Module 6

MBA 702

Module 6: Dividend and Payout Policy

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Our last topic in this course is on dividend and payout policy, that is, the policy by which a firm pays out cash and/or shares to its shareholders.

Companies can return cash to their shareholders either by paying a dividend or by buying back their stock. In this unit we will examine hoe companies decide on the amount and form of this payout, and also look at how payout policy affects the value of the firm.

Payout policy has different meanings for different people. A firm's decision about how much cash to distribute is often combined with its other decisions such as financing and investment decisions. Some firms pay out little cash because management is optimistic about the firm's future and they keep its retained earnings for expansion. But for a firm where the future investment opportunities are non-existent, a dividend increases is announced, and the stock price falls. How do we separate the impact of the dividend increase from the impact of investor disappointment at the lost growth opportunities?

M6 Objectives

- Describe the trade-off between paying dividends and retaining the profits within the company.
- Describe the underlying basis for “stable” dividend policy.
- Describe the underlying basis for “residual” dividend payouts and how this is related to capital budgeting, capital structure, and internal vs. external financing.
- Explain the relationship between a corporation’s dividend policy and the market price of its common stock.

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By the end of this module, you should be able to:

- Describe the trade-off between paying dividends and retaining the profits within the company.
- Explain the relationship between a corporation’s dividend policy and the market price of its common stock.
- Distinguish among the types of dividend policies corporations frequently use.
- Describe why and how a firm might pay noncash dividends (stock dividends and stock splits) instead of cash dividends.
- Explain the purpose and procedures related to stock repurchases.

Dividends

What are Dividends?

- Dividends are distribution from the firm's assets to the shareholders.
  - Regular dividends
  - Extra cash dividend
  - Special cash dividend
  - Liquidating dividend
- Firms are not obligated to pay dividends or maintain a consistent policy with regard to dividends.
- Dividends could be paid in: cash or stocks

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Just what are dividends?

- A regular cash dividend is a cash payment made by a firm to the owners in the normal course of business, usually paid four times a year.
- An extra cash dividend is paid over and above the regular dividend, and it may or may not be repeated
- A special dividend is a one-time dividend paid over and above the regular dividend and it won't be repeated.
- Special dividend s similar, but the name indicates that this dividend is viewed as a truly unusual or one-time dividend
- A liquidating dividend is the payment which usually means that some or all the business has been liquidated.

Here we are talking about dividends on common stock. If a firm has preferred stock, those payments are defined by the original preferred stock agreement, the payout on preferred stock does not change based on the performance of the firm.

Throughout this module, we are referring to only common shareholders and payouts made to them.

- Dividends are distribution from the firm's assets to the shareholders. Recall that the shareholders are the owners of the firm.

- Firms are not obligated to pay dividends or maintain a consistent policy about dividends.
    - If a firm finds it cannot afford to make a dividend payment each year (or quarter), there are no legal ramifications. The stock market may penalize the firm with a stock price decline, but there is no legal recourse.
- Dividends could be paid in: cash or stocks

(Stable) dividend policy

- A firm’s stable dividend policy includes two components:
- Dividend Payout ratio
  - Indicates amount of dividend paid relative to the company’s earnings.
  - Example: If dividend per share is $1 and earnings per share is $2, the payout ratio is 50% (1/2)
  - Recall that a firm’s profits, net income, can go to dividends or added to retained earnings.
- Stability of dividends over time

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A firm’s stable dividend policy includes two components:

Dividend Payout ratio

Indicates amount of dividend paid relative to the company’s earnings.

Example: If dividend per share is $1 and earnings per share is $2, the payout ratio is 50% (1/2)

Recall from modules 1 and 3, net income (firm profits), can be paid out in dividends to shareholders (firm owners) or added to retained earnings (reinvested for future growth of the firm). Most firms do a mix of dividend payouts and reinvestment in the firm.

Stability of dividends over time. Investors and market analysts seem to “like” stable dividends. It means that the firm is comfortable maintaining the dividend level, managers would anticipate steady business and operations. Because of the information content of dividend changes, managers may prefer to maintain a more stable dividend policy. This reduces the uncertainty surrounding expected future dividends and should decrease the risk attributed to the cash flows from the stock.

If there was a one-year anomaly that hurt operations, the firm may well maintain the dividend even if cash flows are not sufficient to support the dividend. In this situation, a steady dividend would imply that the firm anticipates that in the longer term, business is good.

Dividend policy trade-offs

- A high dividend means retaining less of the firm’s profits.
  - This means the firm will have to rely more on external equity financing.
- Similarly, a smaller dividend payment will lead to less reliance on external financing.

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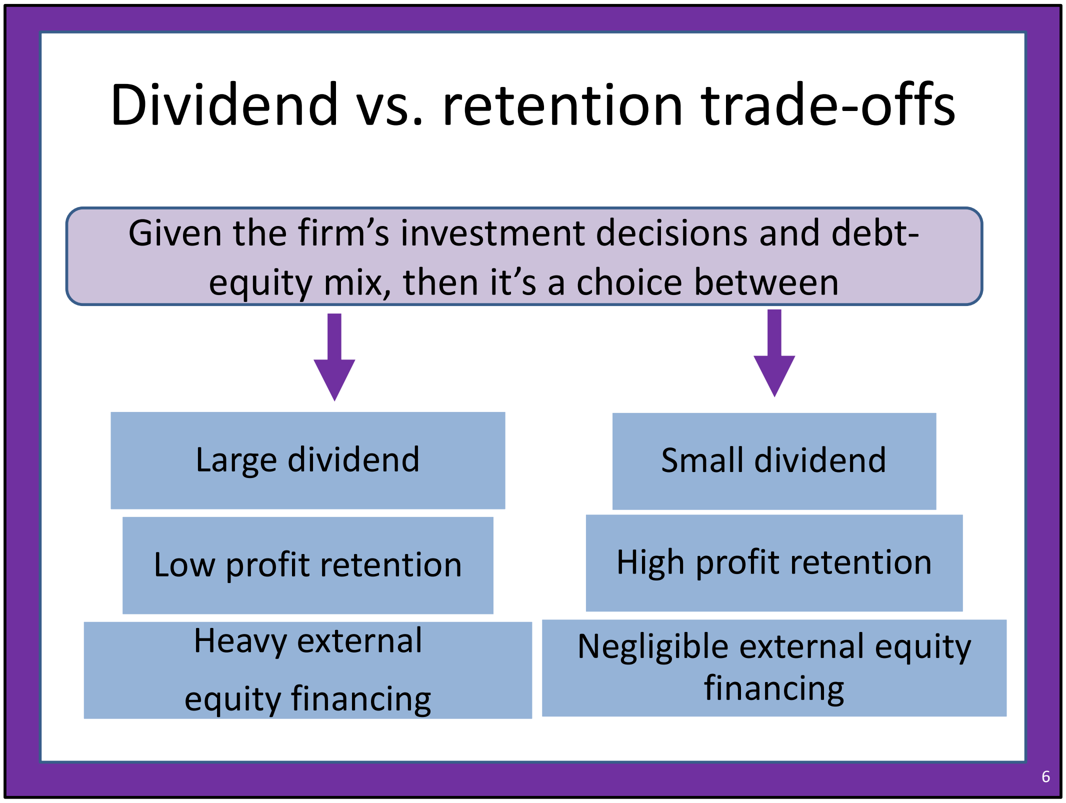
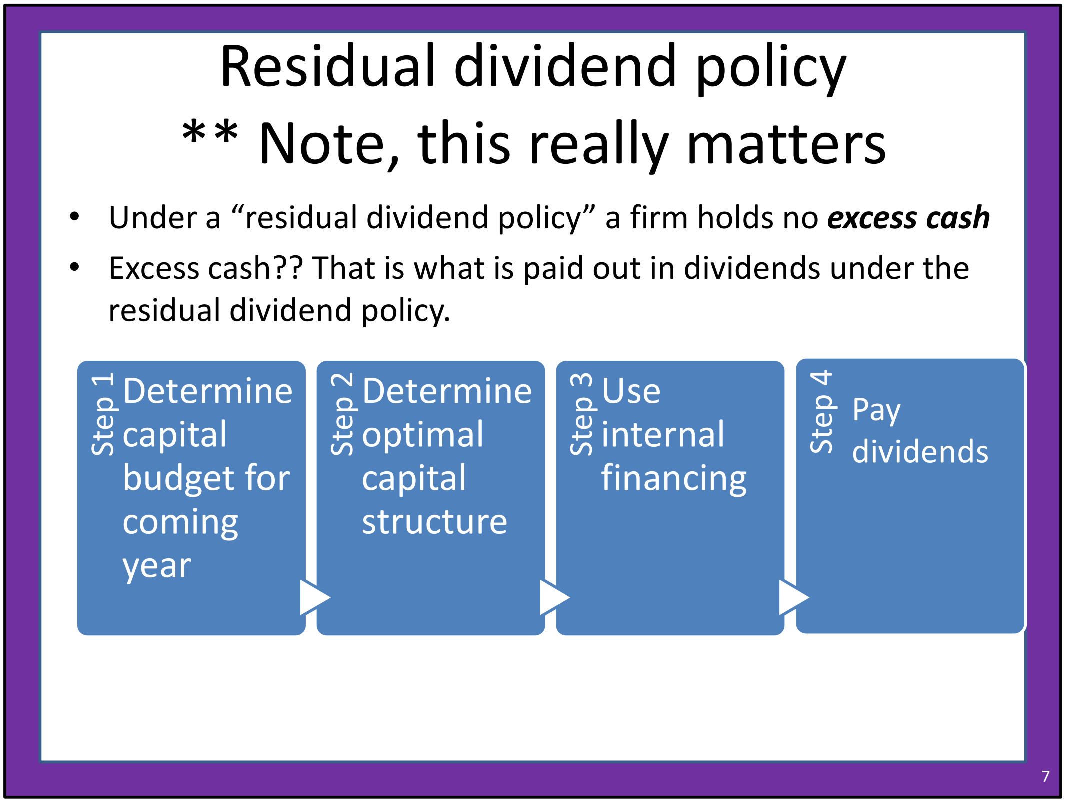
- If management has decided how much to invest and has chosen the debt-equity mix, decision to pay a large dividend means retaining less of the firm’s profits.
- This means the firm will have to rely more on external equity financing.
- Similarly, a smaller dividend payment will lead to less reliance on external financing.



For a firm, the decision between paying out dividends and retaining more of the profits within the firm is deeply associated with the debt-equity mix.

If the firm pays a large dividend, that means low profit retention, which will then require heavy external equity financing.

On the other hand, paying out a small dividend means high profit retention, which then requires negligible external equity financing.



This policy is the one I really want you to focus on, see how this brings together many of the topics we have covered in this course. As MBA students, it is important to understand the links between the various functions of financial managers.

A few slides back I discussed the "stable" dividend policy, that is a choice for many firms. "Keep the analysts happy" by seeking to keep dividends relatively steady. Not all firms see that as the "best" choice.

Under the **residual dividend policy**, firms seek to reinvest or redistribute (pay dividends) all of their excess cash.

How do they determine how much is "excess".

- Step 1) determine the capital budget needs for the coming year (from Module 4): The firm analyzes the potential capital projects for the upcoming period, decides which should be taken on.
- Step 2) the firm determines their "optimal" capital structure. As we are have been looking at capital structure in this module, what is "ideal" for one firm may not be "ideal" for another. Some firms can handle higher debt, such as those with major investment in capital equipment (think about airlines for example). Other firms, with lower fixed assets (which might serve as collateral) would have lower levels of debt

generally.

    - Recall slide 30 from the capital structure notes: The optimal amount of debt is where the actual firm value peaks, maximizing the PV of the tax shield on debt before this is outweighed by the financial distress costs.

- Under the residual dividend policy, a firm chooses to first use internal financing
    - Go back to the prior slide to review how dividend policy affects internal vs. external financing. With residual financing, the firm maximizes internal financing.
- Finally, if internal financing was more than sufficient to cover the firm's growth opportunities, the firm pays out the **excess cash** in dividends.
    - The result of this will be dividends that may change noticeably from one year to the next. If a firm's profits are lower or if the capital needs are higher, that will drive down dividends in a year and vice-versa.

Does dividend policy matter?

- Yes, dividends matter
  - The value of the stock is the present value of future dividends
- No, they may not matter
  - Dividend policy is the decision to pay dividends vs. keeping the funds for reinvestment
  - In theory, if the firm reinvests capital now, it can grow and be able to pay higher dividends in the future

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The subject of "do dividends matter" has been widely studies in finance.

- What we are really looking at is whether the firm should payout cash now or invest the cash and pay it out later.
- Should the firm pay a large percent of earnings now, or, should it keep much or all the profits for growth?

- In favor of "dividends matter" is the dividend growth model: P0 = D1/(r-g), where dividends (and the stock price) are growing at a constant rate, g.

On the "dividends don't matter" side:

- Dividend policy is the decision to pay dividends vs. keeping the funds for reinvestment
- In theory, if the firm reinvests capital now, it can grow and be able to pay higher dividends in the future

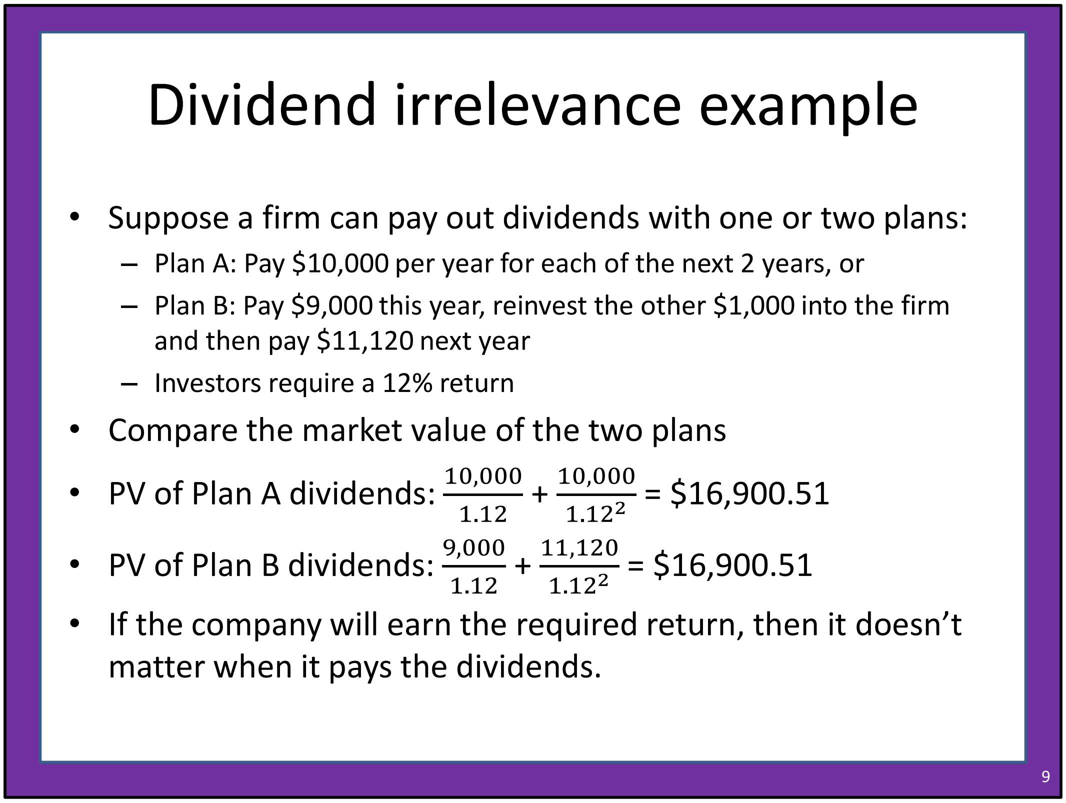
Recall that g, or growth is a function of return on equity and the percentage of profits retained in the firm: g = ROE*(1-payout ratio).

From these equations, dividends, and the percent of funds retained are a balancing act for the firm.

Mathematically, why dividends may not matter:

An increase in the future dividend, D1, will reduce earnings retention and reinvestment. This will reduce the growth rate, g. Therefore, in the P0 = D1/(r-g) equation, both the numerator and the denominator increase, having the net effect on P0 is zero.

Let's just remember Berkshire Hathaway and its no dividend policy, it certainly hasn't hurt Warren Buffett.



- Dividend irrelevance example:
- Suppose a firm can pay out dividends with one or two plans:
  - Plan A: Pay $10,000 per year for each of the next 2 years, or
  - Plan B: 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
- PV of Plan A dividends: $\frac{10,000}{1.12} + \frac{10,000}{1.12^2}$ = $16,900.51
- PV of Plan B dividends: $\frac{9,000}{1.12} + \frac{11,120}{1.12^2}$ = $16,900.51
- The assumption here is that the firm took that $1000 not paid out in year 1 and reinvested it in the firm, earning 12% on the funds. At the end of year 2, the profits on the $1000 plus the expected $10,000 dividend are both paid out to the shareholders.
- If the company will earn the required return, then it doesn't matter when it pays the dividends.
  - It is this "if the company will earn the required return" that is the sticking point. When we talk about "agency conflict", this is the conflict between

owners (shareholders) and firm management. In order for dividend irrelevance to "work", shareholders must have confidence in the firm management that they are truly putting the unpaid dividends to work, and not wasting the funds.

Factors driving a low payout

- **Taxes:** Stockholders in upper income brackets might prefer lower dividend payments (which required immediate payment of taxes), in favor of higher capital gains
- **Flotation costs:** Low payouts can decrease the amount of capital that needs to be raised, thereby lowering flotation costs
- **Dividend restrictions:** Bond indentures often contain a provision that limits the level of dividend payments.

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Low dividend policies can be influenced by:

- Taxes: Stockholders in upper income brackets might prefer lower dividend payments (which required immediate payment of taxes), in favor of higher capital gains
  - The idea is that dividends paid while a stockholder is “younger”, and probably still working, will mean much higher taxes. The marginal tax rate will be higher when overall income is higher.
  - On the other hand, if the gains can be delayed and the stockholder chooses when to sell the stock and realize the capital gain, he/she can time things when their overall income may be lower, resulting in a lower tax rate and lower overall taxes.
    - It is assumed that during retirement, income will be lower, with lower marginal tax rates.
- Flotation costs: Low payouts can decrease the amount of capital that needs to be raised, thereby lowering flotation costs
  - Recall from Module 5 how high the flotation costs can be for a firm compared to the actual receipts from a stock issue.
- Dividend restrictions: Bond indentures often contain a provision that limits the level of dividend payments.

Factors driving a high payout

- **Desire for current income:** Shareholders who want current income (such as retirees) can either invest in companies with high dividend payouts or they can sell shares of stock.
  - Trust funds and endowments may prefer current income because they may be restricted form selling stock.
- **Uncertainty resolution:** There is no guarantee that the higher future dividends will materialize
- **Tax and legal benefits from high dividends:**
  - Corporate investors have a tax exclusion of at least 70% of dividends received
  - Tax-exempt investors don't care about the differential tax treatment between dividends and capital gains

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Why might a high payout be desirable?

- Bottom line: Differences in tax laws and regulations cause some groups to prefer dividends over capital gains. This is known as a "clientele" effect.

The information effect of dividends, or “signaling”

- Evidence shows that large, unexpected change in dividends can have a significant impact on the stock prices.
- A firm’s dividend policy may be seen as a signal about firm’s financial condition. Thus, high dividend could signal expectations of high earnings in the future and vice versa.

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The information effect, or asymmetric information. Firm managers have more information about the health of a company than investors. Unless the firm makes specific statements about the reasons for the change (an extreme example is a firm that reports new and exciting development projects and to fund these, they are lowering the dividend), the following are inferences made by investors:

Changes in dividends convey information

- Dividend increases
    - Management believes the payouts can be sustained
    - Expectation of higher future dividends, increasing the present value of the firm.
    - This is a 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 the firm’s present value.
    - Signal of a firm that is having financial difficulties

Here is an analogy that may help if the above is unclear. Think about dividend "signals" that a company sends and consider how this might be similar to a review we receive at work.

- Did our boss give us a higher than expected raise? That probably means our performance is great and we have a good future with the firm.
- On the other hand, we didn't get a raise and we think that our colleagues did, well, we probably weren't performing up to expectations and might even want to be looking for a new job before we are let go.

Clientele effect

- Different groups of investors have varying preferences towards dividends.
- For example, some investors may prefer a fixed income stream so would prefer firms with high dividends while some investors, such as wealthy investors, would prefer to defer taxes and will be drawn to firms that have low dividend payout. Thus, there will be a clientele effect.
- If a firm changes its dividend policy, it will just have different investors

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Different groups of investors have varying preferences towards dividends.

Investor preference varies and investors will be attracted to the firm with the policies that meet their preferences.

For example, some investors may prefer a fixed income stream so would prefer firms with high dividends while some investors, such as wealthy investors, would prefer to defer taxes and will be drawn to firms that have low dividend payout. Thus there will be a clientele effect.