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 × 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
	$10,000		$10,000

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
	$10,000		$10,000

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

Assets			Liabilities and Equity		
Assets	Increase in assets by $1,000	$11,000	Debt	$ 3,000	Increase in retained earnings by $1,000
			Equity	4,000	
			Retained earnings	4,000	
		$11,000		$11,000	

Cash Dividends

- Case 3. Retaining all earnings to retire outstanding debt

Assets		Liabilities and Equity			
Assets	$10,000	Debt	Reduction in debt by $1,000	$ 2,000	Increase in re-tained earnings by $1,000
		Equity		4,000	
		Retained earnings		4,000	
	$10,000			$10,000	

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	5,000,000
	$6,500,000

  - 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	3,000,000
	$6,500,000

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	5,000,000
	$6,500,000

  - 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	5,000,000
	$6,500,000

Reverse Stock Split

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