The payout policy essay sample

1. Describe how dividends are paid out and how corporations decide how much to pay. 2. Explain how stock repurchases are used to distribute cash to investors. 3. Explain why dividend increases and repurchases are good news for investors and why dividend cuts are bad news. 4. Explain why payout policy would not affect shareholder value in perfect and efficient financial markets. 5. Show how market imperfections, especially the different tax treatment of dividends and capital gains, can affect payout policy.

Payout Policy

Firms can pay cash to shareholders in two major ways; cash dividends and share repurchases. This chapter analyzes both options and provides the student with insight into a firm's payout policy decisions.

How Corporations Pay Cash to Shareholders

Corporations can pay shareholders by paying a dividend or by repurchasing shares. Cash Dividend – Payment of cash by the firm to its shareholders. Stock repurchase – Firm buys back stock from its shareholders.

Paying Dividends

Cash Dividend – Payment of cash by the firm to its shareholders. •Regular Dividend – A dividend that is expected to be paid consistently into the future. •Special Dividend – A dividend that is not likely to be repeated. Stock Dividend/Split – Distributions of additional shares to a firm's stockholders.

Stock Dividends: Example

Imagine a corporation currently has 10 million shares outstanding selling at $60 per share and declares a three-for-two stock split.

After the split, how many shares will be outstanding?

After the split, what will be the new share price?

Dividend Policy: Key Dates

Union Pacific Quarterly Dividend Key Dates

What would you expect to happen to the price of a share of stock on the day it goes ex-dividend?

•Shares of large firms trade constantly, so corporations must specify a particular day's roster of shareholders who qualify to receive any announced dividend. •Key Dates:

•Declaration Date – The date on which the corporation announces a dividend payment. •Ex-dividend Date – Without dividend. Buyer of a stock after the ex-dividend date does not receive the most recently declared dividend.

•Record Date – Shareholders registered on this date will be the ones to receive the most recently declared dividend. •Payment Date – The date the dividend payment is actually sent to shareholders.

Dividends: Example

Imagine a firm has 100, 000 shares outstanding, worth $1 million in total. If the firm issues a $1-per-share cash dividend, how is shareholder wealth affected? Before Dividend:

After Dividend:

After the cash dividend, the market value of the firm falls to $900, 000 and shareholders gain $100, 000 in cash. Stock Repurchases

Four ways to implement:

1. Open-market repurchase
2. Tender offer
3. Auction
4. Direct negotiation

Stock Repurchase – Firm buys back stock from its shareholders. •Open market repurchase: Occurs when the firm purchases stock in the secondary market, just like any other investor. •Tender offer: Firm offers to buy back a stated number of shares at a fixed price. •Auction: Firm states a range of prices at which it is prepared to repurchase. •Direct negotiation: Firm may negotiate repurchase of a block of shares from a major shareholder.

Stock Repurchase: Example

Imagine a firm has 100, 000 shares outstanding, worth $1 million in total. If the firm buys back 10, 000 shares at $10 each, how is shareholder wealth affected? Before Dividend:

After Repurchase:

After the cash dividend, the market value of the firm falls to $900, 000 yet shareholders retain equal ownership in the firm.

Stock Repurchase: Example

After the repurchase, shareholders can sell 10% of their shares and earn $100, 000 in cash, yet still retain ownership equal to that which they had before. The shareholders’ position is exactly the same with the share repurchase as with the cash dividend: •Total shares worth $900, 000

•Cash worth $100, 000

Share Valuation

In chapter 7, the dividend discount model taught us that the price of a share is the PV of future cash flows per share. What if the dividend is a repurchase, not a cash payment?

Consider the following two examples.

Share Valuation: Example 1

Case 1: A firm promises to pay dividends of $100, 000 in perpetuity with 100, 000 shares outstanding. Assume a discount rate of 11. 1%. What is the present value of one of the firm's shares?

Share Valuation: Example 2

Case 2: This same firm decides instead to use the first year's proposed dividends of $100, 000 to repurchase 10, 000 shares of stock. From year 2 onward it will resume annual dividends of $100, 000. What effect does this have on the value of the shares?

Note: Notice how the present value of the security is unchanged whether the firm chooses to issue a cash dividend or repurchase its shares.

Dividend Policy

Survey of Financial Executives: Views on Dividend Policy

Dividends are surprisingly " smooth" annually, and managers are often reluctant to alter them.

•A firm’s target dividend payment is often calculated as a percentage of expected earnings, not a single year’s actual earnings. •When current dividends are less than the target, the dividend is increased gradually toward the target. •When current dividends are greater than the target, the dividend usually is not cut immediately; it is often left alone.

Information Signaling

Dividends and repurchases provide clues about a company’s true financial prospects. Informational aspect of dividends

•Dividend increases send good news about future cash flow and earnings. Dividend cuts send bad news. If management announces an unexpected cut in dividend payments, what do you predict will happen to share price for the firm?

Note: Announcements of share repurchases are also good news for investors, but these announcements usually convey less information than cash dividends do.

The Payout Controversy

What is the effect of a change in dividend payout policy, given a firm’s current capital budgeting and borrowing decisions? •Payout decisions are often intertwined with other financing or investment decisions. •Firms may pay low dividends due to optimistic future growth prospects. This payout decision is a by-product of the capital budgeting decision. •Firms may finance expenditures by borrowing, thus freeing up more capital to be paid out to shareholders. This payout decision is a by-product of the borrowing decision. •Dividend policy always involves a trade-off between higher or lower cash dividends and the issue or repurchase of stock.

Are Dividends Irrelevant?

Franco Modigliani and Merton Miller (MM) showed that dividend policy does not alter firm value under the assumption of perfect financial markets.

MM’s Dividend-Irrelevance Proposition – Under ideal conditions, the value of the firm is unaffected by dividend policy.

Dividend Policy Irrelevance: Example

Case 1: A firm plans to pay annual dividends of $5 per share in perpetuity, and shareholders expect an 8% rate of return. Assume 1, 000, 000 shares outstanding. What are the total dividends paid each period, and what is the present value of each share?

Dividend Policy Irrelevance: Example 2

Case 2: In an attempt to increase share value, this same firm plans to instead pay annual dividends of $10 per share in perpetuity, and still shareholders expect an 8% rate of return. Assume 1, 000, 000 shares outstanding. What is the present value of each share?

*Note: In order to pay the additional $5, 000, 000 in dividends and earn the same profits in the future, the firm must replace the lost cash with a new issue of shares.

*Note: The firm must now pay an additional $400, 000 per year in dividends to the new shareholders:

As long as the company replaces the extra cash it’s paying out, it will earn the same profits and pay our $5, 000, 000 of dividends each year from year 2. $400, 000 of this will be used to satisfy new shareholders.

Divided-Irrelevance Assumptions

In order for MM’s Dividend-Irrelevance Proposition to hold, we must assume an efficient capital market. •Market efficiency implies that transfers of ownership created by shifts in dividend policy are fairly achieved. •Since the overall value of (old and new) stockholders’ equity is unaffected, nobody gains or loses.

Why Dividends May Increase Value

Once we relax the assumptions of perfect and efficient capital markets, many investors claim dividends may actually increase value. •Attracts natural clientele

•Leverages behavioral psychology

•Prevents managers from wasting funds

Always remember this:

•Although there are natural clienteles for high-payout stocks, it does not follow that any particular firm can benefit by increasing its dividends. •The high-dividend clienteles already have plenty of high-dividend stocks to choose from.

Why Dividends May Reduce Value

If dividends are taxed more heavily than capital gains, a company that can convert dividends into capital gains should attract more investors. All other things being equal, investors are willing to pay more for a stock whose returns come in the form of low-taxed capital gains.

Taxation

In recent years, the case for low dividends has been weakened. •Top tax rates on dividends: 15%

•Top tax rates on capital gains: 15%

One advantage to investors: Capital gains taxes are deferrable One advantage to corporations: Corporations pay corporate income tax on only 30% of any dividends received from investments in other corporations.