Payout Policy

Dividend Puzzle

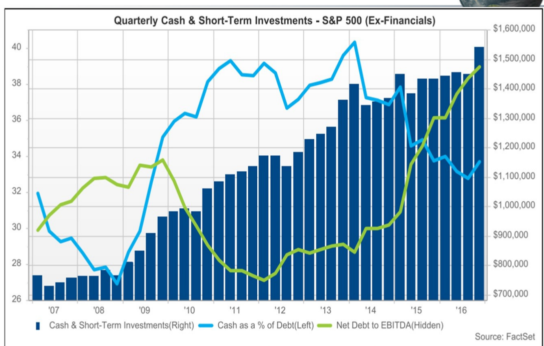
- Why do investors pay attention to dividends?
- Why do corporations pay dividends?

→ The answers are not obvious at all.

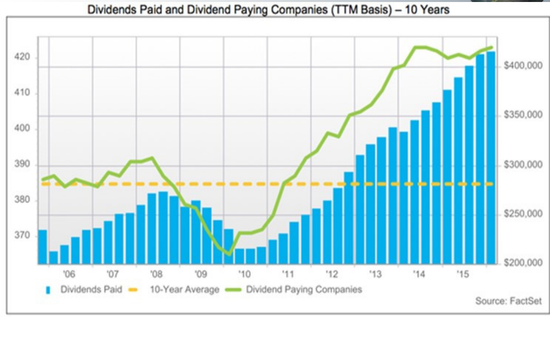
Forms of Dividends

- Cash dividend: Payment of cash by the firm to its shareholders
  - Ex-Dividend Date: Date that determines whether a stockholder is entitled to a dividend payment; anyone holding stock before this date is entitled to a dividend.
- Stock Dividend: Distribution of additional shares to a firm's stockholders
- Stock Splits: Issue of additional shares to firm's stockholders
- Stock Repurchase: Firm buys back stock from its shareholders

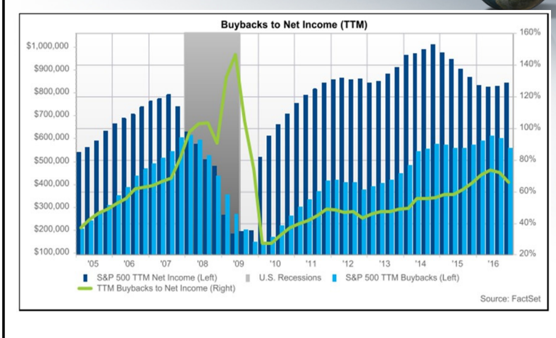
Over $1.5 Trillion in Cash for S&P 500



Dividends are regaining popularity



Stock Repurchases vs. Net Income



Stock Dividend

Example – Solomon Inc. has 2 million shares currently outstanding at a price of $15 per share. The company declares a 50% stock dividend.

1. How many shares will be outstanding after the dividend is paid?
2. After the stock dividend what is the new price per share and what is the new value of the firm?

Answer

1. 2 M x .50 = 1 M ➔ 3 M shares total

   The value of the firm was 2 M x $15 per share, or $30 M. After the dividend the value will remain the same.
2. Price per share = $30 M / 3 M shares = $10

Stock Repurchase

Example - Cash dividend versus share repurchase

Assets		*Liabilities & Equity*	
A. Original balance sheet			
Cash	$150,000	Debt	0
Other assets	850,000	Equity	1,000,000
Value of Firm	1,000,000	Value of Firm	1,000,000

Shares outstanding = 100,000

Price per share = $1,000,000 / 100,000 = $10

Stock Repurchase

Example - Cash dividend versus share repurchase

Assets		*Liabilities & Equity*	
B. After cash dividend			
Cash	$50,000	Debt	0
Other assets	850,000	Equity	900,000
Value of Firm	900,000	Value of Firm	900,000

Shares outstanding = 100,000

Price per share = $900,000 / 100,000 = $9

Stock Repurchase

Example - Cash dividend versus share repurchase

Assets		*Liabilities & Equity*	
C. After stock repurchase			
Cash	$50,000	Debt	0
Other assets	850,000	Equity	900,000
Value of Firm	900,000	Value of Firm	900,000

Shares outstanding = 90,000

Price per share = $900,000 / 90,000 = $10

Dividend: Lintner's "Stylized Facts"

1. Firms have longer term target dividend payout ratios.
2. Managers focus more on dividend changes than on absolute levels.
3. Dividends changes follow shifts in long-run, sustainable levels of earnings rather than short-run changes in earnings.
4. Managers are reluctant to make dividend changes that might have to be reversed.
5. Firms repurchase stock when they have accumulated a large amount of unwanted cash or wish to change their capital structure by replacing equity with debt.

Irrelevant?

- The "bird-in-hand" argument
  - Dividend policy matters because investors value current dividends more highly than uncertain future capital gains.
- Miller and Modigliani assert that the firm's dividend policy is irrelevant to the value of the firm as long as the probability distribution of the firm's cash flows is fixed and there are no taxes.
- Their analysis assumes that increased dividends are financed by the sale of new stock.

➔ The "bird-in-hand" argument is false!

Relevant?

- **Taxes**
  - If dividends are taxed more heavily than capital gains, and capital gains are not taxed until realized, then
  - ➔ A firm with no dividends will be more attractive to taxable individual investors than a similar firm with dividends.
  - ➔ Firms will be tempted to reduce or eliminate dividends and investors prefer smaller dividends or no dividends at all.

Relevant?

- **Transaction costs**
  - An investor who has non-dividend-paying stocks will sell some of his holdings or borrow against his shares to raise cash.
  - Since those transactions are costly, investors may prefer dividends.

Relevant?

- **Clientele Effect**
  - There are natural clients for high-payout stocks, and these clients increase the price of the stock through their demand for a dividend paying stock.
  - But it does not follow that any particular firm can benefit by increasing its dividends.
  - The high dividend clientele already have plenty of high dividend stock to choose from.

Relevant?

- **Information/Signaling**
  - The information content of dividends explain the price reactions and dividend policy could be employed as a signaling mechanism.
  - Dividend policy may convey information on a firm's prospects.
    - Dividend increases send good news about cash flows and earnings. Dividend cuts send bad news.
    - Because a high dividend payout policy will be costly to firms that do not have the cash flow to support it, dividend increases signal a company's good fortune and its manager's confidence in future cash flows.

Summary

- Corporations "smooth" dividends.
- Dividends contain information about the firm.
- 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.