Dividend reinvestment plans

1. Which of the following statements about dividend policies is CORRECT? a. Modigliani and Miller argue that investors prefer dividends to capital gains because dividends are more certain than capital gains. They call this the ? bird-in-the hand? effect. b. One reason that companies tend to avoid stock repurchases is that dividend payments are taxed at a lower rate than gains on stock repurchases. c. One advantage of dividend reinvestment plans is that they allow shareholders to avoid paying taxes on the dividends that they choose to reinvest. . One key advantage of a residual dividend policy is that it enables a company to follow a stable dividend policy. e. The clientele effect suggests that companies should follow a stable dividend policy. *E* The clientele effect suggests that companies should follow a stable dividend policy. 2. Which of the following statements is CORRECT? a. One disadvantage of dividend reinvestment plans is that they increase transactions costs for investors who want to increase their ownership in the company. b.

One advantage of dividend reinvestment plans is that they enable investors to postpone paying taxes on the dividends credited to their account. c. Stock repurchases can be used by a firm that wants to increase its debt ratio. d. Stock repurchases make sense if a company expects to have a lot of profitable new projects to fund over the next few years, provided investors are aware of these investment opportunities. e. One advantage of an open market dividend reinvestment plan is that it provides new equity capital and increases the shares outstanding. *C*

Stock repurchases can be used by a firm that wants to increase its debt ratio. 3. Which of the following statements is CORRECT? a. When firms are

deciding on the size of stock splits—say whether to declare a 2-for-1 split or a 3-for-1 split, it is best to declare the smaller one, in this case the 2-for-1 split, because then the after-split price will be higher than if the 3-for-1 split had been used. b. Back before the SEC was created in the 1930s, companies would declare reverse splits in order to boost their stock prices. However, this was determined to be a deceptive practice, and it is illegal today. c.

Stock splits create more administrative problems for investors than stock dividends, especially determining the tax basis of their shares when they decide to sell them, so today stock dividends are used far more often than stock splits. d. When a company declares a stock split, the price of the stock typically declines—by about 50% after a 2-for-1 split—and this necessarily reduces the total market value of the equity. e. If a firm’s stock price is quite high relative to most stocks—say $500 per share—then it can declare a stock split of say 10-for-1 so as to bring the price down to something close to $50.

Moreover, if the price is relatively low—say $2 per share—then it can declare a ? reverse split? of say 1-for-25 so as to bring the price up to somewhere around $50 per share. *E* If a firm’s stock price is quite high relative to most stocks—say $500 per share—then it can declare a stock split of say 10-for-1 so as to bring the price down to something close to $50. Moreover, if the price is relatively low—say $2 per share—then it can declare a ? reverse split? of say 1-for-25 so as to bring the price up to somewhere around $50 per share. 4. Which of the following statements is CORRECT? a.

If a firm follows the residual dividend policy, then a sudden increase in the number of profitable projects is likely to reduce the firm’s dividend payout. b.

The clientele effect can explain why so many firms change their dividend policies so often. c. One advantage of adopting the residual dividend policy is that this policy makes it easier for corporations to develop a specific and well-identified dividend clientele. d. New-stock dividend reinvestment plans are similar to stock dividends because they both increase the number of shares outstanding but don't change the firm's total amount of book equity. e.

Investors who receive stock dividends must pay taxes on the value of the new shares in the year the stock dividends are received. *A* If a firm follows the residual dividend policy, then a sudden increase in the number of profitable projects is likely to reduce the firm's dividend payout. 5. DeAngelo Corp. ' s projected net income is $150. 0 million, its target capital structure is 25% debt and 75% equity, and its target payout ratio is 65%. DeAngelo has more positive NPV projects than it can finance without issuing new stock, but its board of directors had decreed that it cannot issue any new shares in the foreseeable future.

The CFO now wants to determine how the maximum capital budget would be affected by changes in capital structure policy and/or the target dividend payout policy. Versus the current policy, how much larger could the capital budget be if (1) the target debt ratio were raised to 75%, other things held constant, (2) the target payout ratio were lowered to 20%, other things held constant, and (3) the debt ratio and payout were both changed by the indicated amounts. Increase in Capital Budget Increase Debt Lower Payout Do Both to 75% to 20%_____ a. $114. 0 $73. 3 $333. 9 b. $120. 0 $77. 2 $351. 5 c. 126. 4 $81. 2 $370. 0 d. $133. 0 $85. 5 $389. 5 e. $140.

0 $90. 0 $410. 0 *E* $140. 0 $90. 0 $410. 0 1.) If debt ratio is raised to 75%, the equity ratio is 25%, capital budget = $52. 5 million / 0. 25 = $210 million, the increase is $210 – $70 = $140 million; 2.) Retained income = (100% – 20%)*$150 million = $120 million, if 25% debt and 75% equity = = capital budget = $120 million/0. 75 = $160 million = the increase is $160 – $70 = $90 million; 3.) Retained income $120 million, 75% debt and 25% equity = capital budget = $120 million / 0. 25 = $480 million, the increase is $480 – $70 = $410 million;