

A decorative graphic composed of several overlapping shapes: a green triangle pointing downwards, a green circle, and two white squares. These shapes are layered on top of the background image of a river.

Eurex outlook:

Dividend futures ready for buyback season

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Eurex dividend futures have emerged from the Covid-19 pandemic in a robust state, having adapted from disrupted payment calendars to increased market participant diversity in recent months. Going forward, the outlook is one of cautious optimism, as banks return their focus to shareholder distribution – albeit with share buyback programs set to play a much bigger role in these plans.

When the European Central Bank (ECB) recommended banks not to pay dividends or execute share buybacks in March last year it represented a black swan moment for the dividend futures market. Dividend payments were thrown into disarray as firms hastily pulled back on announcements.

“Covid-19 has certainly introduced unprecedented challenges to the dividend market as to many other things in life,” says Lorenzo Pasquale Longo, head of EMEA synthetic trading at Goldman Sachs.

The ECB’s announcement came alongside many companies voluntarily canceling dividends amid the first wave of Covid-19. Adding to complications, government support for companies often came on the condition of no dividend payments. Where intervention lacked, it also often created uncertainty. Annual General Meetings were often stymied when legislators did not move fast enough to allow virtual meetings in place of physical.

These market conditions were truly unprecedented, shifting the whole paradigm of dividend risk. Government intervention was not a risk that dividend market participants had had to price before. Furthermore, traders had been used to handling futures with a risk profile that increased at longer maturities. Suddenly, near-term risk was the urgent issue in these contracts as firms pulled their dividend payments, often after already announcing them.

“Going back to 2020 we saw a change in the risk profile of how dividends were perceived,” said Stuart Heath, director, equity and index product design at Eurex. “Dividends tend to be a function of the economic forecast, with near term dividends more certain.”

“We saw a significantly changing dynamic and that dynamic moved the dividend risk from the longer end to the very short end, so dividend risk is now front and center for the next year, not just for the longer term.”

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Stuart Heath
Director, Equity and Index Product Design, Eurex

Changing with the times

The challenges Covid-19 threw up have spurred adaptation and even innovation. With dividend payment dates thrown off their usual schedule, contract expiry dates were knocked out of sync and traders needed more precise hedging tools to manage their positions.

Eurex's introduction of quarterly single stock dividend futures and semi-annual index futures now allows traders to hedge their exposure with greater granularity, often in better harmony with single stock future trades. It is an innovation that the market has welcomed, with over 2.2 million contracts traded in the last twelve months.

“Quarterly contracts have been a great innovation. They can serve a different pocket of the market, such as equity finance and the financing of single stock futures.

Lorenzo Pasquale Longo
Head of EMEA Synthetic Trading
Goldman Sachs

“More broadly, historically a large share of the trading in dividend derivatives would happen earlier in the year, with early contracts concentrating on the front end because historically the

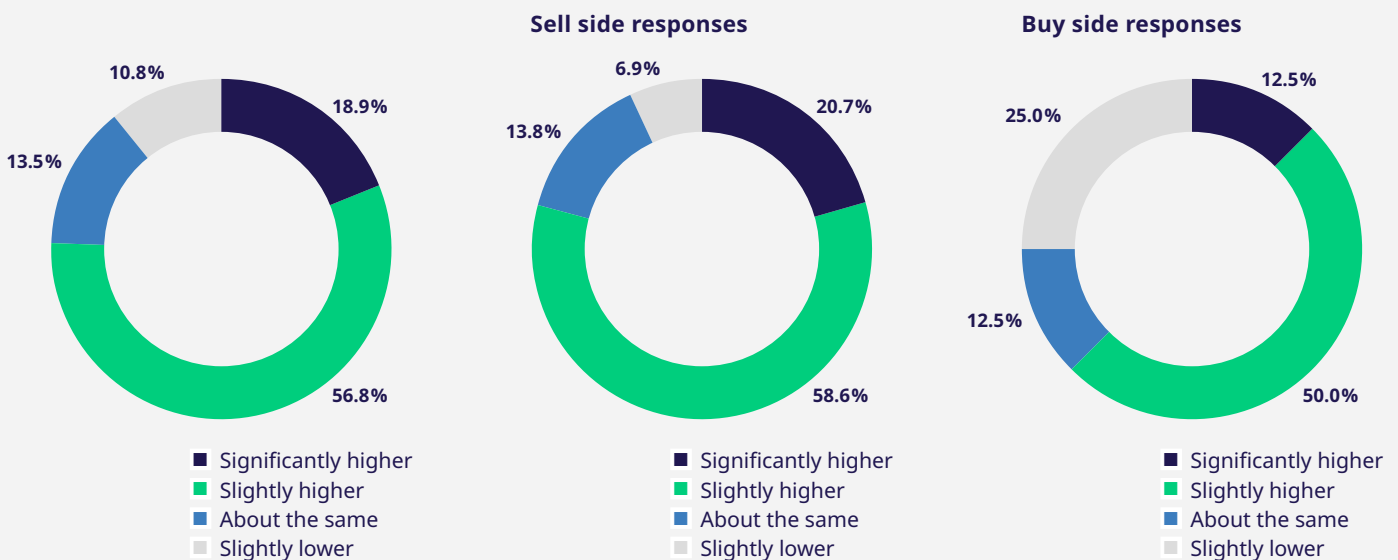
majority of European dividends go out in the first half of the year, specifically in Q2. But it has never been perfect. A significant proportion of dividend risk comes from facilitating quarterly equity futures rolls. If we have learned one thing from 2020 it is that even already announced dividends can get reversed.”

“Moreover, we also see more and more companies actually switch out of yearly dividends to quarterly payments in a reaction to the risk of what happened with AGMs but also the regulators' (actions) in 2020. Overall, quarterly dividend contracts have been a great tool to help us manage risk.”

Trading activity across the board has been encouraging as conditions normalize, with volumes for the year so far already outstripping those of last year. CFTC approval of EURO STOXX® Banks Index Futures and EURO STOXX® Banks Dividend Index Futures in July have also helped boost U.S. demand for the product.

In a survey of around 40 sell and buy side firms conducted by Eurex for this report, respondents' outlook for realized dividends on the EURO STOXX® was bullish in the near term. A majority of respondents thought that the level would be higher over the next six months compared to the same six months last year.

What do you think the level of realized dividends on the EURO STOXX® over the next six months will be compared with the same six months last year?

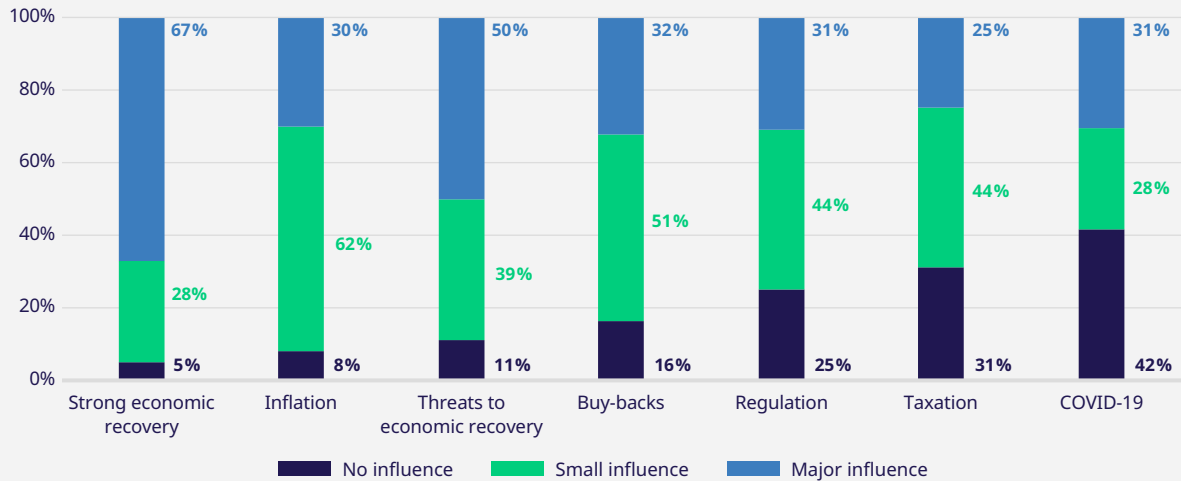


Shadow of buybacks looms

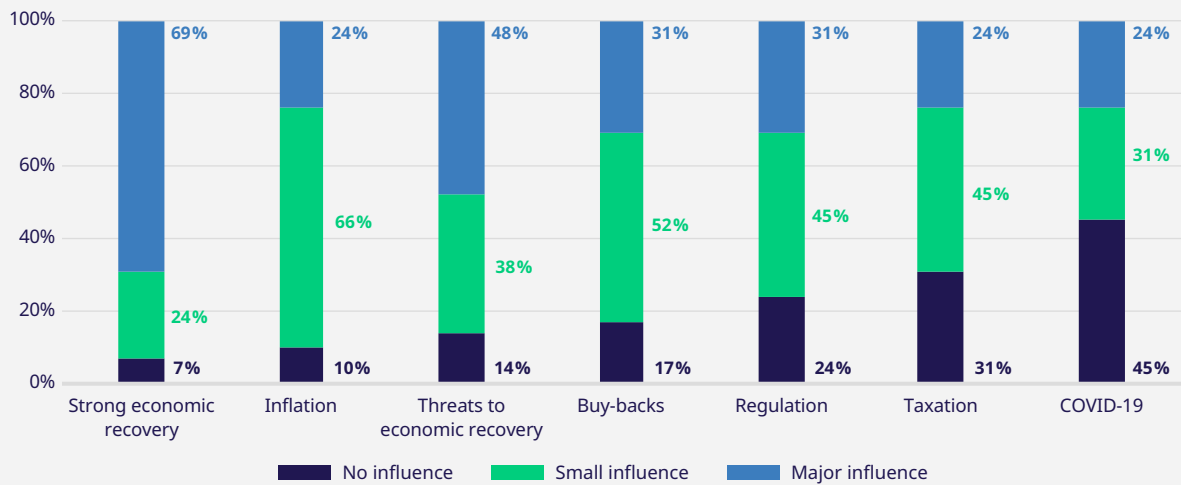
The lifting of regulators' restrictions has combined with an improving economic backdrop and survey responses showed growing optimism on this front

too. A strong economic recovery was top of all the factors that respondents expect to most influence dividend expectations in the next six months.

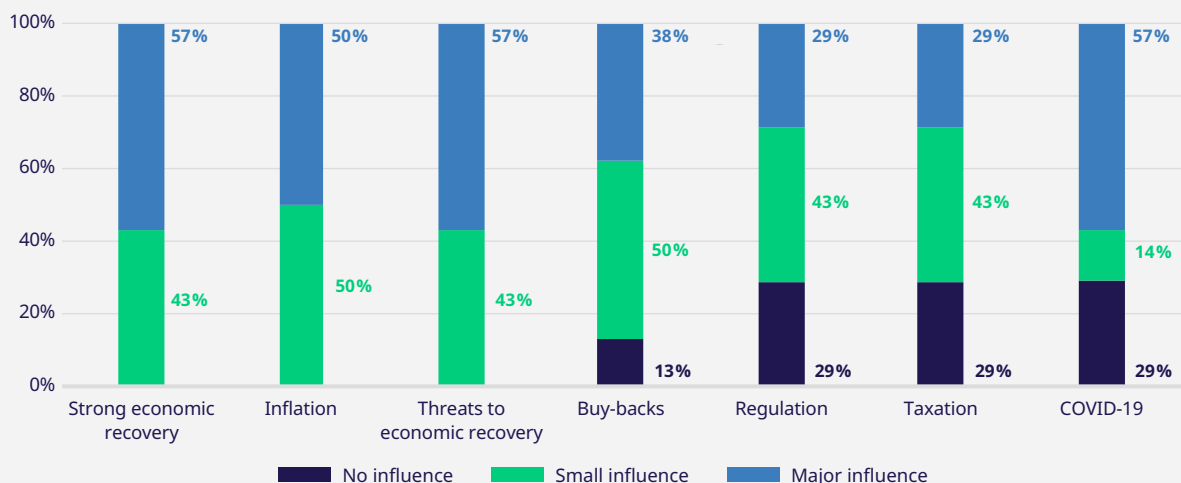
How big an influence do you think the following will have on dividend expectations over the next six months:



Sell side responses



Buy side responses



“For the banks, after a disappointing decade with very volatile dividends and changes of dividend policy on a regular basis, the fact we are entering in a new macroeconomic environment with expectations for higher inflation and interest rates could benefit the sustainability of dividend payments from European banks,” said Kevin Soyer, director, head of EMEA dividend forecasting at IHS Markit. “Alongside the buyback to return some extra cash from time to time.”

There are caveats to this improving sentiment though. The SX7E dividend points index is still not expected to return to pre-pandemic levels until 2024.

One of the issues the market needs to manage is buyback programs of banks and insurance companies. Shareholder distributions are back on the menu against an improving economic backdrop and positive expectations of bank profitability.

But the key question is what form capital returns take, with many banks expected to increase their use of buybacks. The Eurex survey has this fourth on the list of expected influences on dividend expectations (inflation and threats to economic recovery are in second and third place).

“In 2021, we saw certain banks resuming dividends at a lower level,” said Soyer. “For the next few years, we expect a recovery to pre-pandemic level towards 2023/2024. In the long run, dividend payments should come back as the first way to return cash to shareholders but the buyback will also play a key role in the capital allocation to shareholders.”

“There is a two-sided effect from buybacks. Overall, it can be seen as negative because the cash allocated to buybacks won’t be spent on dividends. Still, on the positive side, buybacks reduce the number of shares – so some companies are likely to increase their dividend per share while profits may not be increasing by the same level.”

Buybacks precede the pandemic, with Credit Suisse and UBS operating programs before Covid-19 spread globally. Other European banks had also been planning programs before March 2020.

That activity was put on ice as volatility roiled markets but with conditions now much more stable, the pace is picking up again. Santander, Société Générale, ING and Nordea have all announced their own programs as markets settled.

Buyback programs have the advantage of being flexible, with banks able to pause operations when markets turn volatile. There are also obvious advantages to repurchases at a low share price for firms with low stock valuations.

Buybacks often lead to reduced dividend payments though. Banco Santander’s September announcement on shareholder remuneration marked a clean 50/50 split between cash dividend and repurchases.

This is an obstacle for dividend futures, which depend on dividend payments for their payoffs and have no trigger for buybacks.

The trend isn’t completely bearish, though. As well as the support to dividend per share growth by reducing the number of shares in circulation, buybacks can protect dividends by being the first type of shareholder remuneration that banks will cut in a downturn, as Credit Suisse did in March 2020. This can provide a buffer to dividend payments.

The support for dividend per share ratios is pertinent for single stock dividends, which are based on dividend per share metrics, not market capitalization. However, buybacks are likely to have an unambiguously negative impact on scrip dividends.

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Kevin Soyer

Director, Head of EMEA Dividend Forecasting, IHS Markit

Market make-up shifts

Given the chaos of early 2020, it's not surprising that some traders have left the dividend futures market. But this is being offset by new entrants coming into the market to buy the dip. These included real money accounts that tend to run buy-and-hold strategies.

Also notable were sector specialists, with little previous experience in dividend futures, moving to take advantage of dislocations in the market on names they already traded with other products.

The survey shows that most sell-side firms trading dividends use listed dividends derivatives to do so, with smaller proportions using stocks and swaps. For the buy-side, listed derivatives were the only instrument used to trade dividends.

There has also been an increase in market-making activity and it seems that expertise is not being lost through job changes. A notable trend during the pandemic has been sell-siders moving to trade futures on the buy-side, as portfolio managers. This has mainly affected single name trading activity.

"They understand the front to back cycle and dynamics of this market and that has brought a different viewpoint and a new set of welcome participants for us into the buy-side," said Heath.

Structured products are a key driver of dividend futures supply and 2021 issuance in this market has generally been robust, with growth across all regions. It seems that Europe has lost some market share to Asia and the U.S., though.

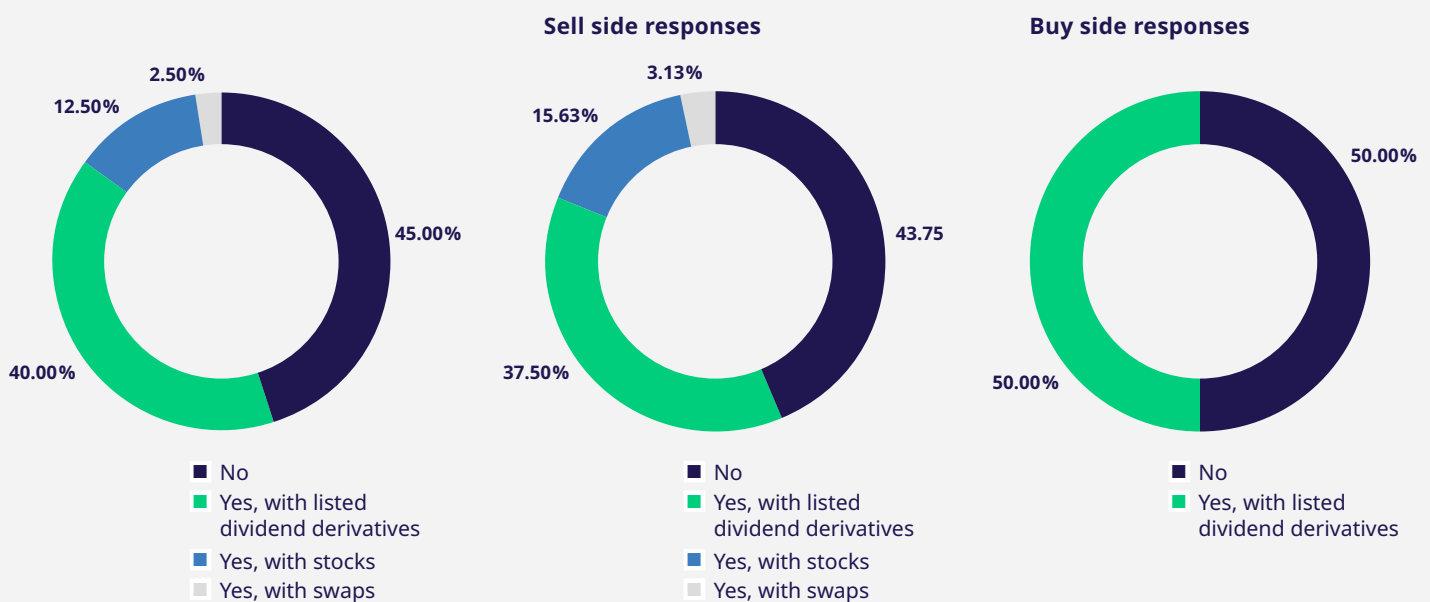
Notable trends in the structured product markets include the popularity of thematic baskets creating ESG exposure as well as a skew to tech names over cyclical. But another growing product has been structures offering dividend protection through a dividend risk profile. The increase of these decrement index products has stemmed some dividend risk supply.

There are also signs of increasing diversity in products being used.

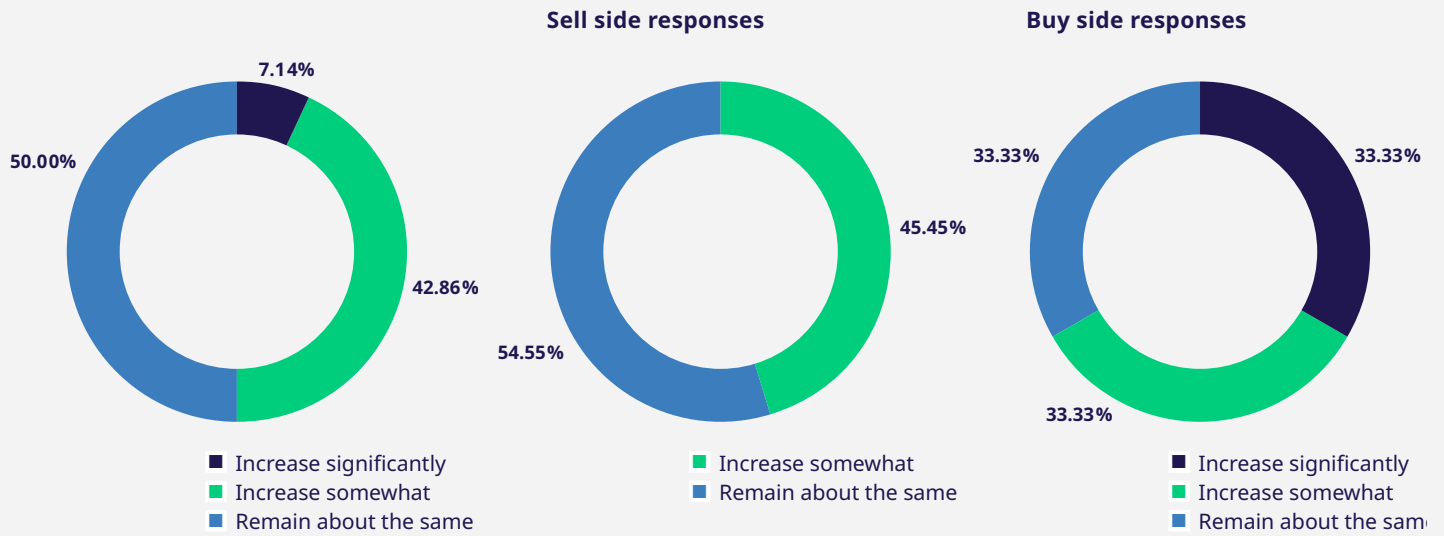
One notable shift in the last eight or nine months has been the growing popularity of single name dividend futures. More market participants are seeking to express their views on what the varying levels of different banks' dividend payments and buyback programs will be.

This is a significant development from a market year mainly favored index products last year, with traders prioritizing having a macro hedge in place.

Are you currently trading dividends?



Over the next 6 months, how do you expect the volume of dividend futures that you trade to change?



ESG could come into play

One new factor that could come to play in the future is ESG. While government intervention on company dividend policies seems to have retracted, it could possibly return if governments make firms integrate ESG performance metrics into their shareholder distribution calculations. The increased need for ESG investment could also eat into cash available for shareholder distribution.

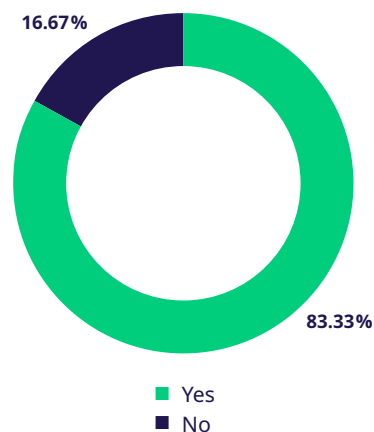
But over the next two years, dividends are set to continue their path of recovery from the 2020 chaos. Buybacks do represent a headwind but there are nuances to this trend that can support dividend futures' performance. It has also been encouraging to see some firms like AXA and Siemens signal their intention to increase dividend payments alongside announcing buy-back programs.

In the nearer term, prospects for growth on the buy-side look promising. Two-thirds of buy-side firms that Eurex surveyed expected the volume of dividend futures they trade to increase over the next six months while the remainder expect levels to stay the same.

The mood also looks upbeat on the sell-side, where a big majority of firms, 83%, said they expected to engage with listed dividend derivatives over the next six months.

While the market's recovery is expected to be steady, not explosive, engagement with the futures product is encouraging, as is its increasing diversity of participants. A lot of ground has been made up and developed since the chaos of H1 2020.

Do you think that your business will engage with listed dividend derivatives over the next six months? (Only sell-side responses)



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