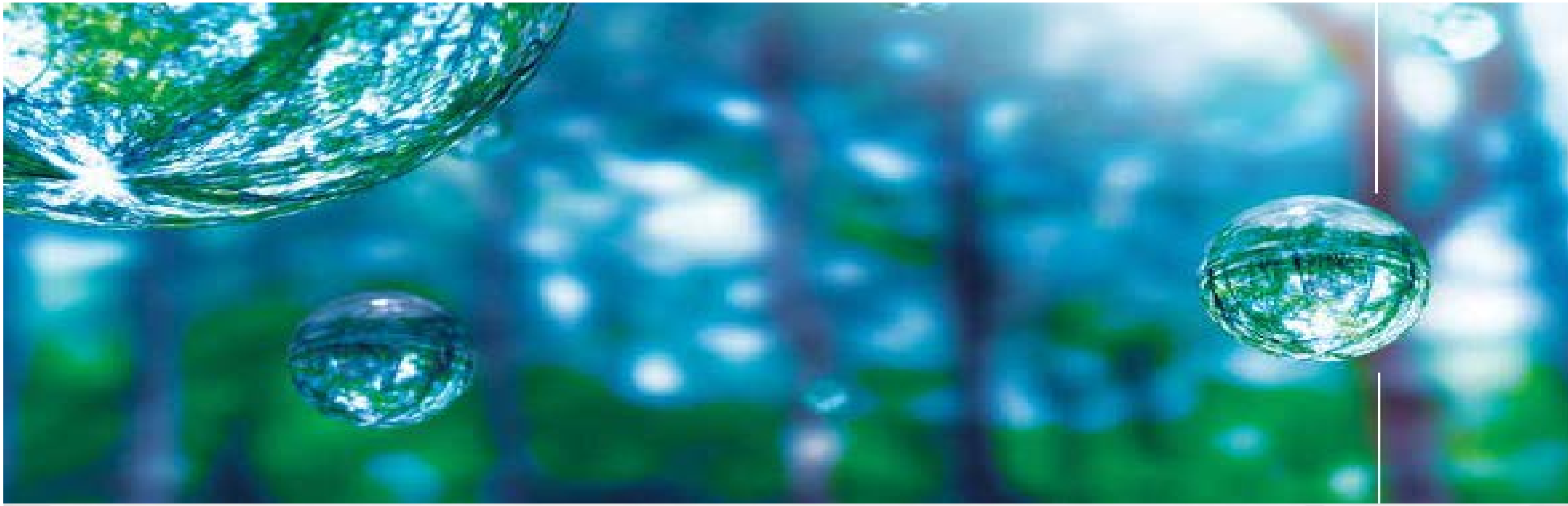


CHAPTER 17

DIVIDENDS AND PAYOUT POLICY

KEY CONCEPTS AND SKILLS

- Understand dividend types and how they are paid
- Understand the issues surrounding dividend policy decisions
- Understand the difference between cash and stock dividends
- Understand why share repurchases are an alternative to dividends

CHAPTER OUTLINE

- Cash Dividends and Dividend Payment
- Does Dividend Policy Matter?
- Real-World Factors Favoring a Low Dividend Payout
- Real-World Factors Favoring a High Dividend Payout
- A Resolution of Real-World Factors
- Stock Repurchases: An Alternative to Cash Dividends
- What We Know and Do Not Know about Dividends and Payout Policies
- Stock Dividends and Stock Splits

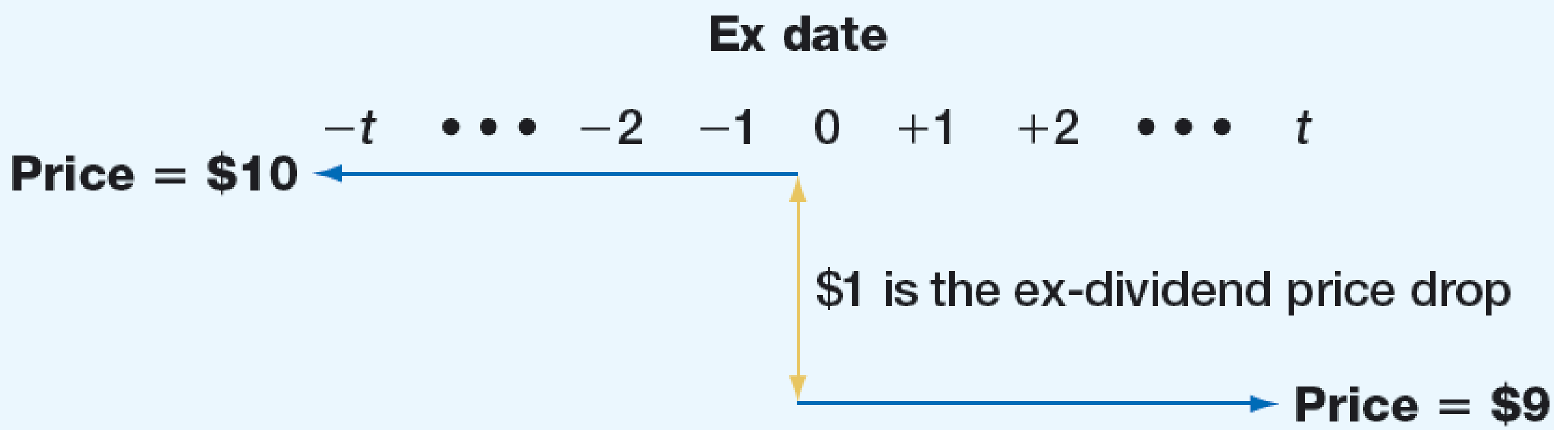
CASH DIVIDENDS

- Regular cash dividend – cash payments made directly to stockholders, usually each quarter
- Extra cash dividend – indication that the "extra" amount may not be repeated in the future
- Special cash dividend – similar to extra dividend, but definitely will not be repeated
- Liquidating dividend – some or all of the business has been sold

DIVIDEND PAYMENT

- Declaration Date – Board declares the dividend, and it becomes a liability of the firm
- Ex-dividend Date
  - Occurs two business days before date of record
  - If you buy stock on or after this date, you will not receive the dividend
  - Stock price generally drops by about the amount of the dividend
- Date of Record – holders of record are determined, and they will receive the dividend payment
- Date of Payment – checks are mailed

FIGURE 17.2
PRICE BEHAVIOR AROUND THE EX-DIVIDEND DATE FOR A $1 CASH DIVIDEND



The stock price will fall by the amount of the dividend on the ex date (Time 0). If the dividend is $1 per share, the price will be $10 − 1 = $9 on the ex date:

Before ex date (Time −1), dividend = $0	Price = $10
On ex date (Time 0), dividend = $1	Price = $9

DOES DIVIDEND POLICY MATTER?

- Dividends matter – the value of the stock is based on the present value of expected future dividends
- Dividend policy may not matter
  - Dividend policy is the decision to pay dividends versus retaining funds to reinvest in the firm
  - In theory, if the firm reinvests capital now, it will grow and can pay higher dividends in the future

ILLUSTRATION OF IRRELEVANCE

- Consider a firm that can either pay out dividends with one of two plans:
  - Plan 1: can pay $10,000 per year for each of the next two years, or
  - Plan 2: can pay $9,000 this year, reinvest the other $1,000 into the firm and then pay $11,120 next year.
  - Investors require a 12% return.
- Compare the market value of the two plans:
  - Present value of Plan 1 dividends:

    PV of constant dividends = $16,900.51
  - Present value of Plan 2 dividends:

    PV growing dividends with reinvestment = $16,900.51
- If the company will earn the required return, then it doesn't matter when it pays the dividends

LOW PAYOUT PLEASE

- Why might a low payout be desirable?
  - Individuals in upper income tax brackets might prefer lower dividend payouts, given the immediate tax liability, in favor of higher capital gains with the deferred tax liability
  - Flotation costs – low payouts can decrease the amount of capital that needs to be raised, thereby lowering flotation costs
  - Dividend restrictions – debt contracts might limit the percentage of income that can be paid out as dividends

HIGH PAYOUT PLEASE

- Why might a high payout be desirable?
  - Desire for current income
    - Individuals that need current income, i.e., retirees
    - Groups that are prohibited from spending principal (trusts and endowments)
  - Uncertainty resolution – no guarantee that the higher future dividends will materialize
  - Taxes
    - Dividend exclusion for corporations
    - Tax-exempt investors don’t have to worry about differential treatment between dividends and capital gains

DIVIDENDS AND SIGNALS

- Asymmetric information – managers have more information about the health of the company than investors
- Changes in dividends convey information
  - Dividend increases
    - Management believes it can be sustained
    - Expectation of higher future dividends, increasing present value
    - Signal of a healthy, growing firm
  - Dividend decreases
    - Management believes it can no longer sustain the current level of dividends
    - Expectation of lower dividends indefinitely; decreasing present value
    - Signal of a firm that is having financial difficulties

CLIENTELE EFFECT

- Some investors prefer low dividend payouts and will buy stock in those companies that offer low dividend payouts
- Some investors prefer high dividend payouts and will buy stock in those companies that offer high dividend payouts

IMPLICATIONS OF THE CLIENTELE EFFECT

- What do you think will happen if a firm changes its policy from a high payout to a low payout?
- What do you think will happen if a firm changes its policy from a low payout to a high payout?
- If this is the case, does dividend *policy* matter?

STOCK REPURCHASE

- Company buys back its own shares of stock
  - Tender offer – company states a purchase price and a desired number of shares
  - Open market – buys stock in the open market
- Similar to a cash dividend in that it returns cash from the firm to the stockholders
- This is another argument for dividend policy irrelevance in the absence of taxes or other imperfections

REAL-WORLD CONSIDERATIONS

- Stock repurchase allows investors to decide if they want the current cash flow and associated tax consequences
- Given our tax structure, repurchases may be more desirable due to the options provided stockholders
- The IRS recognizes this and will not allow a stock repurchase for the sole purpose of allowing investors to avoid taxes

INFORMATION CONTENT OF STOCK REPURCHASES

- Stock repurchases send a positive signal that management believes the current price is low
- Tender offers send a more positive signal than open market repurchases because the company is stating a specific price
- The stock price often increases when repurchases are announced

EXAMPLE: REPURCHASE ANNOUNCEMENT

"America West Airlines announced that its Board of Directors has authorized the purchase of up to 2.5 million shares of its Class B common stock on the open market as circumstances warrant over the next two years …

"Following the approval of the stock repurchase program by the company's Board of Directors earlier today. W. A. Franke, chairman and chief officer said 'The stock repurchase program reflects our belief that America West stock may be an attractive investment opportunity for the Company, and it underscores our commitment to enhancing long-term shareholder value.'

"The shares will be repurchased with cash on hand, but only if and to the extent the Company holds unrestricted cash in excess of $200 million to ensure that an adequate level of cash and cash equivalents is maintained."

WHAT WE KNOW AND DO NOT KNOW

- Corporations "smooth" dividends
- Dividends provide information to the market
- Firms should follow a sensible dividend policy:
  - Don't forgo positive NPV projects just to pay a dividend
  - Avoid issuing stock to pay dividends
  - Consider share repurchase when there are few better uses for the cash

PUTTING IT ALL TOGETHER

- Aggregate payouts are massive and have increased over time
- Dividends are concentrated among a small number of large, mature firms
- Managers are reluctant to cut dividends
- Managers smooth dividends
- Stock prices react to unanticipated changes in dividends

THE MANAGEMENT VIEW OF DIVIDEND POLICY

- Agree or Strongly Agree
  - 93.8% Try to avoid reducing dividends per share
  - 89.6% Try to maintain a smooth dividend from year to year
  - 41.7% Pay dividends to attract investors subject to "prudent man" restrictions
- Important or Very Important
  - 84.1% Maintaining consistency with historic dividend policy
  - 71.9% Stability of future earnings
  - 9.3% Flotation costs to issue new equity

STOCK DIVIDENDS

- Pay additional shares of stock instead of cash
- Increases the number of outstanding shares
- Small stock dividend
  - Less than 20 to 25%
  - If you own 100 shares and the company declared a 10% stock dividend, you would receive an additional 10 shares
- Large stock dividend – more than 20 to 25%

STOCK SPLITS

- Stock splits – essentially the same as a stock dividend except expressed as a ratio
  - For example, a 2 for 1 stock split is the same as a 100% stock dividend
- Stock price is reduced when the stock splits
- Common explanation for split is to return price to a “more desirable trading range”

QUICK QUIZ

- What are the different types of dividends, and how is a dividend paid?
- What is the clientele effect, and how does it affect dividend policy relevance?
- What is the information content of dividend changes?
- What are stock dividends, and how do they differ from cash dividends?
- How are share repurchases an alternative to dividends, and why might investors prefer them?

COMPREHENSIVE PROBLEM

- A company's stock is priced at $50 per share, and it plans to pay a $2 cash dividend.
  - Assuming perfect capital markets, what will the per share price be after the dividend payment?
  - If the average tax rate on dividends is 25%, what will the new share price be?

CHAPTER 17

END OF CHAPTER