CASE SUMMARY- Gainesboro

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**Statement of Problem:**

For years, Gainesboro Machine Tools Corporation has struggled with declining sales (down to $756 million from $858 million two years ago). This has led to a stock price collapse and a drop of dividends paid to shareholders ($.25 per share versus $.77 per share in 2002). However, with the advent of Artificial Workforce, a profitable and promising new product developed by Gainsboro, there is optimism by management for the firm’s performance. Gainesboro must now decide what dividend policy to adapt.

**Discussion:**

Gainesboro has three possible options for their dividend policy. The Company can choose a zero- payout, a 40% payout ratio or a residual payout. In order to evaluate these policies, it is important to look at forecasted cash flows. With an assumption of 15% sales growth, Exhibit 8 for the 40% Payout Ratio dividend scenario shows consistent borrowing needs on the order of about $12 million dollars for the next six years. The 40% payout option would effectively commit Gainesboro to borrowing large sums of money in order to finance cash payments to shareholders, a policy inconsistent with the low debt history of the firm. Furthermore, the 15% sales growth will most likely prove to be erroneous, given increasing expected competition for Artificial Workforce (within the next 12 months). However, if market outlook on Gainesboro’s stock improved because of the strong signals the dividend would send, it could prove to be a good investment into cheaper access to equity capital in the future.

Another option is the zero-dividend payout. Given the high restructuring costs and very low EPS numbers in recent years, this could prove to be the most fiscally prudent option. With the stock price already at low levels, there is a lower bar on earning expectations which would place less pressure on management in the next quarter (noted by the survey to stockbrokers). Gainesboro’s optimism on its future prospects is not shared by market movers. Yet, this option’s costs include backing off a commitment that the directors made to shareholders in a special letter. This is a significant credibility cost that would be incurred. When evaluating this option, it would be important to decide whether the monetary benefits of a conservative dividend policy outweigh the credibility cost.

The final option is a residual payout dividend. On its face, this policy may look to be a good balance between a very high payout (40%) and no payout. By basing dividend payments on projects, Gainesboro increases their flexibility of payment based upon performance of the firm’s projects, relying on operational income to buoy market capitalization and not the dividends. The main tradeoff in this scenario, however, is the discipline of management in the face of unpredictable dividend payments. Because the positive NPV projects are going to vary for the Company over time, the dividend payments will fluctuate. This will rely upon the Directors having discipline when project opportunities fall to cut dividends and not have “sticky” outcomes. Management may prove unable to do this.

**Recommendation:**

Given the significant uncertainty in Gainesboro’s future regarding Artificial Workforce and a lack of faith in the Director’s ability to be disciplined in the dividend policy, it is best to chose the most conservative option, the Zero-Dividend payoff.