

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 Repurchase: An Alternative to Cash Dividends
- What We Know and Do Not Know about Dividends and Payout Policies
- Stock Dividends and Stock Splits

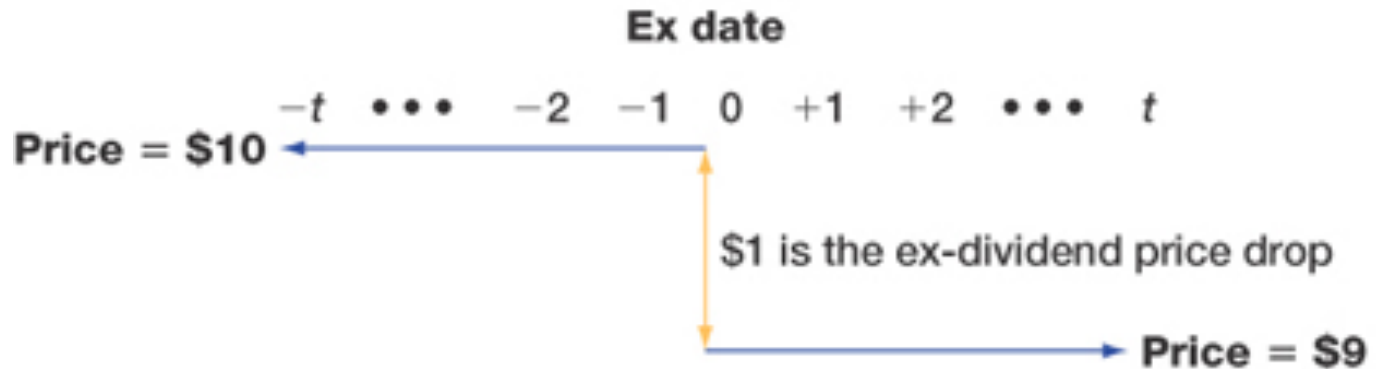
Cash Dividends

- 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

Figure 17.2



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 of \$10,000 per year for each of the next two years or 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. Assume that the firm ceases to exist after two years.
 - Market Value with constant dividend = \$16,900.51
 - Market Value 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 restriction: debt contracts might limit the percentage of income that can be paid out as dividends

Illustration of Deferred Taxes

The shares of A and B both sell for \$100 and offer a pretax return of 10%. However, in the case of Company A the return is entirely in the form of dividend yield (the company pays a regular annual dividend of \$10 per share), while in the case of B the return comes entirely as capital gain (the shares appreciate by 10% a year). Suppose that dividends and capital gains are both taxed at 30%.

- a. What is the after-tax return on share A?
- b. What is the after-tax return on share B to an investor who sells after 2 years? Calculate this return on an annualized basis.

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 the higher dividend 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 the company returns cash 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 tax authorities 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: Stock Repurchase

The board of Flextronics International Ltd., a Singapore company, released another \$200 million to repurchase stock under its standing shareholder authorization to buy back up to 10% of the company's shares. At the close of trading on 13 August 2010, the share price was up 1.5% at \$5.40.

In all the stock had dropped 27% in 2010.

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

Managements' 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
 - If you own 100 shares and the company declared a 10% stock dividend, you would receive an additional 10 shares
- Small stock dividend: less than 20 to 25%
- 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?
- How are share repurchases an alternative to dividends, and why might investors prefer them?
- What are stock dividends, and how do they differ from cash dividends?

One-Tier Corporate Tax System in Singapore, Malaysia & Hong Kong

- Under the new one-tier corporate tax system, earnings are only taxed at the corporate level.
- Dividends are not taxed in the hands of shareholders.



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?



End of Chapter