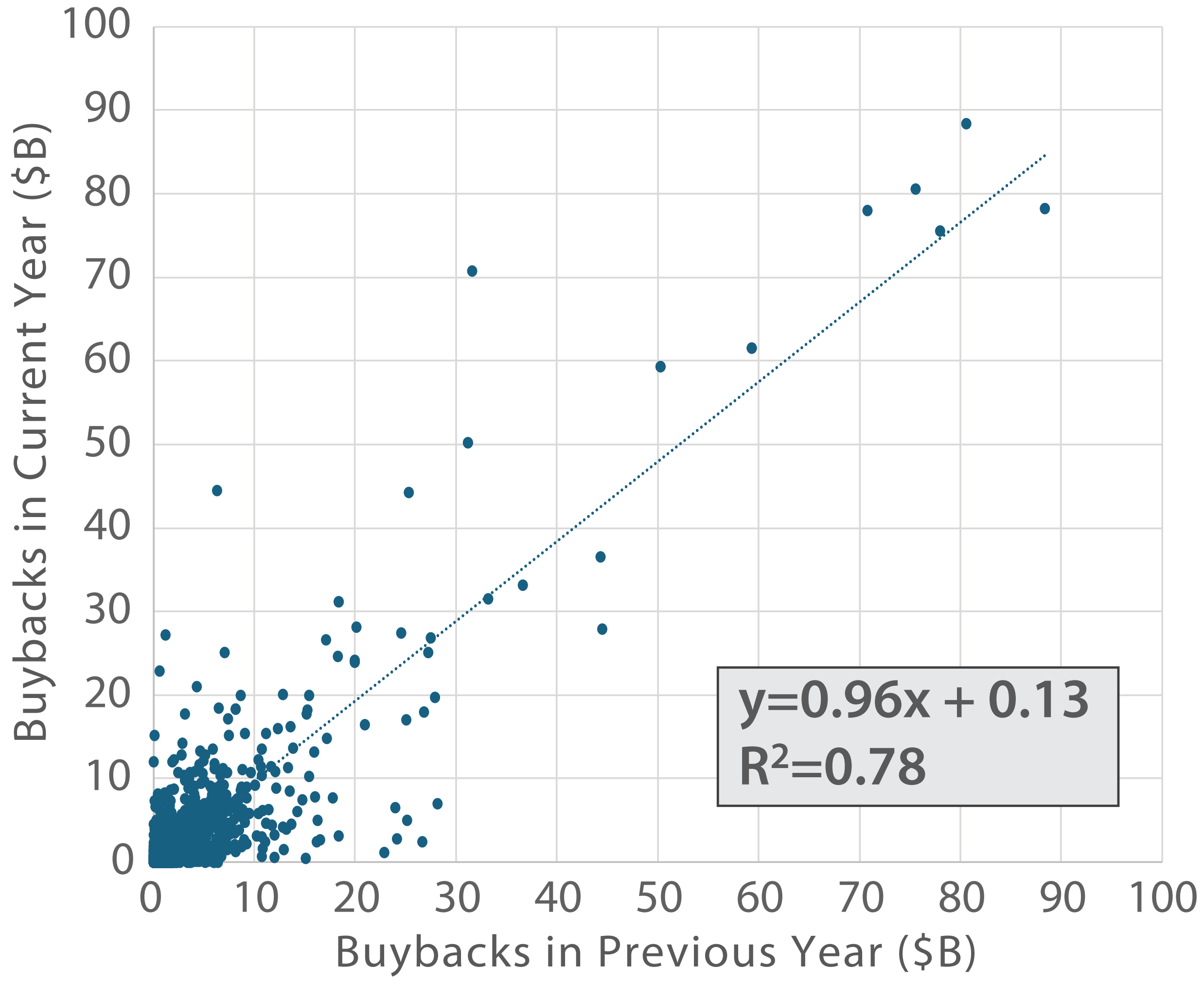


As of December 31, 2023. Source: LSEG. Universe is members of the S&P 500 Index as of calendar year end beginning 12/31/2013 through 12/31/2022. The buyback universe excludes members with net positive stock issuance.

One way to test our thesis is to examine how well dividends and buybacks in one year predict dividends and buybacks, respectively, in the subsequent year. The resulting regressions lead to two strong conclusions in favor of dividends:

- *Dollars spent by a firm on dividends are highly predictive of dividend spending in the subsequent year, with 96% of the variation explained. Buybacks are less predictive of future buybacks.*
- *Dividend spending rises on average almost 3% per year. In contrast, buyback spending erodes by more than 4% per year on average.*

...But Past and Future Buybacks Are Less Linked



As of December 31, 2023. Source: LSEG. Universe is members of the S&P 500 Index as of calendar year end beginning 12/31/2013 through 12/31/2022. The buyback universe excludes members with net positive stock issuance.

Our Conclusions

We view stocks with higher dividend yields as underappreciated in the current market. The high and growing levels of stock-based executive compensation create misleading comparisons with non-dividend-paying stocks. Once non-cash executive compensation is adjusted out, stocks with higher dividend yields are actually superior on both free cash flow margins and free cash flow yields.

Not only do firms with higher dividend yields have better-quality free cash flow, but they also use it in a more shareholder-friendly manner, returning 91% to shareholders in the form of dividends and buybacks, well above the rates for both non-dividend payers and those with low dividend yields. Overall, our research shows two key points: dividend-paying stocks have higher free cash flow, adjusted for non-cash compensation, relative to both revenue and market capitalization, and current dividends are highly predictive of future 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 portfolios. The firm is 100% employee-owned through an Employee Stock Ownership Plan (ESOP).

We continue to evolve and develop portfolios 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.

The investment strategies described herein are those of Miller/Howard Investments. These materials are being provided for illustrative and informational purposes only. The information contained herein is obtained from multiple sources that are believed to be reliable. However, such information has not been verified, and may be different from the information included in documents and materials created by the sponsor firm in whose investment program a client participates. Some sponsor firms may require that these Miller/Howard Investments materials are preceded or accompanied by investment profiles or other documents or materials prepared by such sponsor firms, which will be provided upon a client's request. For additional information, documents and/or materials, please speak to your Financial Advisor.

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.

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.
To receive the current ADV Part 2A free of charge email **compliance@mhinvest.com** / Call (845) 679-9166.
Notification to Clients: Contact your Advisor with any material changes to your financial profile that would impact your appropriateness for investment.

Miller/Howard Investments, The Fuller Building, 45 Pine Grove Ave, Suite 301, Kingston, NY 12401 | (845) 679-9166 | **mhinvest.com**