

Chapter 17

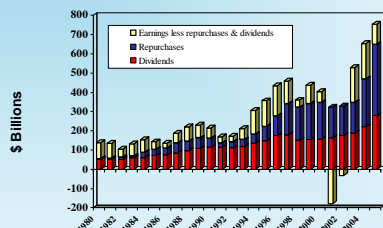
Payout Policy

Choice of Payout Policy

- Companies can pay out cash to shareholders in 2 ways
 - Dividend
 - Stock repurchase
- In the U.S. 64% of firms paid a dividend in 1980 but by 2005 it was only 41% of firms.
 - Some quit, many new growth companies had become public companies

Dividend & Stock Repurchases

U.S. Data 1980 - 2005



How firms pay dividends

- Declaration Date
 - Ex-dividend Date
 - Record Date
 - Payment Date
- Example:
- Oct. 15, company declares a dividend (declaration date)
 - Nov. 1, shares trade ex-dividend
 - Nov. 3, dividend will be paid to holders of record on that date
 - Dec. 1, dividend checks are mailed to shareholders

Types of Dividends

- Regular Cash Dividend
- Special (or extra) Dividend
- Stock Dividend
 - Example – a stock dividend of 10%, for every 100 shares one owns, they will be given 10 additional shares.
 - Essentially the same as a stock split

Repurchase Stock

- 4 methods of stock repurchase
 - Buy shares on the market
 - Tender offer to shareholders
 - Dutch Auction
 - Company tells prices that it would repurchase stocks at, shareholders tell how many shares they would sell at those prices
 - Private Negotiation with major shareholder
 - Sometimes “Green Mail”. An instance in which the company is getting a bidder to leave the target alone.

The Dividend Decision

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Lintner's "Stylized Facts"

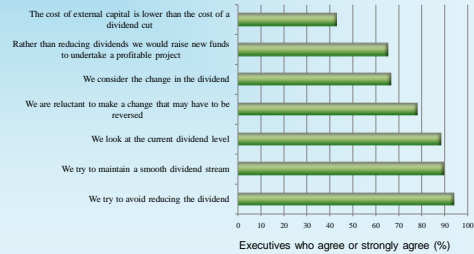
(How Dividends are Determined)

1. Firms have longer term target dividend payout ratios.
2. Managers focus more on dividend changes than on absolute levels.
3. Dividend changes follow shifts in long-run, sustainable levels of earnings rather than short-run changes in earnings.
4. Managers are reluctant to make dividend changes that might have to be reversed.
5. Firms repurchase stock when they have accumulated a large amount of unwanted cash or wish to change their capital structure by replacing equity with debt.

Dividend Decisions

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Dividend Decision Survey (2004)



Information in Dividends

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- Investors can learn from managers actions
 - There is some disagreement if there is information in dividend announcements.
 - Typically:
 - Higher dividends prompt increases in stock prices.
 - Lower dividends result in stock price decreases.
 - Most managers will not increase dividends unless they believe they can continue this into the future.

Information in Repurchases

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- Stock Repurchases may signal confidence about the future.
 - These are typically one time events.
 - If a company is willing to buy back its shares, it could be a signal that management believes that the stock is undervalued.

Payout Controversy

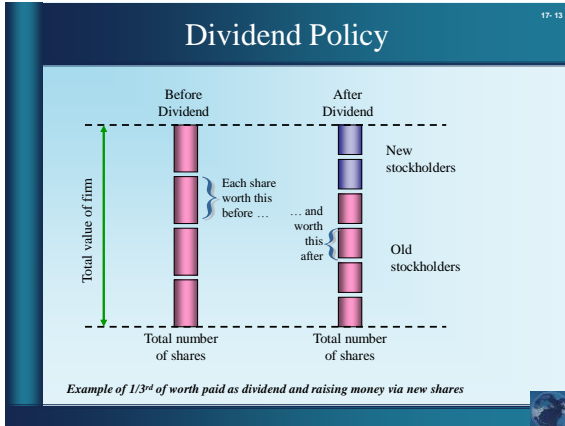
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- A change in payout may provide information about the future. Does the payout change the value of the firm?
 - 3 groups
 - (1) increase in dividend increases firm value
 - (2) higher dividend reduces firm value
 - (3) payout policy makes no difference.
 - No difference – MM's 1961 proof, and is generally accepted (although market imperfections and taxes may alter the situation)

Dividend Policy is Irrelevant

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- Assume firm has investment program. Any surplus will be paid as dividends.
- Firm wants to increase dividend. If borrowing (investment program is fixed), the only way to finance the dividend is sell more stock and use that to pay dividend.



Dividend Policy is Irrelevant

➤ Since investors do not need dividends to convert shares to cash they will not pay higher prices for firms with higher dividend payouts. In other words, dividend policy will have no impact on the value of the firm.

Dividend Policy is Irrelevant

Example - Assume Rational Demiconductor has no extra cash, but declares a \$1,000 dividend. They also require \$1,000 for current investment needs. Using M&M Theory, and given the following balance sheet information, show how the value of the firm is not altered when new shares are issued to pay for the dividend.

Record Date	
Cash	1,000
Asset Value	9,000
Total Value	10,000 +
New Proj NPV	2,000
# of Shares	1,000
price/share	\$12

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Record Date		Pmt Date	
Cash	1,000		0
Asset Value	9,000		9,000
Total Value	10,000 +		9,000
New Proj NPV	2,000		2,000
# of Shares	1,000		1,000
price/share	\$12		\$11

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Example - Assume Rational Demiconductor has no extra cash, but declares a \$1,000 dividend. They also require \$1,000 for current investment needs. Using M&M Theory, and given the following balance sheet information, show how the value of the firm is not altered when new shares are issued to pay for the dividend.

Record Date	Pmt Date	Post Pmt	
Cash	1,000	0	1,000 (91 sh @ \$11)
Asset Value	9,000	9,000	9,000
Total Value	10,000 +	9,000	10,000
New Proj NPV	2,000	2,000	2,000
# of Shares	1,000	1,000	1,091
price/share	\$12	\$11	\$11

NEW SHARES ARE ISSUED

Dividends Increase Value

Market Imperfections and Clientele Effect

There are natural clients for high-payout stocks, but it does not follow that any particular firm can benefit by increasing its dividends. The high dividend clientele already have plenty of high dividend stock to choose from.

These clients increase the price of the stock through their demand for a dividend paying stock.

Dividends Increase Value

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Dividends as Signals

Dividend increases send good news about cash flows and earnings. Dividend cuts send bad news.

Because a high dividend payout policy will be costly to firms that do not have the cash flow to support it, dividend increases signal a company's good fortune and its manager's confidence in future cash flows.

Dividends Decrease Value

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Tax Consequences

Companies can convert dividends into capital gains by shifting their dividend policies. If dividends are taxed more heavily than capital gains, taxpaying investors should welcome such a move and value the firm more favorably.

In such a tax environment, the total cash flow retained by the firm and/or held by shareholders will be higher than if dividends are paid.

Taxes and Dividend Policy

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- Since capital gains are taxed at a lower rate than dividend income, companies should pay the lowest dividend possible.
- Dividend policy should adjust to changes in the tax code.

Other Dividend Theories

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- **Bird-in-the-Hand Theory**
 - Investors think dividends are less risky than potential future capital gains, hence they like dividends.
 - If so, investors would value high payout firms more highly, i.e., a high payout would result in a high stock price.

Other Dividend Theories

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- **Tax Preference**
 - Low payouts mean higher capital gains. Capital gains taxes are deferred.
 - This could cause investors to prefer firms with low payouts, i.e., a high payout results in a low stock price.

Implications of Theories for Managers

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<u>Theory</u>	<u>Implication</u>
Irrelevance	Any payout OK
Bird-in-the-hand	Set high payout
Tax preference	Set low payout