

# **FNCE20005 CORPROATE FINANCIAL DECISION MAKING 2021**

## **TUTORIAL 5: PAYOUT POLICY: FORMS AND INFLUENCES**

Answers to Section B questions to be submitted on Canvas by **10am on Monday, September 6<sup>th</sup>**

### **SECTION A**

#### **Question 1**

Dividends are taxed at a lower rate than capital gains. This suggests that companies should have high dividend-payout ratios. Discuss this statement, giving special attention to its appropriateness in the Australian tax environment.

#### **Question 2**

Explain the likely effects on dividend-payout ratios of each of the following:

- a) The imputation tax system is modified to allow investors only partial (50%) credit for company tax paid.
- b) Personal income (but not capital gains) tax rates are increased.
- c) Capital gains tax is abolished
- d) Interest rates increase substantially
- e) Company profitability increases
- f) Prospectus requirements are tightened, increasing cost of share issues.

#### **Question 3**

Some companies have investment opportunities well in excess of the earnings available to finance them but they still insist on paying dividends. Why?

#### **Question 4**

The imputation system encourages payment of high dividends. Companies that do so may be left short of cash. Comment on this statement.

## **SECTION B – PRIORITY QUESTIONS**

**REMEMBER ALSO THAT ALL ANSWERS MUST BE HANDWRITTEN AND YOUR NAME CLEARLY WRITTEN AT THE TOP OF EACH SUBMITTED PAGE.**

### **QUESTION 5**

Share buybacks are sometimes motivated by the desire to increase earnings per share. Falcon Ltd recorded an operating profit of \$2 million in the last financial year. It has 4 million shares on issue and the market price of the shares is \$5 each. Falcon announces that it will repurchase 10 per cent of each shareholder's shares at \$5 per share.

- a) Calculate Falcon's price–earnings ratio before the buyback.
- b) An observer comments as follows: 'Falcon's buyback should boost its earnings per share from 50 cents to 55 cents, so with the price–earnings ratio remaining the same, the share price should increase'.
  - i. If the observer's argument is correct, what will Falcon's share price be after the buyback?
  - ii. Critically evaluate the observer's argument.

*Tip: A common 'multiple' used in financial markets is the Price / Earnings ratio which measures the ratio of share price to earnings per share. It measures share price per dollar of earnings and is seen by many market participants as a useful measure of the pricing of a stock relative to other comparable stocks. For example – one might multiply the earnings per share of a company by the average Price / Earnings ratio of companies in the same industry to gain an insight into whether the company's shares are mispriced.*

## QUESTION 6

On 12 February 2015 – the large materials company Rio Tinto Ltd announced via a series of media releases to the market its intention to undertake a significant off-market share buyback– as documented in the company announcements section of the ASX website [the ASX ticker code for Rio Tinto is “RIO”].

You will need to review the following two specific company announcements by RIO in order to complete the tasks associated with this question:

1. “*Rio Tinto Limited off-market buy-back tender*” dated 25 February 2015

2. “*Successful completion of A\$560 million off-market buy-back*” dated 7 April 2015

- a) How much was RIO initially intending to buy back?
- b) What do you consider were some of the motivating factors behind the buyback? [For example; Section 3.20 of the February announcement provides some insight into management thinking.]
- c) According to the February announcement (looking at Section 3) – what impact would the buyback have on both the earnings per share for the company as well as the company’s leverage?
- d) According to the February announcement – what was the capital component buyback price and how would the rest of the payment be treated?
- e) According to the February announcement – there were two decisions that RIO shareholders had to make if they wanted to participate in the buyback. What were these two decisions? [Tip: look at the tender form contained in Section 6 of the announcement]
- f) According to the April announcement, which provided final details on the buyback – how many shares were bought back, what were the final terms of the buyback and were all shareholders able to sell as many shares as they wanted into the buyback?