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Corporate Finance

Topic 4:

Payout Policy

Readings

- *Business Finance*: Chapter 11
- Article on the LMS titled *Who really wins with a share buyback?* by K. Wyatt and J. McDonald.

Today's learning objectives

After the lecture, you can explain:

- the two main payout policies: dividends and share buybacks.
- the factors that affect the decision to pay dividends.
- the details of a share buyback.
- how taxes may affect the decision to pay dividends or buy back shares.
- why firms adopt a particular payout policy.

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4.0 Setting the scene

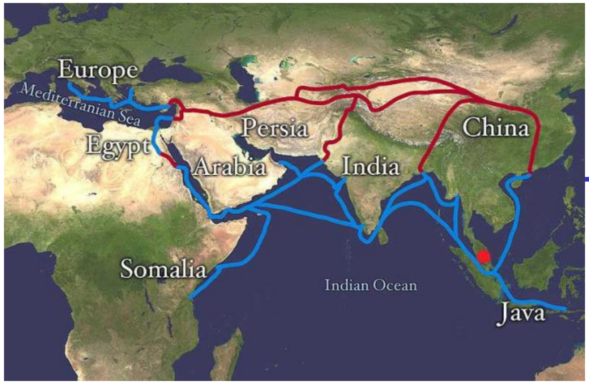
Investors get return on their capital

Investment	Financing
Current assets	Short-term debt
Fixed assets 1. Tangible fixed assets 2. Intangible fixed assets	Long-term debt
	Shareholders' equity

Assets generate cash flow

Investors provide capital

4.0 Setting the scene … a little history



modern trading system:diversify risks and profits

4.0 Setting the scene … today's work

- Dividend policy is concerned with the distribution of cash to shareholders via dividends
- We will concentrate on two methods by which firms distribute earnings to shareholders
  1. Dividends (US)
  2. Share repurchases

They are no difference because the assumption of absence of taxes and transaction costs in this lecture
But obviously, they are transaction costs and taxes, they may be different effects by implications

- In the absence of taxes and transaction costs the two methods of distributing cash are *virtually identical*

background: most (normal, for most industry firms) stocks of firms they pay dividends in Australia are tend to pay twice a year-half yearly or yearly.Exception: trust situation, in which they pay quarterly

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4.0 Setting the scene … in Australia

- Dividends are typically paid semi-annually (interim & final) background: most (normal, for most industry firms) stocks of firms they pay dividends in Australia are tend to pay twice a year-half yearly or yearly.Exception: trust situation, in which they pay quarterly
- Coincide with profit announcements

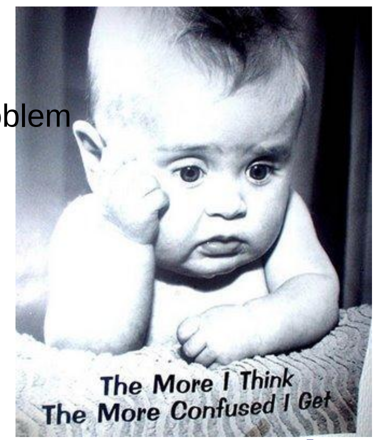
dividend (announcements) pay time at the exactly same time at profit announcements

Samsung shares fall despite forecasting record profits

Last Update: July 07th, 2013 - IST

South Korean firm's quarterly profits up 47% on 2012, but analysts fear smartphone maker faces saturated markets

both going exactly same direction
both unexpectedly positive no problem
/both negative no problems



but sometime they will go opposite direction, which make more confused. But the market price goes with dividend. If the dividend is unexpectedly good, but profit is bad; then the price will go up.(reason why later on)
If you have conflicting signal, the market follows dividend.

- Subject to satisfaction of the Corporations Act and ASX Listing Rules, dividend decisions are discretionary, but can only be paid out of profit

自由决定的

- Mostly paid in cash

cant pay dividend at a capital account, e,g asset evaluation

4.0 Setting the scene … the timetable

- Key dates

total process: from 4 -8weeks

1. Announcement date (declaration date)

a week later. what that means is from the announcement date all the way up until the ex-dividend date, when you purchase the share, you will get with the next dividend. If you purchase it on the ex-dividend date or after, you get the share without dividend. like the call option, you get the right and you get the dividend. AND you will realize

2. Ex-dividend date

on the ex-dividend date, the share price should fall.

3. Books close date (record date)

books close date- free trading date, you registered as the owner of the stock, and you will get the dividend and normally after 2-3 weeks later, there is the payment date, which you will get to check the amount

4. Payment date

4.0 Setting the scene … an example

FairfaxDigital
theage.com.au
THE AGE

NAB profits jump, dividend rises

May 9, 2013

Clancy Yeates
Banking reporter
View more articles from Clancy Yeates
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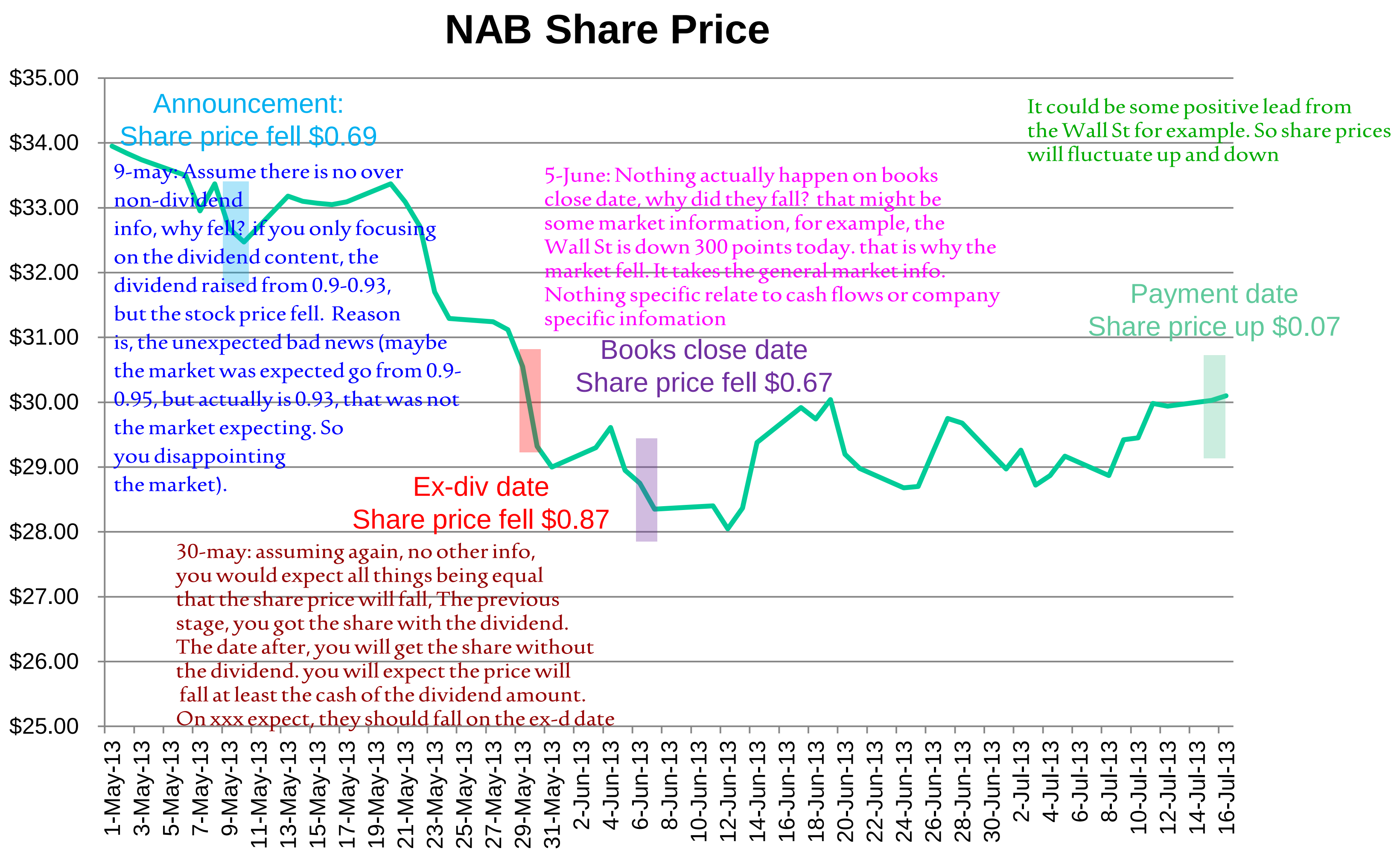
- Announcement
  - Interim dividend of $0.93 (fully franked) announced on 9 May
    临时的
  - Up from $0.90 per share
- Key dates
  1. Announcement date – 9 May 2013
  2. Ex-dividend date – 30 May 2013
  3. Books close date (record date) – 5 June 2013
  4. Payment date – 16 July 2013

4.0 Setting the scene … an example



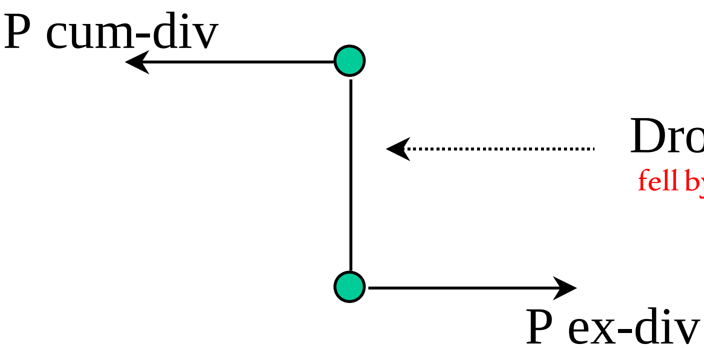
4.0 Dividend drop-off …

like cum-right and ex-right

Cum-Dividend Share Price Vs Ex-Dividend Share Price

you purchase the share WITH the dividend

you purchase the share WITHOUT the dividend



fell by at least the cash dividend, i.e >=$1

Assume a firm have $10 cash, there is no investment, only cash. And they decided to pay dividend on $1, so the company worths $9.

However, we know from the implication, that could be an implication credit attach to it.
For example, assume you are a shareholder in this company, and which you tax rate 50 cents in a dollar. The company prepaid $30 cents in $1 for you. So they prepaid 50 cents too much. So for you, your tax rate is lower than $30 in a dollar, you dont just value $1 cash value in the dividend, you value it more than a dollar, it worths may be more than 1.50 to you. So it depends on the size of and demand of the franking credits of the worth to the dominate/ marginal investors.

- Drop-Off Ratio = $(P_{CUM} - P_{EX})$/Dividend
- In PCM drop-off is equal to one *[Perfect Capital Market]*
- Ratio forms the basis for many empirical tests

The drop-off can be more than the total amount of the cash dividend becoz of the tax effects. So it worths 50 cents in the drop off, it is going to be 150 % of the cum-dividend pric

For example: How much are franking credits actually worth?

the drop-off depends on the franking credits an the dominate marginal investors in the firm

4.1 M&M Dividend Irrelevance Theory

- In 1961, Miller and Modigliani (yes, the same guys!) demonstrated that dividend policy should NOT affect company value.
- Guess what: they had to make assumptions:
  - Company has a set investment plan that is unaffected by the *dividend decision*. means: if you pay out the dividend, you gonna raise more money to replace the cash that flows out. but the investment policy will remain unchanged.
  - Perfectly competitive capital market with no taxes, transaction costs, flotation costs or information costs.
  - Rational investors who are indifferent between receiving dividends or capital gains (since no taxes).

4.1 M&M Dividend Irrelevance Theory: An example

- Brown and Baker each own 50 shares in Barter Ltd, with a market value of $2 per share.
- Barter Ltd decides to pay a dividend of $0.20 per share implying that $20 in retained profits has been distributed. they have to bring in a new shareholder
- As Barter Ltd has a *set investment policy*, they will need to *issue additional shares to recoup the funds paid out as dividends*.
- Barter Ltd issues 11.1 shares to Evans.

sell Evans 11.1 shares. why 11.1 shares? next 2 slides

4.1 M&M Dividend Irrelevance Theory: An example

Barter Ltd.
Market Value Balance Sheet before dividend

Cash	*$100*		*Debt*	*$120*
Other Assets	*$220*		*Equity-*	
			Brown (50 x 2)	*$100*
			Baker (50 x 2)	*$100*
Total	*$320*	the same	*Total*	*$320*

4.1 M&M Dividend Irrelevance Theory: An example

Barter Ltd.

AFTER

Market Value Balance Sheet after dividend

Cash	*$100*	*Debt*	*$120*
Other Assets	*$220*	*Equity-*	
		and sell the share at 1.80(2-0.2)	
		Brown (50 x 1.80)	*$90*
		Baker (50 x 1.80)	*$90*
		Evans (11.1 x 1.80)	*$20* redistributed $20 so new shareholders who provide you a new captial
Total	*$320*	*Total*	*$320*

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4.1 M&M Dividend Irrelevance Theory: An example

Before		After	
MV of equity	*\$200*	*MV of equity*	*\$200*
*MV of **existing** s/h*		*MV of **existing** s/h*	
Brown		*Brown*	
- shares(50 x \$2)	*\$100*	*- shares(50 x \$1.80)*	*\$90*
Baker		*- cash* get cash with selling the share	*\$10*
- shares(50 x \$2)	*\$100*	*Baker*	
		- shares(50 x \$1.80)	*\$90*
		- cash	*\$10*

the total wealth of Brown and Baker unchanged. but the composition of their wealth has changed. Before they are the shares, but now is the shares in cash. Before they both have \$100 in terms of total market value, on the right hand side now, they still have \$100 but the composition of it is sold it. and also dilution of ownership interest.

4.1 M&M Dividend Irrelevance Theory: An example

- As an alternative to the declaration of the dividend – the shareholders could sell at cum-dividend price and create their own *home-made dividend*.

	Before			
	# shares	Share$	Cash$	%
Brown	50	100	0	50%
Baker	50	100	0	50%
Evans	0	0	20	0%
Total	100	200	20	100%

dilution of interest, reduce ownership

	After			
	# shares	Share$	Cash	%
Brown	45	90	10	45%
Baker	45	90	10	45%
Evans	10	20	0	10%
Total	100	200	20	100%

Selling shares at cum-div price ("homemade dividend") has same effect on wealth and ownership as dividend payment.

4.2 Factors affecting the payment of dividends

1. Resolution of uncertainty
2. Shareholders preference for current income
3. Issue and transaction costs
4. Information content of dividends and information asymmetry
5. Agency Costs
6. Taxation

dividend tends to be more certain than the capital gain, if the firm declare the dividend today, lets say paying a dollar, they basically apply to you to pay es-weeks time

much better as a firm that pays dividend because i dont have to occur personal cost to myself, as long as the firm has a lot of free cash flow. But if they pay a cash dividend to you as a shareholder,

because they got consuming need, they have to pay their bill, trips, etc. they can find lifestyle. --general income

if the firm has enough free cash flow, that is fine.
if the firm doesn't have enough free cash flow, they will raise capital, and cost shareholder's indirect costs, but still costs. whenever if you have to raise the capital, the corporation basically you have to issue a perspective for most situations, that costs! lawers, investment bankers, accountants, dont come cheap. at least a few hundred thousand dollars.
Smaller firms dont want to keep on raising capital, so they will try to restrict their dividend payers. becoz of the certain minimum fix costs of producing the perspectives, that is not worth it. so you will see small firms don't pay dividend, becoz pay more dividend, they have to raise more equity capital and minimum charges. like if they wanna raise 5000 but have to pay 3500, not worth.

because they feel pressure, not enough free cash flow. then force to go with more capital gain from you shareholders, just simply transfer from individual level to the firm level. you still be impacted but in indirect basis. WHY? becoz when you go raise equity capital, , there are some costs, and diluted the ownership when bring new shareholders in

MORE IN NEXT FEW SLIDES

4.2.1. Resolution of uncertainty

vs

- "Bird in the hand" argument
- Dividends are less uncertain than capital gains

BUT

- Can resolve uncertainty associated with capital gain by selling share immediately.

But % ownership in firm is reduced and transaction costs incurred!

… so what?

4.2.2 Shareholders preference for current income

Shareholders need

to fund

But they can always sell their shares to do so ……

Yes, but what about costs incurred and dilution of holdings?

Think clearly now - this is a comparison between personal & firm-level costs

versus

and anyway new s/h will dilute you if the firm issues equity to replace the dividend

4.2.3 Issue and transaction costs

- High dividends may imply need for more frequent capital raisings in order to fund investment plan.
- Incur transaction costs in raising capital
  - Direct costs
    - prospectus preparation, legal advice, brokerage fees, underwriting etc.
  - Indirect costs
    - dilution in ownership/value of existing s/h if new shares issued, restrictive covenants enforced by new debtholders
- Therefore, the higher the costs associated with raising capital, the lower the expected level of dividends.

*If there are any **fixed costs** associated with capital raisings, what impact do you think firm size will have on dividend policy?*

4.2.4 Information content of dividends and information asymmetry

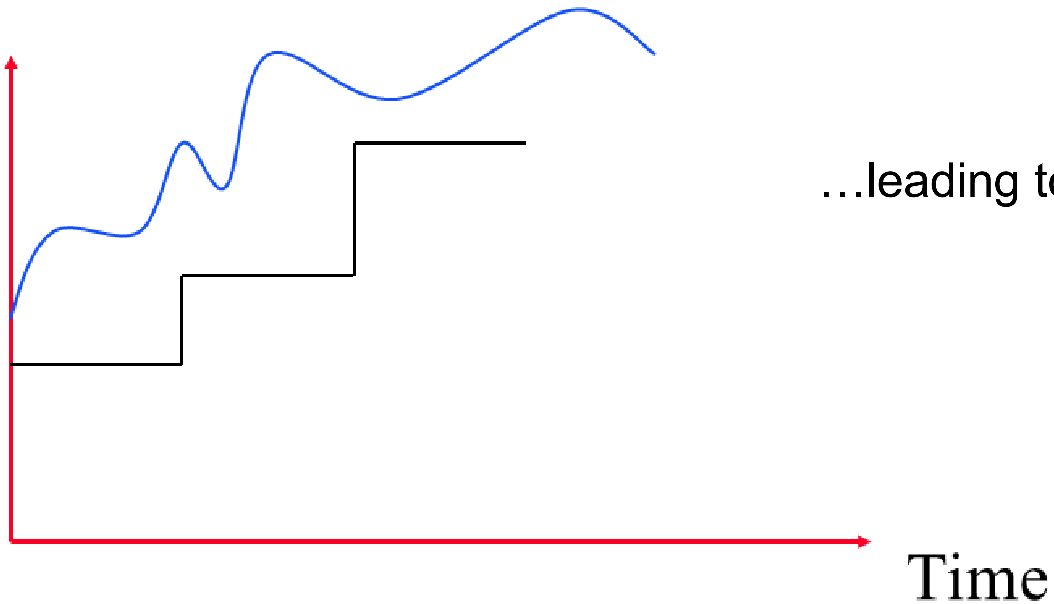
- Information asymmetry between management and s/h

Very strong signal-if you unexpectedly increasing dividends, the market sees that as very positive; if you unexpectedly drop your dividend, the market pound you, because market sees that the management will only oughted the dividend under ex-drawing the circumstances that is

- Market constantly seeking signals from management
- Evidence of a strong price reaction to dividend announcements. if they drop the dividend, then it means they expect in the next few years, the market will be bad
- Implies that market *perceives dividend announcement as a signal by management* about firm prospects.
- Therefore...

4.2.4 Information content of dividends and information asymmetry

- Management reluctant to decrease dividends as it conveys a negative signal to the market about future prospects.
- Management will tend to only <u>increase dividends</u> when the **increase is sustainable**.



…leading to…

4.2.5 Agency problems

- *Separation* of ownership and control in firms creates <u>potential conflict</u> of interest between managers & s/h
- Agency costs include:
  - Wealth lost when management do not act in s/h best interests
    - Consumption of perquisites, inappropriate investment decisions etc.

Source: http://www.lawyerviews.com/emc-corporate-jet-abuse-lawsuit.html

  - Monitoring costs incurred by s/h to ensure that management acts in their best interest.

4.2.5 Agency problems

- Higher dividend payout implies that:
  - *less money available* for managerial perk consumption and overinvestment.

  - *more funds* need to be *raised externally*.
- Effects:
  - Higher payout disciplines management to use remaining funds efficiently.
  - External fund-raising provides s/h with the opportunity to observe management behaviour cheaply!

4.2.6 Taxation

- Until June 1987: Classical tax system in Australia
  - As it operates in the U.S.
  - Company profits and dividends paid from those profits are taxed separately (i.e. effectively taxed twice!).
- Since July 1987: Imputation tax system in Australia
  - Investors get tax credits that undo the corporate tax already paid on the dividends.
  - Australia also has in place capital gains tax (CGT) system whereby increases in the value of an asset are taxed.
  - Differential tax treatment of dividends and capital gains may have effect on the dividend policy preferred by shareholders.

4.2.6 Taxation: Classical system

Company (tc = 30%)	
Company Taxable Income	$1 000
Company Tax	$ 300
After-Tax Profit (div paid)	$ 700
High Tax Individual (tp = 50%)	
Dividend Received	$ 700
Tax	$ 350
Net Return	$ 350
Low Tax Individual (tp = 15%)	
Dividend Received	$ 700
Tax	$ 105
Net Return	$ 595

4.2.6 Taxation: Imputation system

- Under the imputation system, shareholders pay tax on the grossed-up dividend amount, but receive a credit for corporate tax already paid

$$\text{Div}_{\text{Grossed-up}} = \frac{\text{Div}_{\text{Cash}}}{1-t_c} = \frac{700}{1-0.30} = \$1000$$

$$\text{Franking credit} = t_c \times \frac{\text{Div}_{\text{Cash}}}{1-t_c} = 0.30 \times \frac{700}{1-0.30} = \$300$$

4.2.6 Taxation: Imputation system - example

Company (tc = 30%)	
Company Taxable Income	$1 000
Company Tax	($ 300)
After-Tax Profit (div paid)	$ 700

[S/h grossed-up dividend $1 000]

High Tax Individual (tp = 50%)	
Dividend Received	$ 700
Tax (paid on grossed-up dividend)	($ 500)
Tax Credit(for company tax already paid)	$ 300
Net Return	$ 500

4.2.6 Taxation: Imputation system - example

<u>Low Tax Individual (tp = 15%)</u>

Dividend Received	\$ 700
Tax (paid on grossed-up dividend)	(\$ 150)
Tax Credit(for company tax already paid)	<u>\$ 300</u>
Net Return	\$ 850

- <u>Corporate tax</u> is effectively **an interest-free loan to the government** that is *only repaid when shareholders claim the imputation tax credit*
- Therefore, there is a very clear <u>*incentive for firms to distribute franking credits*</u> to shareholders as quickly as possible.
- Tax rate of superannuation funds is 15%

4.2.6 Taxation: Capital Gains Tax

- If companies retain profits, their share price is likely to rise relative to companies that distribute profits, giving rise to capital gains tax liabilities for shareholders if and when the shares are sold.
- Capital gains receive **preferential tax treatment** compared to ‘ordinary’(dividend) income.
- Capital gains tax (CGT) applies only to short-term gains and to long-term real capital gains on assets acquired on or after 20 September 1985, payable only when gains have been realised.
- As of 21 September 1999, **capital gains earned over 12 months** or longer **are subject to CGT discounting**.
- For individuals, only 50 per cent of the gain is taxed at their personal marginal tax rate.

4.2.6 Taxation: Capital Gains Tax

- For superannuation funds, the discount is 33.33 per cent, so 66.66 per cent of the capital gain is subject to CGT.
  - Consequently, effective rates of CGT are likely to be relatively low for many investors.
- However, where a capital gain arises from retention of profits which have been taxed, any CGT that is payable will be in addition to the tax already paid by the company.
- In other words, **retention of profits** can <u>involve double taxation</u> as *imputation credits cannot be transferred* to shareholders through capital gains.

4.2.6 Taxation: Does imputation affect payout policy preferences?

Assume ***Capital Gains Tax = 0*** then;

if tp < tc <u>prefer dividends</u>

(effectively paying tax at personal rate)

if tp > tc <u>prefer capital gains</u>

(effectively paying tax at company rate)

4.2.6 Taxation: Residents

Assume ***Capital Gains Tax > 0*** then;

if tp < tc <u>prefer dividends</u>

(effectively paying tax at personal rate)

if tp > tc <u>*may*</u> prefer dividends

(As capital gains subject to double taxation if there **are** imputation credit in firm)

if tp > tc *may* prefer capital gains

(If **no** imputation credit in firm and/or able to defer realisation of capital gains until personal tax rate falls and/or take advantage of discounted treatment)

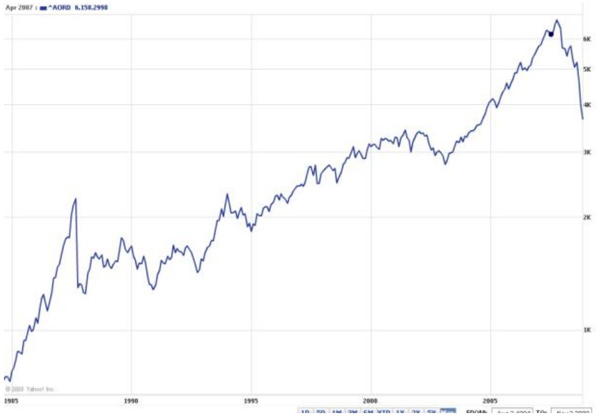
4.2.6 Taxation: Non-residents

- Often unable to take advantage of franking credits.
  - Although mutual tax treaties often allow for some recognition of Australian tax paid when dividends are taken home
- Often still subject to double taxation.

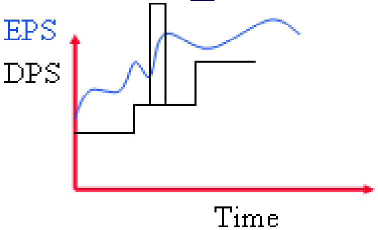
- Preference for capital gains or unfranked dividends.
  - Unfranked dividends are those paid from profits on which corporate tax has not been paid
  - Remember that the tax system gives rise to taxable income upon which tax is levied, whilst the accounting system determines profits from which dividends may be paid.
  - Differences between the systems do arise.

4.2.6 Taxation: Special dividends

- Imputation promotes the payment of dividends
- This can increase dividend volatility



- Information asymmetry implies that market reinterprets dividend announcement as pos/neg. news w.r.t future profitability
- Avoid this by signalling to the market that a portion of the dividend is of a non-recurring or “special” nature



4.2.6 Taxation: Special dividends

woodside

Woodside Petroleum Ltd.
ACN 004 898 962
Woodside Plaza
240 St Georges Terrace
Perth WA 6000
Australia
www.woodside.com.au

ASX Announcement

Tuesday, 23 April 2013

SPECIAL DIVIDEND AND DIVIDEND PAYOUT

The Board of Woodside today announced a plan to return additional cash to its shareholders.

"Woodside is in the fortunate position, at the present time, of having a number of promising growth prospects ahead of it and also experiencing strong cash flows." said Chairman, Michael Chaney.

"Given the lead times involved with the growth projects and forecast reductions in the company's debt levels, the Board has concluded that it would be appropriate to pay a special dividend to shareholders now and increase the company's dividend payout ratio."

"These initiatives reflect the Board's commitment to disciplined capital management and desire to distribute additional franking credits to our shareholders. At the same time we shall continue to pursue growth opportunities where we believe they will create value for shareholders." said Mr Chaney.

But what happens if the firm is a little short of cash? - Solution is…

4.2.6 Taxation: Dividend Reinvestment Plans (DRPs)

- DRPs allow high dividend without loss of cash
- Legally, investors receive the cash and the tax credits, and reinvest cash in company.
  - Subject to the 45-day trading rule which requires shareholders to hold the shares “at risk” for 45 days in order to claim the franking credits
- DRPs are essentially very small rights issues.

Example

- A firm declares a dividend of $0.10 on a share currently worth $1.05 and allows shareholders to reinvest their dividends back into the firm at a price of $0.90 per share.
- This is effectively a 1:9 rights issue at a subscription price of $0.90.(i.e.For every 9 shares that you own [you get $0.90 dividends] you can buy one additional share at subscription price.)

4.2.6 Taxation: Dividend Reinvestment Plans (DRPs)

ASX ANNOUNCEMENT

Tatts Group

21 March 2013

ASX RELEASE

Dividend Reinvestment Plan Price – 2013 Interim Dividend

The Company advises that in respect of the ordinary shares to be issued under the Dividend Reinvestment Plan (DRP) on 5 April, 2013, the issue price per share is $3.07.

The price was calculated in accordance with the DRP Terms and Conditions, and a 1.5% discount has been applied.

Think – Aloud – Paired – Problem – Solving (TAPPS) Exercise

Thinking (2 minutes) → Talking (2 minutes) → Wrap-up (2 minutes)

Think – Aloud – Paired – Problem – Solving (TAPPS) Exercise

- Coleman, Maheswaran and Pinder (2010) asked 1387 financial managers:

What factors were important in making the decision to pay a special dividend?

Factor	Your ranking	Coleman *et al* ranking
Surplus of funds that can't be invested in wealth producing projects		1
Level of dividends paid out previously		4
Level of franking credits available		equal
Ability to pay while avoiding expectation of recurrence		

4.3 Share buybacks

- A share buy-back is when a company purchases its own shares on the stock market and then proceeds to either cancel them (Aust.) or retain them as treasury stock (US). buy back the share from shareholders
- There are legal requirements associated with buy-backs, but generally Australian companies can repurchase **up to 10 per cent** of their ordinary shares <u>in a 12-month period</u>.
  – In some cases they can go beyond this limit – often with the approval of 75% of non-participating shareholders

4.3 Share buybacks

- Types of share buy-back:
  - equal access buy-back — pro-rata to all shareholders.

    top 2: off market buyback

    slight difference: the employee and the minimum holding are not really relevant
  - selective buy-back — repurchase from specific, limited number of shareholders. (requires approval by > 75% of non-selling shareholders)

    top 2 are simlar topic 3 are important

    on market buyback
  - on-market buy-back — repurchase through normal stock exchange trading.
  - employee share scheme buy-back
  - min. holding — buy back small unmarketable parcels of shares

4.3 Share buybacks and taxes

reasons of buyback

- The **tax treatment** of a share buyback **depends** on whether the buyback takes place ***on or off-market***
  - On-market buybacks are subject only to the capital gains tax provisions
    the firms go on the market and buyback shares from shareholders who is willing to sell, tax-capital gains.
    if I sell my share to someone else, but in this situation, the firm will stand in the market and buy the shares from the sellers, there is no difference for me selling to other person. tax consequence is really on the capital gains
  - In the case of an off-market buyback, following a private tax ruling from the Australian Taxation Office, part of the proceeds can be labelled as a dividend – and have attached to it franking credits
    the company can split out the proportion of buyback price between a cash dividend with implication credits involved, and one which is with the capital components, capital gains part.
- Therefore; *share buybacks* may be tax-advantaged relative to *dividends*

4.3 Share buybacks and taxes

- Telstra share buyback
  - Announced a $1b ‘equal-access’ share buyback in October 2003
  - Shareholders invited to tender their shares for sale at a price between $4.20 and $5.40 or alternatively at a clearing price decided by Telstra
  - Share price following announcement was approximately $5 (↑15¢)
  - Buyback was highly popular and offers had to be scaled back
  - Buyback price was set at $4.20
    - Fully franked dividend of $2.70
    - Capital component of $1.50

Who would go ahead with this?

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4.3 Table 1 from Wyatt and McDonald, 2004, 'Who really wins from an off-market share buyback?', *In the Black*, pp. 54 – 57.

						Super fund
Variables						
Telstra's buyback price	$4.20	$4.20	$4.20	$4.20	$4.20	$4.20
MTR	0.0%	18.5%	31.5%	43.5%	48.5%	15.0%
Market price	$4.87	$4.87	$4.87	$4.87	$4.87	$4.87
1% brokerage	$0.05	$0.05	$0.05	$0.05	$0.05	$0.05
Market price less brokerage	$4.82	$4.82	$4.82	$4.82	$4.82	$4.82
Assumed cost base	$3.00	$3.00	$3.00	$3.00	$3.00	$3.00
Capital component of buyback	$1.50	$1.50	$1.50	$1.50	$1.50	$1.50
Consequences to dividend of taking Telstra offer						
Fully franked dividend	$2.70	$2.70	$2.70	$2.70	$2.70	$2.70
Franking credit	$1.16	$1.16	$1.16	$1.16	$1.16	$1.16
Assessable income	$3.86	$3.86	$3.86	$3.86	$3.86	$3.86
Tax on that assessable income	$0.00	$0.71	$1.22	$1.68	$1.87	$0.58
After tax proceeds	$3.86	$3.14	$2.64	$2.18	$1.99	$3.28
Capital gains consequences						
Capital component of buyback	$1.50	$1.50	$1.50	$1.50	$1.50	$1.50
Assumed cost base	$3.00	$3.00	$3.00	$3.00	$3.00	$3.00
Nominal capital gain/loss	–$1.50	–$1.50	–$1.50	–$1.50	–$1.50	–$1.50
Discounted capital gain/loss	–$0.75	–$0.75	–$0.75	–$0.75	–$0.75	–$1.00
Tax impact of gain/loss	$0.00	–$0.14	–$0.24	–$0.33	–$0.36	–$0.15
After tax proceeds	$1.50	$1.64	$1.74	$1.83	$1.86	$1.65
Total after tax proceeds	**$5.36**	**$4.78**	**$4.38**	**$ 4.01**	**$ 3.85**	**$4.93**

4.3 Table 1 from Wyatt and McDonald, 2004, 'Who really wins from an off-market share buyback?', *In the Black*, pp. 54 – 57.

From previous slide →

MTR	0.0%	18.5%	31.5%	43.5%	48.5%	15.0%
Total after tax proceeds	**$5.36**	**$4.78**	**$4.38**	**$ 4.01**	**$ 3.85**	**$4.93**
Sell on market						
Market price less brokerage	$4.82	$4.82	$4.82	$4.82	$4.82	$4.82
Nominal capital gain/loss	$1.82	$1.82	$1.82	$1.82	$1.82	$1.82
Discounted capital gain/loss	$0.91	$0.91	$0.91	$0.91	$0.91	$1.21
Tax impact of gain/loss	$0.00	$0.17	$0.29	$0.40	$0.44	$0.18
Total after tax proceeds	**$4.82**	**$4.65**	**$4.53**	**$4.43**	**$4.38**	**$4.64**
Gain/loss if accept buyback	**$0.54**	**$0.13**	**–$0.15**	**–$0.42**	**–$0.53**	**$0.29**
Gain/loss for 5000 shares	**$2679**	**$647**	**–$780**	**–$2098**	**–$2647**	**$1447**

So – does this imply that the share buyback was oversubscribed by low-income earners, pensioners and charities?

4.3 Tightening up the regulation of share buybacks … or not …

- Tax determination TD 2004/22
  - TD 2004/22 had the effect of reducing the impact of the buyback discount on the capital loss claimed by the shareholder
  - Operates by calculating tax liability with reference to the *deemed* consideration (whilst adjusting values to reflect the increase in the general level of share prices after the announcement date, i.e. set by market price at time of announcement)

4.3 Tightening up the regulation of share buybacks … or not …

- Tax determination TD 2004/22
  - Recall
    - Capital loss $_{\text{Before}}$ = \$3 − \$1.50 = \$1.50
  - Assume:
    - You purchased the share for \$3.00
    - Telstra 5-day VWAP prior to the announcement = \$4.90
    - Assume that on the day of the announcement the market increased by 0.5%
  - Capital gain/loss
    - The deemed consideration = \$4.90(1.005)= \$4.92
    - Capital component = \$4.92 −\$2.70 = \$2.22
    - Capital loss $_{\text{After}}$ = \$3 − \$2.22 = \$0.78 *Instead of \$3 − \$1.50 = \$1.50!*

4.3 Tightening up the regulation of share buybacks … or not …

- Board of Taxation prepared a report in May 2009 on the taxation of off-market share buybacks
- Six recommendations (2 important – 4 administrative):

  Recommendation One

  - Removal of the 14% cap on the buyback discount

  Recommendation Three

  - Notional losses should be denied to all s/h participating in buybacks in listed firms (unless total proceeds fall short of the initial cost)
- None of them have been implemented – there are other "regulatory priorities"

4.4 Why buyback shares?

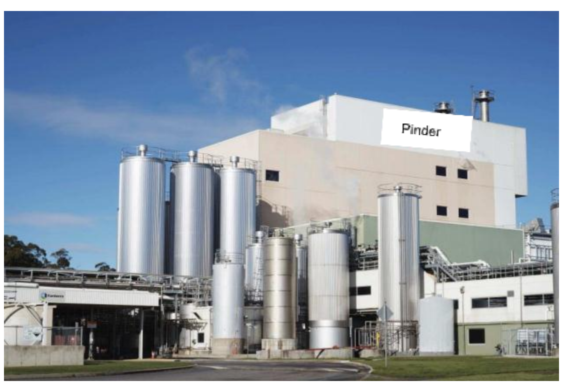
1. Improved performance measures
2. Signaling and undervaluation
3. Resource allocation
4. Financial flexibility
5. Employee share options

4.4 Why buyback shares?

1. Improved performance measures

$$EPS = \frac{Earnings}{Number\ of\ shares}$$

- So … decrease number of shares – increase EPS!
  - But then, why not buyback all shares but 1?
- Where is the cash coming from?



OR

4.4 Why buyback shares?

2. Signaling and undervaluation

– Managers buying back company stock indicates that they believe the stock is undervalued by the market.

– Alternatively, a buy-back announcement could be accompanied by some new information
  - e.g. sale of unprofitable asset/division.

4.4 Why buyback shares?

3. Resource allocation

– Share repurchase returns capital to shareholders, who can reallocate funds into profitable activities through the capital market.

4. Financial flexibility

– Payment of dividends is a long-term commitment and sudden major changes (especially decreases) in dividend policy are unappreciated by market.

– Buy-backs offer an alternative way to make distributions that may not be permanent.

4.4 Why buyback shares?

5. Employee share options

- Unlike paying dividends, share repurchases do not lead to the ex-dividend price drop-off.
  - Indeed – often the share price will rise!
- Call option holders (typically management) prefer a share repurchase to a dividend payout as a means of distributing profits to shareholders.

  - Dividend yields are small though remember – 2%-4% p.a.

4.5 Empirical evidence: Dividend substitution in the US.

"Financial flexibility and the choice between dividends and stock repurchases", Jagannathan, Stephens and Weisbach, *Journal of Financial Economics*, 57, 2000, 355-384.

- Dividends are paid by firms with higher permanent operating cash flows, while:
- Repurchases are used by firms with higher temporary, non-operating cash flows.
- Repurchasing firms also have much more volatile cash flows and distributions.
- Firms repurchase stock following poor stock market performance and increase dividends following good performance

4.5 Empirical evidence: Australia

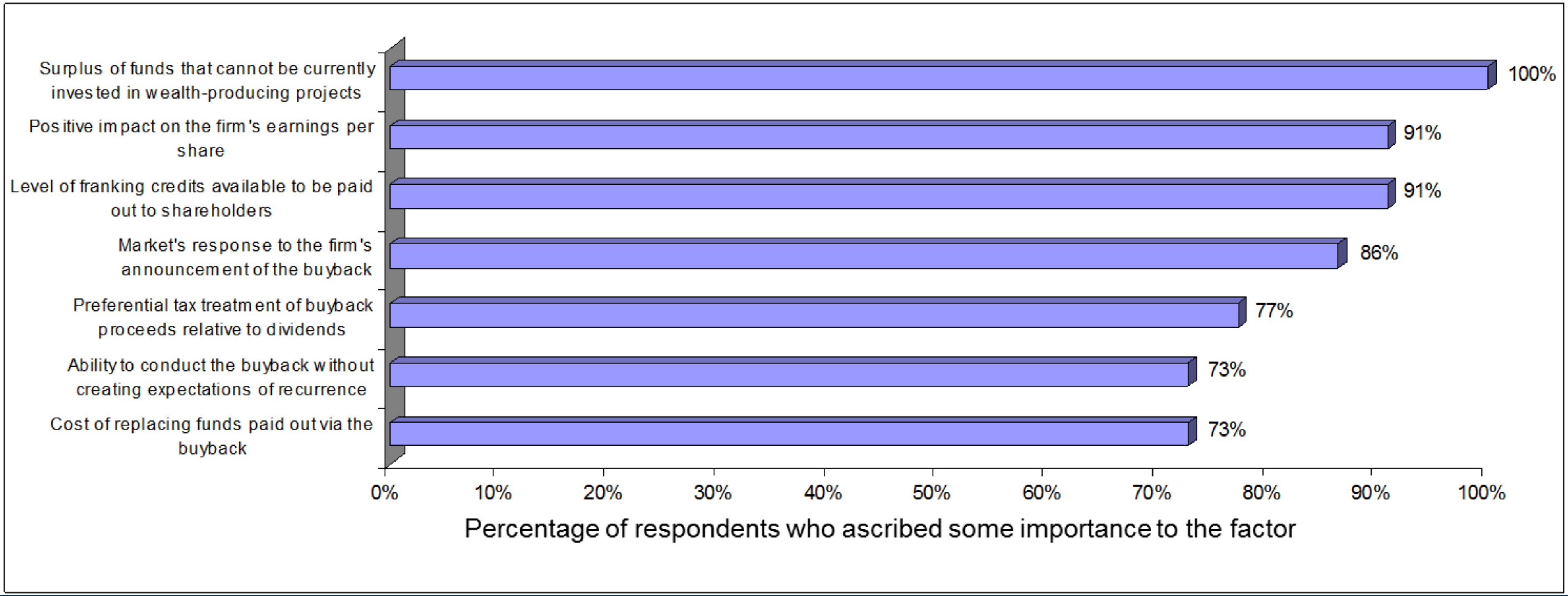
"Management choice of buyback method: Australian evidence", Brown and Norman, *Accounting and Finance*, 50, 2010, 767-782.

- Managers favour off-market buybacks to distribute franking credits when the buyback is larger and is generating more cash flows
- On-market buybacks are more likely to be used when the firm is undervalued

4.5 Empirical evidence: Australia

"Narratives in managers' corporate finance decisions", Coleman, Maheswaran and Pinder, *Accounting and Finance*, 50, 2010, 605-633.

- Managers were asked what factors were important in deciding whether to undertake a share buyback



4.5 Empirical evidence: Australia

“Narratives in managers' corporate finance decisions”, Coleman, Maheswaran and Pinder, *Accounting and Finance*, 50, 2010, 605-633.

- Interviews with managers were also conducted:

“The recent share buyback was a straight tax decision.”

[Treasurer mining company]

“The presence of a large number of retail investors on the registry is a major consideration and it’s probably one of the reasons why we’ve actually chosen special dividends as opposed to buybacks.”

[GM Strategy finance firm]