DIVIDENDS AND OTHER PAYOUTS

DIFFERENT TYPES OF DIVIDENDS

- The dividend decision determines what funds flow to investors and what funds are retained by the firm for reinvestment.
- However, dividends cannot be viewed in isolation: share repurchases
- Public companies usually pay regular cash dividends four times a year.
- Sometimes firms will pay a regular cash dividend and an extra cash dividend.
- Another type of dividend is paid out in shares of stock: stock dividend.

THE INDIFFERENCE PROPOSITION

- MM make the following assumptions:

1. There are neither taxes nor brokerage fees, and no single participant can affect the market price of the security through his or her trades: Perfect Markets
2. All individuals have the same beliefs concerning future investments, profits, and dividends: Homogeneous Expectations
3. The investment policy of the firm is set ahead of time, and is not altered by changes in dividend policy.

THE INDIFFERENCE PROPOSITION

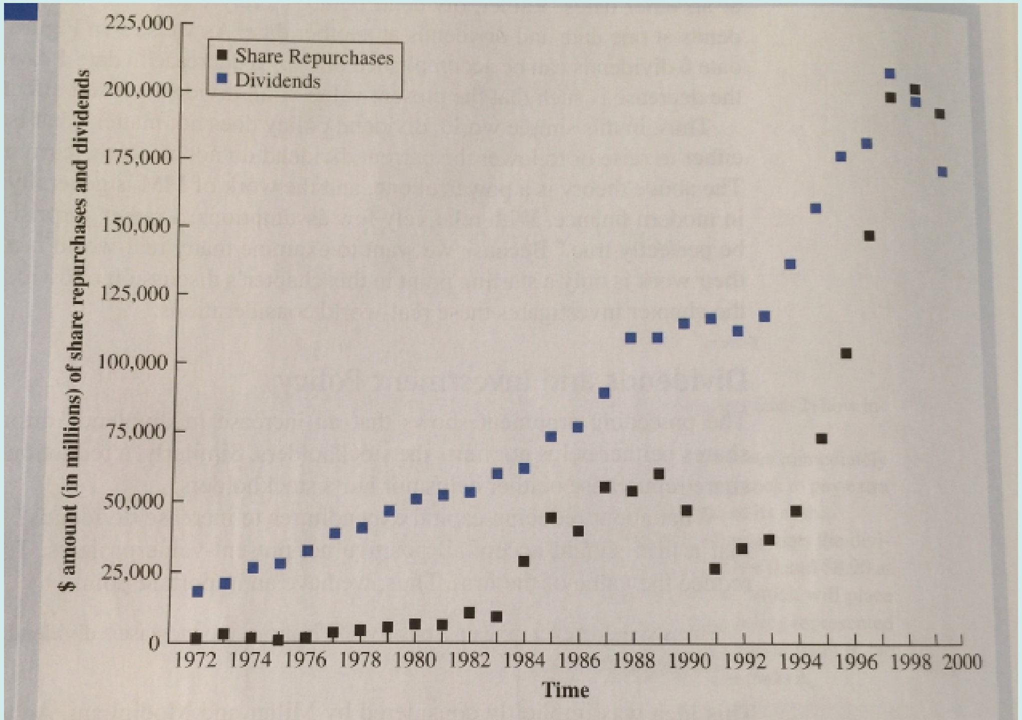
- Dividend policy is irrelevant. The changes the managers make in dividend policy can be undone by an individual who, by either reinvesting dividends or selling off stock, can achieve the same e.
- Dividends are relevant.
- Dividend policy is irrelevant.
- Dividend policy cannot raise the dividend per share at one date while holding the dividend level per share constant at all other dates.
- Rather, dividend policy merely establishes the trade-off between dividends at one date and dividends at another date.

THE INDIFFERENCE PROPOSITION

- In this simple world, dividend policy does not matter.
- Managers choosing either to raise or to lower the current dividends do not affect the current value of their firm.
- Implicit idea: Firms should never give up a positive NPV project to increase a dividend (or to pay a dividend for the first time).

REPURCHASE OF STOCK

- Instead of paying dividends, a firm may use cash to repurchase shares of its own stock.



This figure shows the dollar amount of both share repurchases and dividends for U.S. firms for each year from 1972 to 2000. The dollar amount of share repurchases was actually greater than that of dividends for each of the last two years of the sample period.

SOURCE: Adapted from Table 1 of Grullon, Gustavo, and Roni Michaely, "Dividends, Share Repurchases, and the Substitution Hypothesis," *Journal of Finance* (August 2002).

REPURCHASE OF STOCK

- Share repurchases are typically plished in one of three ways.
- First, companies may simply purchase their own stock, just as anyone would buy shares of a particular stock: open-market purchases
- Second, the firm could institute a tender offer.
- Here, the firm announces to all of its stockholders that it is willing to buy a fixed number of shares at a specific price.

REPURCHASE OF STOCK

- Suppose A&C, Inc. has 1 million shares of stock outstanding, with a stock price of $50 per share.
- The firm makes a tender offer to buy back 300,000 shares at $60 per share.
- A&C chooses a price above $50 to induce shareholders to sell, that is, tender, their shares.
- In the extreme case where all outstanding shares are tendered, A&C will buy back 3 out of every 10 shares that a shareholder has.

REPURCHASE OF STOCK

- Finally, firms may repurchase shares from specific individual stockholders: targeted repurchase
- Suppose ABC Corporation purchased approximately 10% of the outstanding stock of XYZ Corporation in April at around $38 per share.
- At that time, ABC announced to the SEC that it might eventually try to take control of XYZ.
- In May, XYZ repurchased the ABC holdings at $48 per share, well above the market price at that time. This offer was not extended to other shareholders.

DIVIDEND VERSUS REPURCHASE: CONCEPTUAL EXAMPLE

	For Entire Firm	Per Share
Extra Dividend		(100,000 shares outstanding)
Proposed dividend	$300,000	$3.00
Forecasted annual earnings after dividend	450,000	4.50
Market value of stock after dividend	2,700,000	27.00
Repurchase		(90,000 shares outstanding)
Forecasted annual earnings after repurchase	$450,000	$5.00
Market value of stock after repurchase	2,700,000	30.00

In a perfect market, the firm is indifferent between a dividend payment and a share repurchase.

DIVIDEND VERSUS REPURCHASE: REAL-WORLD CONSIDERATIONS

- Why do some firms choose repurchases over dividends? Five of the most common reasons:
- 1. Flexibility
- It is well known that firms view dividends as a commitment to their stockholders and are quite hesitant to reduce an existing dividend.
- Repurchases do not represent a similar commitment.
- Thus, a firm with a permanent increase in cash flow is likely to increase its dividend.
- Conversely, a firm whose cash flow increase is only temporary is likely to repurchase shares of stock.

DIVIDEND VERSUS REPURCHASE: REAL-WORLD CONSIDERATIONS

- 2. Executive Compensation
- Executives are frequently given stock options as part of their overall compensation.
- Existing stock options will always have greater value when the firm repurchases shares instead of paying a dividend, since the stock price will be greater after a repurchase than after a dividend.

DIVIDEND VERSUS REPURCHASE: REAL-WORLD CONSIDERATIONS

- 3. Offset to Dilution
- The exercise of stock options increases the number of shares outstanding: exercise causes dilution of the stock.
- Firms frequently buy back shares of stock to offset this dilution.

DIVIDEND VERSUS REPURCHASE: REAL-WORLD CONSIDERATIONS

- 4. Repurchase as Investment
- Many companies buy back stock because they believe that a repurchase is their best investment.
- This occurs more frequently when managers believe that the stock price is temporarily depressed.
- Here, it is likely thought that (1) investment opportunities in nonfinancial assets are few, and (2) the firm’s own stock price should rise with the passage of time.

DIVIDEND VERSUS REPURCHASE: REAL-WORLD CONSIDERATIONS

- 4. Repurchase as Investment - continued
- Empirical evidence:
- The immediate stock market reaction to the announcement of a stock repurchase is usually quite favorable.
- Some empirical work has shown that the long-term stock price performance of securities after a buyback is better than the stock price performance of comparable companies that do not repurchase.

Dividend Versus Repurchase: Real-World Considerations

- 5. Taxes
- Repurchases provide a tax advantage over dividends.

PERSONAL TAXES, ISSUANCE COSTS, AND DIVIDENDS

- no taxes, no transaction costs, and no uncertainty → dividend policy is irrelevant
- In the US, both cash dividends and capital gains are taxed at a maximum rate of 15%.
- However, since dividends are taxed when distributed while the taxes on capital gains are deferred until the stock is sold, the tax rate on dividends is greater than the effective rate on capital gains.

PERSONAL TAXES, ISSUANCE COSTS, AND DIVIDENDS

- Firms without sufficient cash to pay a dividend
- Firms with sufficient cash to pay a dividend
  1. Select Additional Capital-Budgeting Projects
  2. Acquire Other Companies
  3. Purchase Financial Assets
  4. Repurchase Shares

REAL-WORLD FACTORS FAVORING A HIGH-DIVIDEND POLICY

- Since the tax rate on dividends is above the effective tax rate on capital gains, financial managers will seek out ways to reduce dividends.
- Share repurchase has many of the benefits of a dividend with less of a tax disadvantage.
- Reasons why a firm might pay its shareholders high dividends, even in the presence of personal taxes on these dividends?

REAL-WORLD FACTORS FAVORING A HIGH-DIVIDEND POLICY

- Desire for Current e
- Many individuals desire current e: retired people
- These individuals would bid up the stock price should dividends rise and bid down the stock price should dividends fall.
- MM point out that this argument does not hold in their theoretical model. An individual preferring high current cash flow but holding low-dividend securities could easily sell off shares to provide the necessary funds.
- Thus, in a world of no transactions costs, a high-current-dividend policy would be of no value to the stockholder.