Chapter 14

Dividends and
Dividend 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?
- Establishing a Dividend Policy
- Stock Repurchase: An Alternative to Cash Dividends
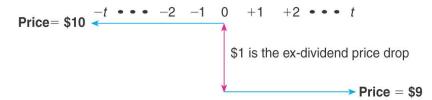- Stock Dividends and Stock Splits

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 won't 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 upcoming dividend
  - Stock price generally drops by approximately 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 14.2 The Ex-Day Price Drop

Ex date

$-t$ • • • -2 -1 0 $+1$ $+2$ • • • t

Price$= \$10$

$\$1$ is the ex-dividend price drop

Price $= \$9$

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 equal to $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.
  - 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, with their immediate tax consequences, 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 – 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 in low tax brackets
  - 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

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?

Information Content of Dividends

- Stock prices generally rise with <u>unexpected</u> increases in dividends and fall with <u>unexpected</u> decreases in dividends

- Does this mean that the average investor prefers a high dividend payout ratio?

- No – changes in the dividend send a signal about management's view concerning future prospects

Dividend Policy in Practice

- Residual dividend policy
- Constant growth dividend policy – dividends, increased at a constant rate each year
- Constant payout ratio – a constant percentage of earnings is paid out each year
- Compromise dividend policy

Residual Dividend Policy

- Determine capital budget
- Determine target capital structure
- Finance investments with a combination of debt and equity in line with the target capital structure
  - Remember that retained earnings are equity
  - If additional equity is needed, issue new shares
- If there are excess earnings, then pay the remainder out in dividends

Example: Residual Dividend Policy

- Given
  - Need $5 million for new investments
  - Target capital structure: D/E = 2/3
  - Net Income = $4 million
- Finding dividend
  - 40% of $5 million financed with debt ($2 million)
  - 60% of $5 million financed with equity ($3 million)
  - NI – equity financing = $4 million - $3 million = $1 million, paid out as dividends

Compromise Dividend Policy

- Goals, ranked in order of importance:
  - Avoid cutting back on positive NPV projects to pay a dividend
  - Avoid dividend cuts
  - Avoid the need to issue equity
  - Maintain a target debt/equity ratio
  - Maintain a target dividend payout ratio
- Companies want to accept positive NPV projects while avoiding negative signals

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 – company buys its own 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 and other imperfections

Real-World Considerations

- Stock repurchase allows investors to decide if they want the current cash flow and associated tax consequences
- Investors face capital gains taxes instead of ordinary income taxes (lower rate)
- In our current tax structure, repurchases may be more desirable due to the options they provide 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 repurchase sends a positive signal that management believes that 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

Stock 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."

Stock Dividends

- Distribute 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"