Dividend Policy & Some Financial Jargons

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Dividends as a Passive Residual

Can the payment of cash dividends affect shareholder wealth?

If so, what dividend-payout ratio will maximize shareholder wealth?

- The firm uses earnings plus the additional financing that the increased equity can support to finance any expected positive-NPV projects.
- Any unused earnings are paid out in the form of dividends. This describes a passive dividend policy.

Irrelevance of Dividends

A. Current dividends versus retention of earnings

- M&M contend that the effect of dividend payments on shareholder wealth is exactly offset by other means of financing.
- The dividend plus the "new" stock price after dilution exactly equals the stock price prior to the dividend distribution.

Irrelevance of Dividends

B. Conservation of value

- M&M and the total-value principle ensures that the sum of market value plus current dividends of two firms identical in all respects other than dividend-payout ratios will be the same.
- Investors can "create" any dividend policy they desire by selling shares when the dividend payout is too low or buying shares when the dividend payout is excessive.

Relevance of Dividends

A. Preference for dividends

- Uncertainty surrounding future company profitability leads certain investors to prefer the certainty of current dividends.
- Investors prefer “large” dividends.
- Investors prefer the company to distribute them directly.

Relevance of Dividends

B. Taxes on the investor

- Capital gains taxes are deferred until the actual sale of stock. This creates a timing option.
- Capital gains are preferred to dividends, everything else equal (due to tax structure)
- Certain institutional investors pay no tax.

Relevance of Dividends

B. Taxes on the investor (continued)

- Corporations generally prefer to receive dividends rather than capital gains (because of tax structure).
- The result is clienteles of investors with different dividend preferences. In equilibrium, there will be the proper distribution of firms with differing dividend policies to exactly meet the needs of investors.
- Thus, dividend-payout decisions are relevant.

Other Dividend Issues

- Flotation costs
- Transaction costs and divisibility of securities
- Institutional restrictions
- Financial signaling

Empirical Work on Dividend Policy

Tax Effect

- Dividends are taxed more heavily than capital gains, so before-tax returns should be higher for high-dividend-paying firms.
- Empirical results largely confirm.

Financial Signaling

- Expect that increases (decreases) in dividends lead to positive (negative) excess stock returns.
- Empirical results are consistent with these expectations.

Implications for Corporate Policy

- Distribute excess funds to shareholders and stabilize the absolute amount of dividends if necessary (passive).
- Payouts greater than excess funds should occur only in an environment that has a net preference for dividends.

Implications for Corporate Policy

- There is a positive value associated with a modest dividend. Could be due to institutional restrictions or signaling effects.
- Dividends in excess of the passive policy does not appear to lead to share price improvement because of taxes and flotation costs.

Factors Influencing Dividend Policy

Legal Rules

- Governments prohibit the payment of dividends if these dividends impair "capital" (usually par value of common stock).

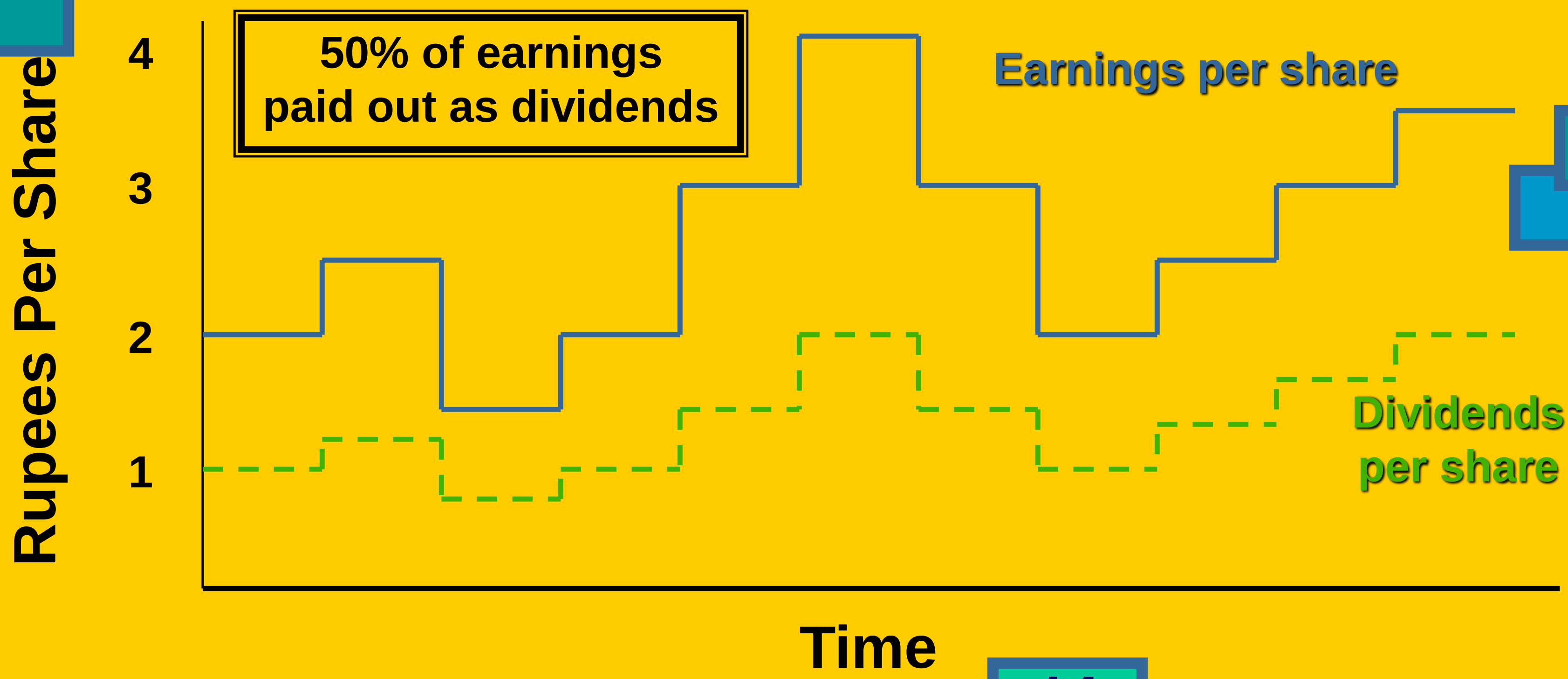
Factors Influencing Dividend Policy

Other Issues to Consider

- Funding Needs of the Firm
- Liquidity
- Ability to Borrow
- Restrictions in Debt Contracts
- Control

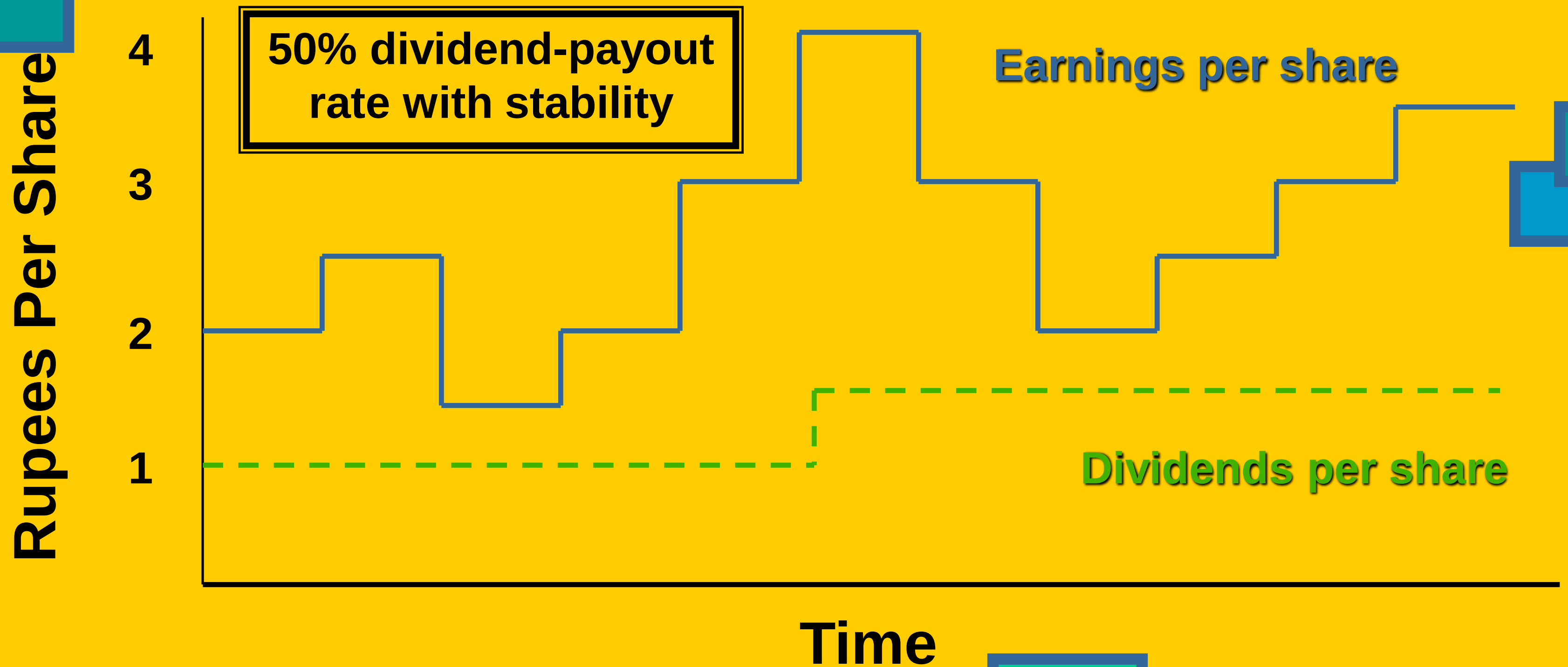
Dividend Stability

Stability -- maintaining the position of the firm's dividend payments in relation to a trend line.



Dividend Stability

Dividends begin at 50% of earnings, but are stable and increase only when supported by growth in earnings.



Valuation of Dividend Stability

- Information content -- management may be able to affect the expectations of investors through the informational content of dividends. A stable dividend suggests that the company expects stable or growing dividends in the future.
- Current income desires -- some investors who desire a specific periodic income will prefer a company with stable dividends to one with unstable dividends.
- Institutional considerations -- a stable dividend may permit certain institutional investors to buy the common stock as they meet the requirements to be placed on the organizations “approved list.”

Types of Dividends

Regular Dividend

- **The dividend that is normally expected to be paid by the firm.**

Extra dividend

- A nonrecurring dividend paid to shareholders in addition to the regular dividend. It is brought about by special circumstances.

Stock Dividends and Stock Splits

Stock Dividend -- A payment of additional shares of stock to shareholders. Often used in place of or in addition to a cash dividend.

Small-percentage stock dividends

- Typically less than 25% of previously outstanding common stock.

Stock Dividends, EPS, and Total Earnings

After a small-percentage stock dividend, what happens to EPS and total earnings of individual investors?

- Assume that Manish owns 10,000 shares and the firm earned $2.50 per share.
- Total earnings = $2.50 x 10,000 = $25,000.
- After the 5% stock dividend, investor Manish owns 10,500 shares and the same proportionate earnings of $25,000.
- EPS is then reduced to $2.38 per share because of the stock dividend ($25,000 / 10,500 shares = $2.38 EPS).

Bonus Issues

Large-percentage stock dividends

- Typically 20% or greater of previously outstanding stock.
- The material effect on the market price per share causes the transaction to be accounted for differently. Reclassification is limited to the par value of additional shares rather than pre-stock-dividend value of additional shares.
- Assume a company with 400,000 shares of $5 par common stock outstanding pays a 100% stock dividend. The pre-stock-dividend market value per share is $40. How does this impact the shareholders' equity accounts?

B/S Changes for the Bonus Issue

- $2 million ($5 x 400,000 new shares) transferred (on paper) “out of” retained earnings.
- $2 million transferred “into” common stock account.

'Bonus Issue' or 'Large-Percentage Stock Dividends'

Before 100% Stock Dividend

Common stock	
($5 par; **400,000 shares**)	**$ 2,000,000**
Additional paid-in capital	**1,000,000**
Retained earnings	**7,000,000**
Total shareholders' equity	$10,000,000

After 100% Stock Dividend

Common stock	
($5 par; **800,000 shares**)	**$ 4,000,000**
Additional paid-in capital	**1,000,000**
Retained earnings	**5,000,000**
Total shareholders' equity	$10,000,000

Stock Dividends and Stock Splits

Stock Split -- An increase in the number of shares outstanding by reducing the par value of the stock.

- Similar economic consequences as a 100% stock dividend.
- Primarily used to move the stock into a more popular trading range and increase share demand.
- Assume a company with 400,000 shares of $5 par common stock splits 2-for-1. How does this impact the shareholders’ equity accounts?

Stock Splits

Before 2-for-1 Stock Split	
Common stock	
($5 par; **400,000 shares**)	**$ 2,000,000**
Additional paid-in capital	**1,000,000**
Retained earnings	**7,000,000**
Total shareholders' equity	$10,000,000

After 2-for-1 Stock Split	
Common stock	
($2.50 par; **800,000 shares**)	**$ 2,000,000**
Additional paid-in capital	**1,000,000**
Retained earnings	**7,000,000**
Total shareholders' equity	$10,000,000

Value to Investors of Stock Dividends or Stock Splits

- Effect on investor total wealth
- Effect on investor psyche
- Effect on cash dividends
- More popular trading range
- Informational content

Stock Dividends and Stock Splits

Reverse Stock Split -- A stock split in which the number of shares outstanding is decreased.

- Used to move the stock into a more popular trading range and increase share demand.
- Usually signals negative information to the market upon its announcement (consistent with empirical evidence).
- Assume a company with 400,000 shares of $5 par common stock splits 1-for-4. How does this impact the shareholders' equity accounts?

Reverse Stock Splits

Before 1-for-4 Stock Split

Common stock	
($5 par; **400,000 shares**)	**$ 2,000,000**
Additional paid-in capital	**1,000,000**
Retained earnings	**7,000,000**
Total shareholders' equity	$10,000,000

After 1-for-4 Stock Split

Common stock	
($20 par; **100,000 shares**)	**$ 2,000,000**
Additional paid-in capital	**1,000,000**
Retained earnings	**7,000,000**
Total shareholders' equity	$10,000,000

Stock Repurchase

Stock Repurchase -- The repurchase (buyback) of stock by the issuing firm, either in the open (secondary) market or by self-tender offer.

Reasons for stock repurchase:

- Available for management stock-option plans
- Available for the acquisition of other companies
- "Go private" by repurchasing all shares from outside stockholders
- To permanently retire the shares

Methods of Repurchase

- <u>Fixed-price self-tender offer</u> -- An offer by a firm to repurchase some of its own shares, typically at a set price.
- <u>Dutch auction self-tender offer</u> -- A buyer (seller) seeks bids within a specified price range, usually for a large block of stock or bonds. After evaluating the range of bid prices received, the buyer (seller) accepts the lowest price that will allow it to acquire (dispose of) the entire block.
- <u>Open-market purchase</u> -- A company repurchases its stock through a brokerage house on the secondary market.

Repurchasing as Part of Dividend Policy

Assume:

Earnings after taxes	$ 800,000
Number of common shares outstanding	÷ 400,000
Earnings per share	$ 2
Current market price per share	$ 31
Expected dividend per share	$ 1
Expected total dividends to be paid out	$ 400,000

Repurchasing as Part of Dividend Policy

If dividend is paid, shareholders receive:

■ Expected dividend per share	$	1
■ Market price per share	$	30
■ Total value	$	31

If shares repurchased, shareholders receive:

■ Dividend per share	$	0
■ Market price per share*	$	31
■ Total value	$	31

* Shares repurchased = $400,000 / $31 = 12,903

Original P/E ratio = $30/$2 = 15

"New" EPS = $800,000 / 387,097 = $2.07

"New" market price = $2.07 x 15 = $31

Summary of Repurchasing as Part of Dividend Policy

- The capital gain arising from the repurchase (stock rising from $30 to $31) exactly equals the dividend ($1) that would have otherwise been paid.
- This result holds in the absence of taxes and transaction costs.
- To the taxable investor, capital gains (repurchases) are favored to dividend income as the tax on the capital gain is postponed until the actual sale of the common shares.

Summary of Repurchasing as Part of Dividend Policy

- Stock repurchases are most relevant for firms with large amounts of excess cash that might otherwise generate a significant taxable transaction to investors.

Possible Signaling Effect

- Repurchases have a positive signaling effect.
- For example, if the stock is undervalued management may tender for shares at a "premium." This signals that the share prices are undervalued.

Administrative Considerations: Procedural Aspects

Record Date -- The date, set by the board of directors when a dividend is declared, on which an investor must be a shareholder of record to be entitled to the upcoming dividend.

The board of directors met on May 8th to declare a dividend payable to shareholders on June 15th to the shareholders of record on May 31st.

Administrative Considerations: Procedural Aspects

Ex-dividend Date -- The first date on which a stock purchaser is no longer entitled to the recently declared dividend.

The buyer and seller of the shares have several days to ***settle*** (pay for the shares or deliver the shares).

Administrative Considerations: Procedural Aspects

Declaration Date -- The date that the board of directors announces the amount and date of the next dividend.

Payment Date -- The date when the corporation actually pays the declared dividend.