DIVIDEND POLICY/ DISTRIBUTION POLICY

Mature companies with stable cash flows and limited growth opportunities tend to return large amounts of their cash flows to shareholders, either by paying dividends or by using the cash to repurchase common stock. In contrast, rapidly growing companies with good investment opportunities are prone to invest most of their available cash flows in new projects and thus are less likely to pay dividends or repurchase stock. Here are the central issues addressed in this chapter:

- *Can a company increase its value through its choice of **distribution policy**, defined as*
    - *The level of distributions,*
    - *The form of distributions (cash dividends versus stock repurchases), and*
    - *The stability of distributions? Do different groups of shareholders prefer one form of distribution over the other? Do shareholders perceive distributions as signals regarding a firm's risk and expected future free cash flows?*

OVERVIEW OF DIVIDEND POLICY

A company must have cash before it can make a cash distribution to shareholders. Occasionally the cash comes from a recapitalization or the sale of an asset, but in most cases it comes from the company's internally generated free cash flow. Recall that FCF is defined as the amount of cash flow available for distribution to investors after expenses, taxes, and the necessary investments in operating capital. Thus, the source of FCF depends on a company's investment opportunities and its effectiveness in turning those opportunities into realities. Notice that a company with many opportunities will have large investments in operating capital and might have negative FCF even if the company is profitable. But when growth begins to slow, a profitable company's FCF will be positive and very large.

After FCF becomes positive, how should a company use it? There are only five potentially "good" ways to use free cash flow:

(1) Pay interest expenses,
(2) Pay down the principal on debt,
(3) Pay dividends,
(4) Repurchase stock, or
(5) Buy non-operating assets such as Treasury bills or other marketable securities.

A company's capital structure choice determines its payments for interest expenses and debt principal. A company's value typically increases over time, even if the company is mature, which implies its debt will also increase over time if the company maintains a target capital structure. If a company instead were to pay off its debt, then it would lose valuable tax shields associated with the deductibility of interest expenses. Therefore, most companies make net additions to debt over time rather than net repayments, even if FCF is positive. This "negative use" of FCF provides even more FCF for the other uses.

A company's working capital policies, on the other hand, determine its level of marketable securities. The higher the working capital requirements, the higher will be the level of marketable securities held.

In summary, a company's investment opportunities and operating plans determine its level of FCF. The company's capital structure policy determines the amount of debt and interest payments. Working capital policy determines the investment in marketable securities. The remaining FCF should be distributed to shareholders, with the only question being how much to distribute in the form of dividends versus stock repurchases. Obviously this is a simplification, since companies (1) sometimes scale back their operating plans for sales and asset growth if such reductions are needed to maintain an existing dividend, (2) temporarily adjust their current financing mix in response to market conditions, and (3) often use marketable securities as shock absorbers for fluctuations in short-term cash flows. Still, there is an interdependence among operating plans (which have the biggest impact on free cash flow), financing *plans (which have the biggest impact on the cost of capital), working capital policies (which determine the target level of marketable securities), and shareholder distributions.*

PROCEDURES FOR CASH DISTRIBUTIONS

Companies can distribute cash to shareholders via cash dividends or stock repurchases. In this section we describe the actual procedures used to make cash distributions.

Dividend Payment Procedures

Dividends are normally paid annually (but usually there is an interim dividend payout preceding the final dividend payout), and, if conditions permit, the dividend is increased once each year. For example, suppose EABL Corporation paid a Ksh. 2.00 dividend per share in 2010, comprising of Ksh. 0.50 interim dividend and Ksh. 1.50 final dividend per share. In common financial parlance, we say that in 2010 EABL's annual dividend was Ksh.2.00. In late 2010, EABL's board of directors met, reviewed projections for 2011, and decided to keep the 2011 dividend at Ksh.2.00. The directors announced the Ksh.2 rate, so stockholders could count on receiving it unless the company experienced unanticipated operating problems. The actual payment procedure is as follows.

1. *Declaration date. On the declaration date—say, on Thursday, November 11—the directors meet and declare the regular dividend, issuing a statement similar to the following: "On November 11, 2010, the directors of EABL Corporation met and declared the dividend of Ksh. 2.00 per share, payable to holders of record as of Friday, December 10, payment to be made on Friday, January 7, 2011." For accounting purposes, the declared dividend becomes an actual liability on the declaration date. If a balance sheet were constructed, an amount equal to Ksh.2.00 × n0, where n0 is the number of shares outstanding would appear as a current liability, and retained earnings would be reduced by a like amount.*
2. *Holder-of-record date. At the close of business on the holder-of-record date, December 10, the company closes its stock transfer books and makes up a list of shareholders as of that date. If EABL Corporation is notified of the sale before 5 p.m. on December 10, then the new owner receives the dividend. However, if notification is received after 5 p.m. on December 10, the previous owner gets the dividend check.*
3. *Ex-dividend date. Suppose Otieno Oloo buys 100 shares of stock from John Kamau on December 7. Will the company be notified of the transfer in time to list the buyer as the new owner and thus pay the dividend to her? To avoid conflict, the securities industry has set up a convention under which the right to the dividend remains with the stock until two business days prior to the holder-of-record date; on the second day before that date, the right to the dividend no longer goes with the shares. The date when the right to the dividend leaves the stock is called the ex-dividend date. In this case, the ex-dividend date is two days prior to December 10, which is December 8:*

   Dividend goes with stock: Tuesday, December 7
   Ex-dividend date: Wednesday, December 8
   Thursday, December 9
   Holder-of-record date: Friday, December 10

   Therefore, if the buyer is to receive the dividend, she must buy the stock on or before December 7. If she buys it on December 8 or later, Seller will receive the dividend because he will be the official holder of record. EABL's dividend amounts to Ksh.2.00, so the ex-dividend date is important. Barring fluctuations in the stock market, we would normally expect the price of a stock to drop by approximately the amount of the dividend on the ex-dividend date. Thus, if EABL closed at Ksh.32.00 on December 7, it would probably open at about Ksh. 30 on December 8.
4. *Payment date. The company actually pays the dividend on January 7, the payment date, to the holders of record.*

STOCK REPURCHASE PROCEDURES

Stocks repurchases occur when a company buys back some of its own outstanding stock. Three situations can lead to stock repurchases. First, a company may decide to increase its leverage by issuing debt and using the proceeds to repurchase stock. Second, many firms have given their employees stock options, and companies often repurchase their own stock to sell to employees when employees exercise the options. In this case, the number of outstanding shares reverts to its pre-repurchase level after the options are exercised. Third, a company may have excess cash. This may be due to a one-time cash inflow, such as the sale of a division, or the company may simply be generating more free cash flow than it needs to service its debt.

Stock repurchases are usually made in one of three ways.

(1) A publicly owned firm can buy back its own stock through a broker on the open market.

(2) The firm can make a tender offer, under which it permits stockholders to send in (that is, "tender") shares in exchange for a specified price per share. In this case, the firm generally indicates it will buy up to a specified number of shares within a stated time period (usually about two weeks). If more shares are tendered than the company wants to buy, purchases are made on a pro rata basis.

(3) The firm can purchase a block of shares from one large holder on a negotiated basis. This is a targeted stock repurchase.

CASH DISTRIBUTIONS AND FIRM VALUE

*A company can change its value of operations only if it changes the cost of capital or investors' perceptions regarding expected free cash flow. This is true for all corporate decisions, including the distribution policy. Is there an **optimal distribution policy** that maximizes a company's intrinsic value?*

*The answer depends in part on investors' preferences for returns in the form of dividend yields versus capital gains. The relative mix of dividend yields and capital gains is determined by the **target distribution ratio**, which is the percentage of net income distributed to shareholders through cash dividends or stock repurchases, and the **target payout ratio**, which is the percentage of net income paid as a cash dividend.*

Notice that the payout ratio must be less than the distribution ratio because the distribution ratio includes stock repurchases as well as cash dividends. A high distribution ratio and a high payout ratio mean that a company pays large dividends and has small (or zero) stock repurchases. In this situation, the dividend yield is relatively high and the expected capital gain is low. If a company has a large distribution ratio but a small payout ratio, then it pays low dividends but regularly repurchases stock, resulting in a low dividend yield but a relatively high expected capital gain yield. If a company has a low distribution ratio, then it must also have a relatively low payout ratio, again resulting in a low dividend yield and, it is hoped, relatively high capitals gain. In this section, we examine three theories of investor preferences for dividend yield versus capital gains:

(1) The dividend irrelevance theory,

(2) The dividend preference theory (also called the "bird in the hand" theory), and

(3) The tax effect theory.

Dividend Irrelevance Theory

*The original proponents of the **dividend irrelevance theory** were Merton Miller and Franco Modigliani (MM). They argued that the firm's value is determined only by its **basic earning power** and its **business risk**. In other words, MM argued that the value of the firm depends only on the income produced by its assets, not on how this income is split between dividends and retained earnings. To understand MM's argument, recognize that any shareholder can in theory construct his own dividend policy. For example, if a firm does not pay dividends, a shareholder who wants a 5% dividend can "create" it by selling 5% of his stock. Conversely, if a company pays a higher dividend than an investor desires, the investor can use the unwanted dividends to buy additional shares of the company's stock. If investors could buy and sell shares and thus create their own dividend policy without incurring costs, then the firm's dividend policy would truly be irrelevant. In developing their dividend theory, MM made a number of important* *assumptions, especially the absence of taxes and brokerage costs. If these assumptions are not true, then investors who want additional dividends must incur brokerage costs to sell shares and must pay taxes on any capital gains. Investors who do not want dividends must incur brokerage costs to purchase shares with their dividends. Because taxes and brokerage costs certainly exist, dividend policy may well be relevant. We will discuss empirical tests of MM's dividend irrelevance theory shortly.*

Dividend Preference (Bird-In-The-Hand) Theory

The principal conclusion of MM's dividend irrelevance theory is that dividend policy does not affect a stock's value or risk. Therefore, it does not affect the required rate of return on equity, rs. In contrast, Myron Gordon and John Lintner both argued that a stock's risk declines as dividends increase: A return in the form of dividends is a sure thing, but a return in the form of capital gains is risky. In other words, a ***bird in the hand*** *is worth more than two in the bush. Therefore, shareholders prefer dividends and are willing to accept a lower required return on equity. The possibility of agency costs leads to a similar conclusion. First, high payouts reduce the risk that managers will squander cash because there is less cash on hand. Second, a high-payout company must raise external funds more often than a low payout company, all else held equal. If a manager knows that the company will receive frequent scrutiny from external markets, then the manager will be less likely to engage in wasteful practices. Therefore, high payouts reduce the risk of agency costs. With less risk, shareholders are willing to accept a lower required return on equity.*

Tax Effect Theory: Capital Gains Are Preferred

In Kenya, individual investors pay 5% withholding tax on dividends but zero rates on long-term capital gains. There are two reasons why stock price appreciation still is taxed more favorably than dividend income. First, the time value of money means that a Shilling of taxes paid in the future has a lower effective cost than a Shilling paid today. So even when dividends and gains are taxed equally, capital gains are never taxed sooner than dividends. Second, if a stock is held until the shareholder dies, then no capital gains tax is due at all: the beneficiaries who receive the stock can use its value on the date of death as their cost basis and thus completely escape the capital gains tax.

Because dividends most cases taxed more highly than capital gains, investors might require a higher pre-tax rate of return to induce them to buy dividend-paying stocks. Therefore, investors may prefer that companies minimize dividends. If so, then investors should be willing to pay more for low-payout companies than for otherwise similar high-payout companies.

EMPIRICAL EVIDENCE ON DISTRIBUTION POLICIES

It is very difficult to construct a perfect empirical test of the relationship between payout policy and the required rate of return on stock. First, all factors other than distribution level should be held constant; that is, the sample companies should differ only in their distribution levels. Second, each firm's cost of equity should be measured with a high degree of accuracy. Unfortunately, we cannot find a set of publicly owned firms that differ only in their distribution levels, nor can we obtain precise estimates of the cost of equity. Therefore, no one has yet identified a completely unambiguous relationship between the distribution level and the cost of equity or firm value. Although none of the empirical tests is perfect, recent evidence does suggest that firms with higher dividend payouts also have higher required returns. This tends to support the tax effect hypothesis, although the size of the required return is too high to be fully explained by taxes. Agency costs should be most severe in countries with poor investor protection. In such countries, companies with high dividend payouts should be more highly valued than those with low payouts because high payouts limit the extent to which managers can expropriate shareholder wealth. Recent research shows that this is the case, which supports the dividend preference hypothesis in the case of companies with severe agency problems. Although the evidence from these studies is mixed as to whether the average investor uniformly prefers either higher or lower distribution levels, other research does show that individual investors have strong preferences. Also, other research shows that investors prefer stable, predictable dividend payouts (regardless of the payout level) and that they interpret *dividend changes as signals about firms' future prospects. We discuss these issues in the next several sections.*

CLIENTELLE EFFECT

As indicated earlier, different groups, or clienteles, of stockholders prefer different dividend payout policies. For example, retired individuals, pension funds, and university endowment funds generally prefer cash income, so they may want the firm to pay out a high percentage of its earnings. Such investors are often in low or even zero tax brackets, so taxes are of no concern. On the other hand, stockholders in their peak earning years might prefer reinvestment, because they have less need for current investment income and would simply reinvest dividends received—after first paying income taxes on those dividends. Therefore, investors who want current investment income should own shares in high–dividend payout firms, while investors with no need for current investment income should own shares in low–dividend payout firms.

Evidence from several studies suggests that there is, in fact, a clientele effect. It's been argued by MM and others that one clientele is as good as another, so the existence of a clientele effect does not necessarily imply that one dividend policy is better than any other. However, MM may be wrong, and neither they nor anyone else can prove that the aggregate makeup of investors permits firms to disregard clientele effects. This issue, like most others in the dividend arena, is still up in the air.

INFORMATION CONTENT OR SIGNALING HYPOTHESIS

When MM set forth their dividend irrelevance theory, they assumed that everyone—investors and managers alike—has identical information regarding a firm's future earnings and dividends. In reality, however, different investors have different views on both the level of future dividend payments and the uncertainty inherent in those payments, and managers have better information about future prospects than public stockholders. It has been observed that an increase in the dividend is often accompanied by an increase in the price of a stock and that a dividend cut generally leads to a stock price decline. Some have argued this indicates that investors prefer dividends to capital gains. However, MM saw this differently. They noted the well-established fact that corporations are reluctant to cut dividends, which implies that corporations do not raise dividends unless they anticipate higher earnings in the future.

Thus, MM argued that a higher than expected dividend increase is a signal to investors that the firm's management forecasts good future earnings. Conversely, a dividend reduction, or a smaller than expected increase, is a signal that management is forecasting poor earnings in the future. Thus, MM argued that investors' reactions to changes in dividend policy do not necessarily show that investors prefer dividends to retained earnings. Rather, they argue that price changes following dividend actions simply indicate that there is important information, or signaling, content in dividend announcements.

SETTING THE TARGET DISTRIBUTION LEVEL

1. ***THE RESIDUAL DISTRIBUTION MODEL***

   When deciding how much cash to distribute to stockholders, two points should be kept in mind:
   (1) the overriding objective is to maximize shareholder value, and
   (2) the firm's cash flows really belong to its shareholders, so a company should refrain from retaining income unless its managers can reinvest that income to produce returns higher than shareholders could themselves earn by investing the cash in investments of equal risk.

   On the other hand, recall from the previous chapter that internal equity (reinvested earnings) is cheaper than external equity (new common stock issues) because it avoids flotation costs and adverse signals. This encourages firms to retain earnings so as to avoid having to issue new stock. When establishing a distribution policy, one size does not fit all. Some firms produce a lot of cash but have limited investment opportunities—this is true for firms in profitable but mature industries in which few opportunities for growth exist. Such firms typically distribute a large *percentage of their cash to shareholders, thereby attracting investment clienteles that prefer high dividends. Other firms generate little or no excess cash because they have many good investment opportunities. Such firms generally don't distribute much cash but do enjoy rising earnings and stock prices, thereby attracting investors who prefer capital gains. Generally, firms in stable, cash-producing industries such as utilities, financial services, and tobacco pay relatively high dividends, whereas companies in rapidly growing industries such as computer software tend to pay lower dividends. For a given firm, the optimal distribution ratio is a function of four factors: (1) investors' preferences for dividends versus capital gains, (2) the firm's investment opportunities, (3) its target capital structure, and (4) the availability and cost of external capital. The last three elements are combined in what we call the residual distribution model. Under this model a firm follows these four steps when establishing its target distribution ratio:*

(1) It determines the optimal capital budget;

(2) It determines the amount of equity needed to finance that budget, given its target capital structure;

(3) It uses reinvested earnings to meet equity requirements to the extent possible; and

(4) It pays dividends or repurchases stock only if more earnings are available than are needed to support the optimal capital budget. The word residual implies "leftover," and the residual policy implies that distributions are paid out of "leftover" earnings.

THE PROS AND CONS OF DIVIDENDS AND STOCK REPURCHASES

The advantages of repurchases can be listed as follows.

1. Repurchase announcements are viewed as positive signals by investors because the repurchase is often motivated by management's belief that the firm's shares are undervalued.

2. Stockholders have a choice when the firm distributes cash by repurchasing stock
—they can sell or not sell. Those stockholders who need cash can sell back some of their shares while others can simply retain their stock. With a cash dividend, on the other hand, stockholders must accept a dividend payment.

3. Dividends are "sticky" in the short run because management is usually reluctant to raise the dividend if the increase cannot be maintained in the future, and cutting cash dividends is always avoided because of the negative signal it gives. Hence, if the excess cash flow is thought to be only temporary, management may prefer making the distribution in the form of a stock repurchase to declaring an increased cash dividend that cannot be maintained.

4. Companies can use the residual model to set a target cash distribution level and then divide the distribution into a dividend component and a repurchase component. The dividend payout ratio will be relatively low, but the dividend itself will be relatively secure, and it will grow as a result of the declining number of shares outstanding. The company has more flexibility in adjusting the total distribution than it would if the entire distribution were in the form of cash dividends, because repurchases can be varied from year to year without giving off adverse signals.

5. Repurchases can be used to produce large-scale changes in capital structures. For example, a company may borrow cash and use the funds to repurchase some of its common stock and thus quickly change its capital structure.

6. Companies that use stock options as an important component of employee compensation usually repurchase shares in the secondary market and then use those shares when employees exercise their options. This technique allows companies to avoid issuing new shares and thus diluting earnings.

Repurchases have three principal disadvantages.

1. Stockholders may not be indifferent between dividends and capital gains, and the price of the stock might benefit more from cash dividends than from repurchases.

Cash dividends are generally dependable, but repurchases are not.

2. The selling stockholders may not be fully aware of all the implications of a repurchase, or they may not have all the pertinent information about the corporation's present and future activities. However, in

order to avoid potential stockholder suits, firms generally announce repurchase programs before embarking on them.
3. The corporation may pay too much for the repurchased stock—to the disadvantage of remaining stockholders. If the firm seeks to acquire a relatively large amount of its stock, then the price may be bid above its equilibrium level and then fall after the firm ceases its repurchase operations.

When all the pros and cons on stock repurchases versus dividends have been totaled, where do we stand? Our conclusions may be summarized as follows.
1. Because of the deferred tax on capital gains, repurchases have a tax advantage over dividends as a way to distribute income to stockholders. This advantage is reinforced by the fact that repurchases provide cash to stockholders who want cash while allowing those who do not need current cash to delay its receipt. On the other hand, dividends are more dependable and thus are better suited for those who need a steady source of income.
2. The danger of signaling effects requires that a company not have volatile dividend payments, which would lower investors' confidence in the company and adversely affect its cost of equity and its stock price. However, cash flows vary over time, as do investment opportunities, so the "proper" dividend in the residual model sense varies. To get around this problem, a company can set its dividend low enough to keep dividend payments from constraining operations and then use repurchases on a more or less regular basis to distribute excess cash. Such a procedure will provide regular, dependable dividends plus additional cash flow to those stockholders who want it.
3. Repurchases are also useful when a firm wants to make a large shift in its capital structure, wants to distribute cash from a one-time event such as the sale of a division, or wants to obtain shares for use in an employee stock option plan.