Dividend policy at linear technology

ASSIGN BUSTER

Linear Technology's payout policy can be observed from Exhibit 3. From Q1 93 onwards, Linear has been steadily paying out dividends every quarter. Over the years, the dividends paid out to shareholders have also increased. From the dividend payout ratio (Appendix, Table 1), it is evident that especially in 2002 to 2003, dividends being distributed have increased from its previously steady ratio of approximately 0. 100. Dividends in both years have increased despite the fall in net income.

There were stock splits for Linear in 1993, 1996, 1999 and 2000. This meant that the residual shares owned increased, and that shareholders can then receive more dividends. However since dividend payout ratio remained fairly stable, this reflects greatly on Linear's strong earnings.

Linear Technology has no financing needs, given its large cash balance of US$1. 565 billion in 2003 and positive net cash flow from 1992. Net income has also been positive since 1992, with net income in the first 3 quarters of 2003 at US$170. 6 million.

Current liabilities stand at US$135. 6 million[1], and long-term liabilities at $97. 5 million. Accounts receivable as at March 2003 was at $83. 6 million, current assets at $1. 741 billion, leading to total assets of $2. 031 billion.

Hence, this leads to quick and current ratios of 12. 2 and 12. 8 respectively (Appendix), and a debt ratio of 7. 5. This figure indicates that assets far exceed liabilities in the short and long term, proving that the company has sufficient liquidity and long-term solvency.

Additionally, as Linear CFO Paul Coghlan has indicated that he had “ no plans for acquisitions” (Pg 3), all factors point to the absence of any requirement for external financing.

Linear Technology should return at least a significant portion of its cash to shareholders as holding the cash generates very little income, at 3. 3%. Yet, investors in this sector, Information Technology[2], generally expect a return on book equity of 14. 9% (Exhibit 5).

Keeping the cash in the firm in the form of retained earnings will lead to capital gains for investors upon sale of the stock. As the majority of shareholders of Linear are institutional investors, it is likely that they hold the stock for a long period, thus incurring the rate of 20% for long-term capital gain[3] for taxpayers in the highest tax bracket. Should the bill be passed, the capital gains tax rate would be 15%. This rate is prior to the passing of the Bill put forward by the House of Representatives (Pg 4). Any interest income generated by the cash in subsequent years will also be taxed at federal corporate tax rate of 35%[4]

Choosing to return the cash through share repurchases will lead to the same capital gains tax for shareholders[5]. As the cash is no longer with the company, less corporate tax will be incurred, possibly leading to a more favorable capital structure.

Should the cash be returned through dividends, prior to the passing of the Bill, investors would shoulder the highest personal tax rate of 38. 6% on dividends (Pg 5). Should the bill be passed, this rate would be reduced to the

proposed capital gains tax rate of 15%. Share price will also fall by the amount of the dividend[6].

The results are summarized in the Appendix (Table 2). Returning the cash would thus make the most sense in the absence of any prospective projects as it reduces the tax burden of the company, and is especially favorable in view of the proposed Bill. Assuming perfect capital markets, the return of cash via stock repurchases or dividends would have identical effects should the Bill be passed.

If Linear were to pay out its entire cash balance as a special dividend, the share price and the market value of equity would be reduced due to the ex-dividend date effects. It is relatively common for a stock’s price to decrease on the ex-dividend date by an amount roughly equal to the dividend paid. This reflects the decrease in the company’s assets resulting from the declaration of the dividend. However, earnings in the Income statement would not be changed because dividends paid are not classified as an expense, but rather a deduction of retained earnings. Also, in this case, the payment of dividends is unlikely to affect future earnings and profitability. Furthermore, since the payment of cash dividends does not involve a change in the number of shares, earnings per share would not be changed.

If Linear repurchased shares at market price instead, market value of equity would be also reduced, but the share price would not be changed. But in some cases, share price might be increased by signalling theory, as the buyback of shares may indicate that management feels that the share is undervalued. Similarly, earnings would not be changed, but earnings per

share would be increased from the reduction in number of shares. The results are summarized in Table 3 (Appendix).

A dividend is paid to shareholders through cash or shares as a return of profit for holding the stock. Firms may also choose to issue dividends in order to compete against other firms in the market for investor's money. There are many reasons for the change in rate of dividends. The first reason is due to competitors where the firm must change its rate in order to compete with competitor changes in dividends. Competitors in the market may push for higher dividends in years where the economy is doing better and lower their dividends in poor economic times.

Another reason could potentially be due to shareholders' pressure to increase dividends as a reason to continue holding or to improve the share performance of the stock. These shareholders may be in the form of institutional shareholders i. e. mutual funds or hedge funds. Also, shareholder pressure on the firm including activist shareholders will potentially alter dividend policy by pressuring management.

The natural maturity of a firm's growth may lead its management to pay out more dividends to its shareholders. Certain industries such as technology and mining generally store profit until the company matures and has stable income in order to return periodical profit to its investors. Thus, there may be changes in rate of dividend initiations depending on the life cycle stage of each firm.

Lastly, changes in dividend rates may be due to tax rates where it may be more profitable for shareholders to push for dividends if dividends are taxed

less than capital gains or vice versa. Changes in tax may cause dividend rates to change dependent on favourable or unfavourable tax circumstances.

Paul Coghlan should recommend the distribution of special dividends slightly higher than the usual amount of $0. 05 per share for the past 3 quarters. This would be substantiated by the 3 to 7% growth in FY2003 3Q which met expectations, as well as the lack of opportunities for investment of cash on hand, higher than the current return of 3%. The financial effects of this dividend would also not be significant on the expected return on the share as well, especially if the tax rate for dividends is changed to a lower rate. Investors would have already priced in the tax cost of consistent dividend issue, given the consistent dividend policy of Linear Technology.

An increase in dividends would also signal strong growth prospects, improve the financials of the company in terms of return on assets and return on equity, and reduce the tax burden on the company in the long term, as interest revenue would be taxed. Share repurchases should also be continued to avoid dilution of shares through the exercise of stock options awarded to employees.

References:

[1] Linear Technology. (2003). Linear Technology Corporation Consolidated Condensed Balance Sheets. http://cds. linear. com/docs/Investor/Linear_Technology_Earnings_PR_FY2003_Q3. pdf

[2]MSCI Inc. (n. d). Global Industry Classification Standard (GICS). http://www. mscibarra. com/resources/pdfs/GICSSectorDefinitions. pdf

[3]Krawczyk, K. and Wright, L. (Oct 2004). Dividends and Capital Gains Planning After the 2003 Tax Act. http://www. nysscpa. org/cpajournal/2004/1004/essentials/p36. htm

[4] Taylor, J. (2002). Corporation Income Tax Brackets and Rates, 1909-2002. http://www. irs. gov/pub/irs-soi/02corate. pdf

[5] Pettit, J. (2001). Is a Share Buyback Right for You? http://hbswk. hbs. edu/archive/2233. html

[6] Mueller, J. (2009). Dividend Facts You May Not Know. http://www. investopedia. com/articles/stocks/07/dividend_implications. asp#axzz27S3Elt2p