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Rule changes boost LICs

New test helps listed investment companies pay dividends.

By John Robinson, GMI

The Federal Government recently made changes to legislation covering dividend payments. The reforms have been welcomed by many companies; particularly listed investment companies (LICs).

The amendments mean that rather than being required to pay a dividend out of profits, companies must apply a solvency test in determining the amount that can be paid to shareholders. The changes should give companies greater ability to manage the payment of dividends in varying economic conditions and increase certainty for shareholders as to the level of dividends to be paid.

*(Editor's note: To learn more about LICs, **register for the free ASX webinar** - Listed Companies Revisited - on August 31. More details are at the end of this story.)*

LICs are listed on ASX and provide investors access to a diverse range of underlying investments managed by professional investment managers. Depending on the mandate of the particular LIC, the investments may include property, listed or unlisted shares, and can vary from being Australian-based portfolios to being international and sector specific.

Global Mining Investments (GMI), for example, has a portfolio of approximately 50 listed and unlisted metal and mining investments with operations in many locations, and across several commodities. Its investments are listed on global sharemarkets that are not readily accessible to Australian investors and its investment portfolio is managed by an expert natural resources team from BlackRock Investment Management (UK) Limited.

Fixed pool of assets

Although the underlying investments of LICs are often similar to those offered by managed funds, they differ in that they can be readily bought and sold by investors on ASX, and are able to pay dividends, which are usually fully franked. LICs are closed-end, meaning the investment manager is able to focus on managing a fixed pool of assets rather than having to continually rebalance the portfolio or liquidate investments due to unforeseen fund inflows and outflows.

Because LICs are companies, a key feature that distinguishes them from managed funds is their ability to pay dividends, an important consideration for investors, particularly retail investors and self managed super funds (SMSFs) that rely on a steady flow of income from investments.

It is important for investors that there is an element of certainty in the dividends that are payable from their equity investments. Under the previous profits-based test it was difficult for LICs to provide dividend guidance to shareholders as their own income and profits from dividends, other sources and the realisation of investments, was uncertain.

The focus of LICs is generally to maintain and grow the value of their investments and net assets, rather than generating profits. Although this aim of capital growth is often consistent with the investment aims of shareholders, it ideally needs to be balanced with the desire of many shareholders to also receive a regular return from their investments through franked dividends.

Accounting standards amended

Previously, the requirement to pay dividends from profits may have caused some LICs to sell investments they would have preferred to hold, in order to realise a profit. It also meant that in times of economic downturn, many LICs were forced to suspend or reduce their dividend payments.

This was exacerbated during the recent global financial crisis when many LICs were required under accounting standards to record significant unrealised impairment losses, thereby decreasing their profit position and retained earnings, and causing dividend payment to be reduced, in some cases to nil. Amendments have now been made to accounting standards that should mean similar impairment losses are not required to be booked in the future.

LICs are usually recipients of dividend income that may be available to be passed on by them as part of their own dividend payments. The receipt of dividend income from underlying investments can be unreliable, however, particularly in times of economic downturn, and this impeded the ability of LICs to be able to predict and manage their own dividend payments under the previous profit-based dividend test.

The particular sector in which the LIC invests may also not be a significant payer of dividends. For example, because GMI is a resources-based company, many of its investments do not pay dividends - GMI therefore only having limited dividend income to pass through to its own investors when applying the former profits-based test.

Rather than paying dividends out of profits, the payment is now dependent on solvency-based considerations. The Corporations Act 2001 has been amended to require that a company can only pay a dividend if:

- Its assets exceed its liability immediately before the dividend is declared and the excess is sufficient to enable payment of the dividend.
- The dividend is fair and reasonable to the company's shareholders as a whole.
- The payment of the dividend does not materially prejudice the company's ability to pay its creditors.

Although a company must ensure it meets the new requirements in order to be able to pay a dividend, the new rules should mean that companies are able to provide shareholders with greater guidance as to the level of dividends that will be paid. Companies may also need to consider whether any changes to their constitutions are required to allow them to implement the changes.

LICs ordinarily have highly liquid assets, few creditors and low levels of gearing. They should therefore be in a position to pay dividends to shareholders if the board chooses to, regardless of economic conditions and profits generated by the company from either the realisation of investments or receipt of dividend income.

With the introduction of the new tests, LICs are well positioned to be able to manage the payment of dividends and provide shareholders with greater certainty now that the payment of dividends is based on cash flow, capital management and solvency considerations, rather than profits.

Monthly disclosure of NTA backing

LICs are required to publish their net tangible asset (NTA) backing per share on a monthly basis, with ASX and investors being regularly advised of the underlying value of each LIC, creating a very transparent sector for investors. Despite this transparency, many LICs traditionally trade at a discount to their NTA, with the uncertainty around regular returns to shareholders in the form of dividends possibly being a contributor to this discount.

The increased ability of companies to provide certainty to shareholders on dividend expectations should make LICs a more attractive investment to many investors, thereby increasing the share price and assisting in narrowing the discount to NTA.

The new dividend rules are yet to be fully applied and tested by companies, but the new solvency-based test is a positive outcome for companies, particularly LICS, and their shareholders, in enabling companies to better manage dividend payments and increase the certainty of dividend returns.

About the author

John Robinson is chairman of Global Mining Investments, a leading listed investment company that specialises in global mining shares.

From ASX

The **ASX LIC webinar** provide investors with the opportunity to learn:

- The range and styles of LICs - around 60 are listed on ASX
- Asset backing and NTA comparisons
- Franked dividends and the benefits afforded to SMSFs
- Incorporation of LICs in portfolios
- Recent performance through GFC and beyond

This is your opportunity to hear from ASX education experts about LICs.

Who should attend?

- Investors that have already chosen to use LICs in their portfolios seeking an update on the status of this investment class.
- Investors who may not have considered LICs as an investment suited to their needs.
- Advisers who may be looking for a straight forward low cost way to gain diversified exposure to equities for clients.
- Advisers currently using LICs with client portfolios seeking to revisit the basics of LICs.

Additional information

ASX Presenters: Jonathan Morgan

External Presenters: Argo Investments, Wilson Asset Management, Global Mining Investments, Whitefield and Sylvastate Limited, AFIC

Webinar length: the presentations will run for 90 minutes. There will be opportunities for you to ask questions throughout the session.

Questions: if you would like any further information about the session please email **managed.investments@asx.com.au**.

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