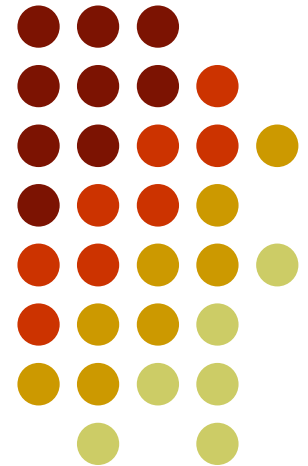


The Features of Stock

Chapter 6





Outline

- Dividend policy
 - Cash dividends
 - Stock dividends
- Stock splits
- Repurchase of stock
- References: BF Chap 10

Equity



- Ownership in a corporation
- Residual claim
- Riskier than debt from investors' perspective



“Agency” Assumptions

- Management represents the owners
- Management is the agent of the owners
- The “agency” problem
 - Possible conflict of interest

Rights of Common Stockholders



- Voting authority to elect a board of directors
 - Board of directors: body elected by and responsible to stockholders to set policy and hire management to run a corporation
- Cumulative voting
 - Voting system that encourage minority representation by permitting stockholders to cast all their shares (votes) for one candidate for the firm's board of directors
- Preemptive rights and rights offerings



Cumulative Voting

- Suppose a firm has 1,000 shares outstanding and a board of directors composed of five members. The 70% majority would have a total of 3,500 votes (700 shares \times 5). The 30% minority would have 1,500 votes.

Majority Candidates		Votes
A		700
B		700
C		700
D		700
E		700
Minority Candidates		Votes
F		750
G		750

Preemptive rights and rights offerings



- Preemptive rights
 - Right of current stockholders to maintain their proportionate ownership in the firm
- Rights offerings
 - Sale of new securities to stockholders by offering them the option (right) to purchase new shares



Cash Dividends

- Distribution from earnings paid in the form of cash
- Distribution of dividends does not affect paid-in capital in the balance sheet
 - Suppose initially the firm's balance sheet is

Assets		Liabilities and Equity	
Assets	\$10,000	Debt	\$ 3,000
		Common stock	4,000
		Retained earnings	3,000
	<u>\$10,000</u>		<u>\$10,000</u>



Cash Dividends

- During the year the firm earns \$1,000
 - Case 1. Distributing the earning

Assets		Liabilities and Equity	
Assets	\$10,000	Debt	\$ 3,000
		Equity	4,000
		Retained earnings	3,000
	<u>\$10,000</u>		<u>\$10,000</u>

- Case 2. Retaining all of the earnings to acquire additional assets

Assets		Liabilities and Equity		
Assets	Increase in assets by \$1,000	Debt	\$ 3,000	
		Equity	4,000	
		Retained earnings	4,000	Increase in retained earnings by \$1,000
	<u>\$11,000</u>		<u>\$11,000</u>	



Cash Dividends

- Case 3. Retaining all earnings to retire outstanding debt

Assets		Liabilities and Equity			
Assets	\$10,000	Debt	Reduction—	\$ 2,000	
		Equity	in debt by	4,000	Increase in re-
		Retained earnings	\$1,000	4,000	tained earnings
					by \$1,000
	<u>\$10,000</u>			<u>\$10,000</u>	



Cash Dividends

- Payout ratio
 - Ratio of cash dividends to earnings
 - Proportion of earnings that are distributed
- Date of record
 - Day on which an investor must own stock in order to receive the dividend payment
- Ex dividend
 - Stock purchases exclusive of any dividend payment



Cash Dividends

- Price of stock declines by the amount of the dividend
- Pay date / Distribution date
 - Day on which a dividend is paid to stockholders



Stock Dividends

- Distribution from earnings paid in additional shares of stock
- Does not affect assets, liabilities, or total equity
- Dilution of existing shares
 - Reduction in earnings per share as the result of issuing additional shares
- Price adjusts for stock dividend



Stock Dividends: Example

- Assume a 10% stock dividend
 - Initial equity section of a balance sheet

Equity: \$1 par common stock (2,000,000 shares authorized; 1,000,000 outstanding)	\$1,000,000
Additional paid-in capital	500,000
Retained earnings	<u>5,000,000</u>
	<u><u>\$6,500,000</u></u>

- After stock dividend

Equity: \$1 par common stock (2,000,000 shares authorized; 1,100,000 outstanding)	\$1,100,000
Additional paid-in capital	2,400,000
Retained earnings	<u>3,000,000</u>
	<u><u>\$6,500,000</u></u>



Stock Splits

- Recapitalization achieved by changing the number of shares outstanding
- After the price of a stock has risen substantially, management may choose to split the stock.
- Does not affect proportionate ownership
- Does not affect assets, liabilities, or total equity
- Stock price adjusts for the split



Stock Splits: Example

- Assume a 2 for 1 stock split
 - Initial equity section of a balance sheet

Equity: \$1 par common stock (2,000,000 shares authorized; 1,000,000 outstanding)	\$1,000,000
Additional paid-in capital	500,000
Retained earnings	<u>5,000,000</u>
	<u><u>\$6,500,000</u></u>

- After the stock split

Equity: \$0.50 par common stock (2,000,000 shares authorized; 2,000,000 outstanding)	\$1,000,000
Additional paid-in capital	500,000
Retained earnings	<u>5,000,000</u>
	<u><u>\$6,500,000</u></u>



Reverse Stock Split

- Assume a 1 for 5 stock split
 - Number of shares reduces: 1,000,000 outstanding → 200,000 outstanding
 - Stock price increases: \$1 par → \$5 par



Stock Repurchases

- Corporations with cash may reduce the number of existing shares through buy back programs.
- The decrease in outstanding shares may
 - increase earnings per share
 - increase the price of the stock
- Repurchasing shares may be viewed as an alternative to paying cash dividends.
- Stockholders have the option to sell or retain their shares.



Summary

- What is equity
- Why may cumulative voting give minority stockholders representation on a firm's board of directors?
- Cash dividends
 - Payout ratio
 - Impact of retaining earnings versus paying cash dividends on a firm's balance sheet (3 cases)



Summary

- Stock dividends
 - Dilution of existing shares
 - Impact of stock dividends on a firm's balance sheet
- Stock splits
 - What is stock split?
 - Impact of stock splits on a firm's balance sheet
- Stock repurchases
 - Number of outstanding shares decreases
 - Earning per shar and stock price increase