Fundamentals of Corporate Finance, 2/e

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Chapter 17:
Dividends, Stock Repurchases, and Payout Policy

Learning Objectives

1. EXPLAIN WHAT A DIVIDEND IS, AND DESCRIBE THE DIFFERENT TYPES OF DIVIDENDS AND THE DIVIDEND PAYMENT PROCESS. CALCULATE THE EXPECTED CHANGE IN A STOCK'S PRICE AROUND AN EX-DIVIDEND DATE.
2. EXPLAIN WHAT A STOCK REPURCHASE IS AND HOW COMPANIES REPURCHASE THEIR STOCK. CALCULATE HOW TAXES AFFECT THE AFTER-TAX PROCEEDS THAT A STOCKHOLDER RECEIVES FROM A DIVIDEND AND FROM A STOCK REPURCHASE.

Learning Objectives

3. DISCUSS THE BENEFITS AND COSTS ASSOCIATED WITH DIVIDEND PAYMENTS AND COMPARE THE RELATIVE ADVANTAGES AND DISADVANTAGES OF DIVIDENDS AND STOCK REPURCHASES.
4. DEFINE STOCK DIVIDENDS AND STOCK SPLITS AND EXPLAIN HOW THEY DIFFER FROM OTHER TYPES OF DIVIDENDS AND FROM STOCK REPURCHASES.
5. DESCRIBE FACTORS THAT MANAGERS CONSIDER WHEN SETTING THE DIVIDEND PAYOUTS FOR THEIR FIRMS.

Dividends

- The term payout policy is generally used to refer to a firm's overall policy regarding distributions of value to stockholders.
- A dividend is something of value that is distributed to a firm's stockholders on a pro-rata basis—that is, in proportion to the percentage of the firm's shares that they own.
- A dividend can involve the distribution of cash, assets, or something else, such as discounts on the firm's products that are available only to stockholders.

Dividends

- When a firm distributes value through a dividend, it reduces the value of the stockholders' claims against the firm.
- Reduces the stockholders' investment in a firm by returning some of that investment to them.
- The value that stockholders receive through a dividend was already theirs and so a dividend simply takes this value out of the firm and returns it to stockholders.

Dividends

- TYPES OF DIVIDENDS
  - **Regular Cash Dividend**

    The most common form, it is the cash dividend that is paid on a regular basis.

    Are generally paid on a quarterly basis and are a common means by which firms return some of their profits to stockholders.

    The size of a firm's regular cash dividend is typically set at a level that management expects the company to be able to maintain in the long run, barring some major change in the fortunes of the company.

Dividends

- TYPES OF DIVIDENDS
  - **Extra dividends**

    Management can afford to err on the side of setting the regular cash dividend too low because it always has the option of paying an extra dividend if earnings are higher than expected.

    Extra dividends are often paid at the same time as regular cash dividends and are used by some companies to ensure that a minimum portion of earnings is distributed to stockholders each year.

Dividends

- TYPES OF DIVIDENDS
  - **Special Dividend**

    A special dividend, like an extra dividend, is a one-time payment to stockholders.

    Special dividends tend to be considerably larger than extra dividends and to occur less frequently.

    They are used to distribute unusually large amounts of cash.

Dividends

- TYPES OF DIVIDENDS
  - **Liquidating Dividend**

    Is a dividend that is paid to stockholders when a firm is liquidated.

    Distributions of value to stockholders can also take the form of discounts on the company’s products, free samples, and the like.

    These noncash distributions are not thought of as dividends, in part because the value received by stockholders is not in the form of cash and in part because the value received by individual stockholders does not often reflect their proportional ownership in the firm.

Dividends

- THE DIVIDEND PAYMENT PROCESS
  - **The Board Vote**

    The process begins with a vote by a company's board of directors to pay a dividend.

    As stockholder representatives, the board must approve any distribution of value to stockholders.
  - **The Public Announcement**

    The date on which this announcement is made is known as the declaration date, or announcement date, of the dividend.

Dividends

- THE DIVIDEND PAYMENT PROCESS
  - **The Public Announcement**

    The announcement typically includes the amount of value that stockholders will receive for each share of stock that they own, as well as the other dates associated with the dividend payment process.

    The price of a firm's stock often changes when a dividend is announced because the public announcement sends a signal to the market about what management thinks the future performance of the firm will be.

Dividends

- THE DIVIDEND PAYMENT PROCESS
  - **The Public Announcement**

    If the signal differs from what investors expected, they will adjust the prices at which they are willing to buy or sell the company's stock accordingly.

    This means that a dividend decision sends information to investors and that information is incorporated into stock prices at the time of the public announcement.

Dividends

- THE DIVIDEND PAYMENT PROCESS
  - **The Ex-Dividend Date**

    The ex-dividend date is the first date on which the stock will trade without rights to the dividend.

    An investor who buys shares before the ex-dividend date will receive the dividend, while an investor who buys the stock on or after the ex-dividend date will not.

    Before the ex-dividend date, a stock is said to be trading cum dividend, or with dividend.

Dividends

- THE DIVIDEND PAYMENT PROCESS
  - **The Ex-Dividend Date**

    On or after the ex-dividend date, the stock is said to trade ex-dividend.

    The price of the firm's shares changes on the ex-dividend date even if there is no new information about the firm.

    This drop simply reflects the difference in the value of the cash flows that the stockholders are entitled to receive before and after the ex-dividend date.

Dividends

- THE DIVIDEND PAYMENT PROCESS
  - **The Record Date**

    The record date typically follows the ex-dividend date by two business days.

    The record date is the date on which an investor must be a stockholder of record (that is, officially listed as a stockholder) in order to receive the dividend.

    The reason that the ex-dividend day precedes the record date is that it takes time to update the stockholder list when someone purchases shares.

Dividends

- THE DIVIDEND PAYMENT PROCESS
  - **The Payable Date**

    The final date in the dividend payment process is the payable date, when the stockholders of record actually receive the dividend.

Exhibit 17.1: The Dividend Payment Process Time Line for a Public Company

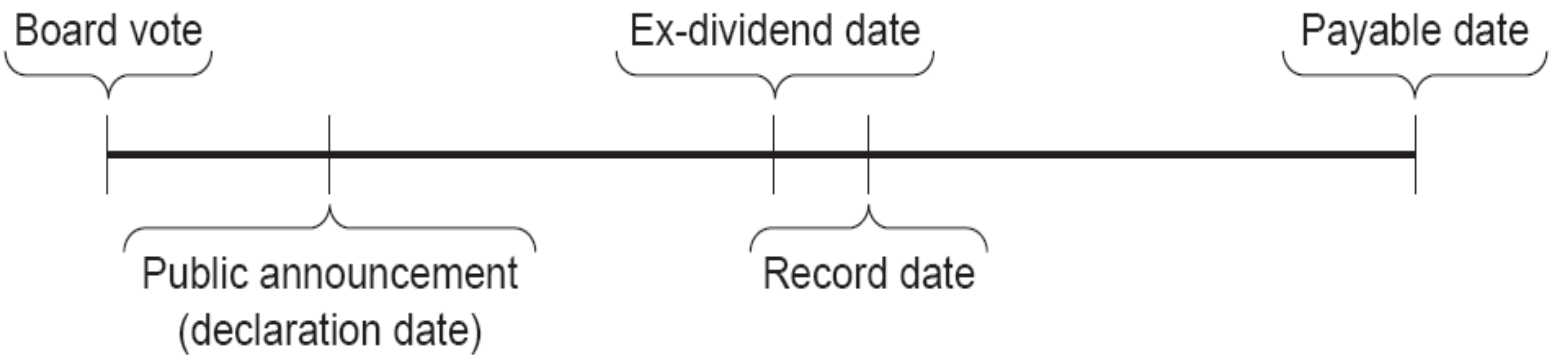

EXHIBIT 17.1

The Dividend Payment Process Time Line for a Public Company

The dividend payment process begins when the board votes to pay a dividend. Shortly afterward, the firm publicly announces its intent to pay a dividend, along with, at a minimum, the amount of the dividend and the record date. The ex-dividend date, which is set by the stock exchange, normally precedes the record date by two days. The payable date is the date on which the firm actually pays the dividend.

Dividends

- THE DIVIDEND PAYMENT PROCESS AT PRIVATE COMPANIES
  - **It is not as well defined for private companies as it is for public companies because**

    shares are bought and sold less frequently,

    fewer stockholders and,

    no stock exchange is involved in the dividend payment process.
  - **It is easy to inform all stockholders of the decision to pay a dividend, and it is easy to actually pay it.**
  - **There is no public announcement, and there is no need for an ex-dividend date.**
  - **The record date and payable date can be any day on or after the day that the board approves the dividend.**

Exhibit 17.2: Key Dates for Wal-Mart's Q1 Dividend 2005

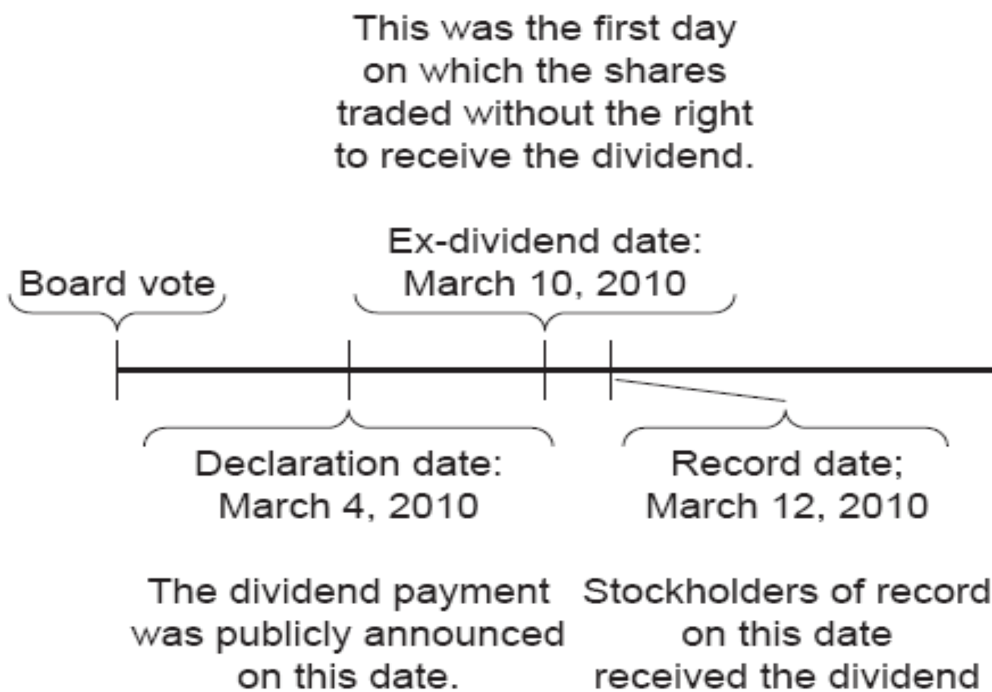

EXHIBIT 17.2
Key Dates for Wal-Mart's First Quarter 2010 Dividend

This exhibit summarizes the key dates and time line for the regular cash dividend that Wal-Mart paid on April 5, 2010.

Stock Repurchases

- With a stock repurchase, a company buys some of its shares from stockholders.
- HOW STOCK REPURCHASES DIFFER FROM DIVIDENDS
  - **First, they do not represent a pro-rata distribution of value to the stockholders, because not all stockholders participate.**

    Individual stockholders decide whether they want to participate in a share repurchase.

Stock Repurchases

- HOW STOCK REPURCHASES DIFFER FROM DIVIDENDS
  - **Second, when a company repurchases its own shares, it removes them from circulation.**

    This reduces the number of shares of stock that are held by investors. Removing a large number of shares from circulation can change the ownership of the firm.

Stock Repurchases

- HOW STOCK REPURCHASES DIFFER FROM DIVIDENDS
  - **Third, stock repurchases are taxed differently than dividends.**

    The total value of dividends is normally taxed.

    Conversely, when a stockholder sells shares back to the company, the stockholder is taxed only on the profit from the sale.

Stock Repurchases

- HOW STOCK REPURCHASES DIFFER FROM DIVIDENDS
  - **Fourth, the way in which we account for dividends and stock repurchases on a company's balance sheet is also different.**

    When the company pays a cash dividend, the cash account on the assets side of the balance sheet and the retained earnings account on the liabilities and stockholders' equity side of the balance sheet are reduced.

Stock Repurchases

- HOW STOCK REPURCHASES DIFFER FROM DIVIDENDS

  In contrast, when a company uses cash to repurchase stock, the cash account on the assets side of the balance sheet is reduced, while the treasury stock account on the liabilities and stockholders' equity side of the balance sheet is increased (becomes more negative).

Stock Repurchases

- HOW STOCK IS REPURCHASED: 3 WAYS
  - **Open-market Repurchase**

    First, they can simply purchase shares in the market, much as you would. These kinds of purchases are known as open-market repurchases which are a very convenient way of repurchasing shares on an ongoing basis.

    Open-market repurchases can be cumbersome because the government limits the number of shares that a company can repurchase on a given day.

Stock Repurchases

- HOW STOCK IS REPURCHASED: 3 WAYS
  - **Open-market Repurchase**

    These limits, which are intended to restrict the ability of firms to influence their stock price through trading activity, mean that it could take months for a company to distribute a large amount of cash using open-market repurchases.

Stock Repurchases

- HOW STOCK IS REPURCHASED: 3 WAYS
  - **Tender Offer**

    When the management of a company wants to distribute a large amount of cash at one time and does not want to use a special dividend, it can repurchase shares using a tender offer, which is an open offer by a company to purchase shares.

    There are two types of tender offers: fixed price and Dutch auction.

Stock Repurchases

- HOW STOCK IS REPURCHASED: 3 WAYS
  - **Tender Offer**

    With a fixed-price tender offer, management announces the price that will be paid for the shares and the maximum number of shares that will be repurchased.

    Interested stockholders then tender their shares by letting management know how many shares they are willing to sell.

Stock Repurchases

- HOW STOCK IS REPURCHASED: 3 WAYS
  - **Tender Offer**

    With a Dutch auction tender offer, the firm announces the number of shares that it would like to repurchase and asks the stockholders how many shares they would sell at a series of prices, ranging from just above the price at which the shares are currently trading to some higher number.

    Stockholders then tell the company how many of their shares they would sell at the various offered prices.

Stock Repurchases

- HOW STOCK IS REPURCHASED: 3 WAYS
  - **Targeted Stock Repurchase**

    Is through direct negotiation with a specific stockholder. These targeted stock repurchases are typically used to buy blocks of shares from large stockholders.

    Can benefit stockholders because managers may be able to negotiate a per-share price that is below the current market price since the stockholder who owns a large block of shares might have to offer the shares for a below-market price in order to sell them all in the open market.

Exhibit 17.3: Descriptive Statistics

EXHIBIT 17.3 **Descriptive Statistics for Stock Repurchases in the United States, 1984–2001**

Open-market repurchase programs are the most common means of repurchasing shares. However, managers tend to use other methods when they want to repurchase a large percentage of their firm's total shares.

	Open-Market Repurchase Programs	Fixed-Price Tender Offers	Dutch Auction Tender Offers	Targeted Stock Repurchases
Average percentage of shares repurchased	7.37%	29.46%	15.88%	13.00%
Average premium paid over market price	NA	20.74%	14.72%	1.92%
Percentage of cases where repurchase price was below market price	NA	0.00%	0.40%	44.78%
Average market-adjusted stock price change following repurchase announcement	2.39%	7.68%	7.60%	−1.81%
Number of observations	6,470	303	251	737

Source: Information from Urs C. Peyer and Theo Vermaelen, "The Many Facets of Privately Negotiated Stock Repurchases," *Journal of Financial Economics* 75 (2005), 361–395.

Dividends and Firm Value

- Dividend policy can affect the value of a firm.
- The general conditions under which capital structure policy does not affect firm value are:
  - There are no taxes.
  - There are no information or transaction costs.
  - The real investment policy of the firm is fixed.

Dividends and Firm Value

- Dividend policy does not matter under the above conditions because a stockholder can "manufacture" any dividends he or she wants at no cost when these conditions hold.
- A stockholder could also undo a company's dividend policy by simply reinvesting the dividends that the company pays in new shares.
- If investors could replicate a company's dividend policy on their own at no cost, they would not care whether or not the company paid a dividend.

Dividends and Firm Value

- BENEFITS OF DIVIDENDS
  - **It attracts investors who prefer to invest in stocks that pay dividends.**
  - **While it is true that the investor could simply sell some stock each month to cover expenses, in the real world it may be less costly—and it is certainly less trouble—to simply receive regular cash dividend payments instead.**

Dividends and Firm Value

- BENEFITS OF DIVIDENDS
  - **Recall that under the M&M conditions, there are no transaction costs.**
  - **In the real world, though, the retiree or institutional investor will have to pay brokerage commissions each time he or she sells stock.**
  - **The dividend check, in contrast, simply arrives each quarter.**

Dividends and Firm Value

- BENEFITS OF DIVIDENDS
  - **Of course, the retiree will have to consider the impact of taxes on the value of dividends versus the value of proceeds from the sale of stock; but it is quite possible that receiving dividends might, on balance, be more appealing.**
  - **Other investors have no current need for income from their investment portfolios and prefer not to receive dividends.**

Dividends and Firm Value

- BENEFITS OF DIVIDENDS
  - **Some argue that a large regular dividend indicates that a company is financially strong because the "signal" of strength can result in a higher stock price.**
  - **The problem with this line of reasoning is that it ignores the possibility that a company might have more than enough money for all its future investment opportunities because it does not have many future investment opportunities.**

Dividends and Firm Value

- BENEFITS OF DIVIDENDS
  - **If the board of directors of a company votes to pay the stockholders dividends that amount to more than the excess cash that the company is producing from its operations, then the money to pay the dividends will have to come from selling equity periodically in the public markets.**
  - **The need to raise equity in the capital markets will help align the incentives of managers with those of stockholders because it increases the cost to mangers of operating the business inefficiently.**

Dividends and Firm Value

- COSTS OF DIVIDENDS
  - **There are costs to the firm associated with dividends.**
  - **Taxes are among the most important costs.**
  - **Owners of stocks that pay dividends often have to pay brokerage fees if they want to reinvest the proceeds.**

Dividends and Firm Value

- COSTS OF DIVIDENDS
  - To eliminate this cost, some companies offer dividend reinvestment programs (DRIPs). Through a DRIP, a company sells new shares, commission free, to dividend recipients who elect to automatically reinvest their dividends in the company's stock.
  - To the extent that a company uses a lot of debt financing, paying dividends can increase the cost of debt.

Dividends and Firm Value

- STOCK PRICE REACTIONS TO DIVIDEND ANNOUNCEMENTS
  - **Using the cash flow identity of sources and uses of cash, we can see that an expected increase in the cash flow from operations is a good signal, and investors will interpret it as suggesting that cash flows to stockholders will increase in the future.**

Dividends and Firm Value

- STOCK PRICE REACTIONS TO DIVIDEND ANNOUNCEMENTS
  - **The cash flow identity suggests that managers change dividend polices when something fundamental has changed in the business and it is this fundamental change that causes the stock price to change.**

Dividends and Firm Value

- We can think about the market's reaction to a dividend announcement in the context of the cash flow identity

$$\begin{array}{ccc} \textbf{Sources} & = & \textbf{Uses} \\ \mathrm{CFOA}_t + \mathrm{Equity}_t + \mathrm{Debt}_t & = & \mathrm{Div}_t + \mathrm{Repurchases}_t + \mathrm{Interest}_t + \mathrm{Principal}_t + \mathrm{Inv}_t \end{array}$$

where:

$$\begin{aligned} \mathrm{CFOA}_t &= \text{cash flow to investors from operating activity in period } t \\ \mathrm{Equity}_t &= \text{proceeds from the sale of stock in period } t \\ \mathrm{Debt}_t &= \text{proceeds from the sale of debt in period } t \\ \mathrm{Div}_t &= \text{dividends paid in period } t \\ \mathrm{Repurchases}_t &= \text{cash used to repurchase stock in period } t \\ \mathrm{Interest}_t &= \text{interest payments to debt holders in period } t \\ \mathrm{Principal}_t &= \text{principal payments on debt in period } t \\ \mathrm{Inv}_t &= \text{investments in net working capital and fixed assets period } t \end{aligned}$$

Dividends and Firm Value

- DIVIDENDS VERSUS STOCK PURCHASES
  - **Stock repurchases are an alternative to dividends as a way of distributing and they have some distinct advantages over dividends.**
  - **They give stockholders the ability to choose when they receive the distribution, which affects the timing of the taxes they must pay as well as the cost of reinvesting funds that are not immediately needed.**
  - **Stockholders who sell shares back to a company pay taxes only on the gains they realize, and historically these capital gains have been taxed at a lower rate than dividends.**

Dividends and Firm Value

- DIVIDENDS VERSUS STOCK PURCHASES
  - From management's perspective, stock repurchases provide greater flexibility in distributing value.
  - Even when a company publicly announces an ongoing open-market stock repurchase program, as opposed to a regular cash dividend, investors know that management can always quietly cut back or end the repurchases at any time.

Dividends and Firm Value

- DIVIDENDS VERSUS STOCK PURCHASES
  - **This means that if future cash flows are not certain, managers are likely to prefer to distribute extra cash today by repurchasing shares through open-market purchases because this enables them to preserve some flexibility.**
  - **Since most ongoing stock repurchase programs are not as visible as dividend programs, they cannot be used as effectively to send a positive signal about the company's prospects to investors.**

Dividends and Firm Value

- DIVIDENDS VERSUS STOCK PURCHASES
  - **A more subtle issue concerns the fact that managers can choose when to repurchase shares in a stock repurchase program.**
  - **Just like other investors, managers prefer purchasing shares when they believe that the shares are undervalued in the market.**

Dividends and Firm Value

- DIVIDENDS VERSUS STOCK PURCHASES
  - **The problem is that since managers have better information about the prospects of the company than do other investors, they can take advantage of this information to the detriment of other investors.**
  - **Management is supposed to act in the best interest of all its stockholders.**

Exhibit 17.4: Dividend Payments and Stock Repurchases

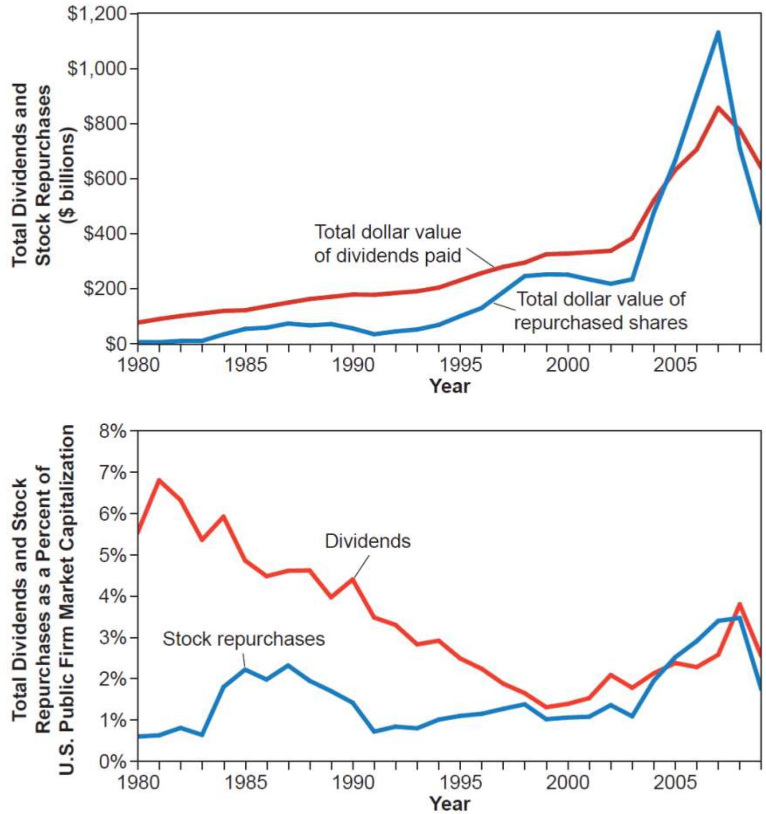

EXHIBIT 17.4

Dividend Payments and Stock Repurchases by U.S. Public Firms, 1980–2009

Both the dollar value of dividends paid by U.S. public firms and the dollar value of stock repurchases increased over the period from 1980 to 2009, as shown in the top figure. However, the increase was more pronounced for stock repurchases. Despite these increases in dollar values, total distributions of value as a percentage of the total market capitalization (total equity value) of U.S. firms actually decreased, as shown in the bottom figure.

Source: Estimated by authors using data from the Standard and Poors' Compustat database.

Stock Dividends and Stock Splits

- STOCK DIVIDENDS
  - **One type of "dividend" that does not involve the distribution of value is known as a stock dividend.**
  - **When a company pays a stock dividend, it distributes new shares of stock on a pro-rata basis to existing stockholders.**

Stock Dividends and Stock Splits

- STOCK DIVIDENDS
  - **The only thing that happens when the stock dividend is paid is that the number of shares each stockholder owns increases and their value goes down proportionately.**
  - **The stockholder is left with exactly the same value as before.**

Stock Dividends and Stock Splits

- STOCK SPLITS
  - **A stock split is quite similar to a stock dividend, but it involves the distribution of a larger multiple of the outstanding shares.**
  - **We can often think of a stock split as an actual division of each share into more than one share.**

Stock Dividends and Stock Splits

- STOCK SPLITS
  - **Besides their size, a key distinction between stock dividends and stock splits is that stock dividends are typically regularly scheduled events, like regular cash dividends, while stock splits tend to occur infrequently during the life of a company.**

Stock Dividends and Stock Splits

- REASONS FOR STOCK DIVIDENDS AND SPLITS
  - **The most-often cited reason for stock dividends or splits is known as the trading range argument which proposes that successful companies use stock dividends or stock splits to make their shares more attractive to investors.**
  - **It has historically been more expensive for investors to purchase odd lots of less than 100 shares than round lots of 100 shares.**

Stock Dividends and Stock Splits

- REASONS FOR STOCK DIVIDENDS AND SPLITS
  - **Odd lots are less liquid than round lots because more investors want to buy round and it is relatively expensive for companies to service odd-lot owners.**
  - **Researchers have however found little support for this explanation.**
  - **The transaction costs argument no longer carries much weight, as there is now little difference in the costs of purchasing round lots and odd lots.**

Stock Dividends and Stock Splits

- REASONS FOR STOCK DIVIDENDS AND SPLITS
  - **One real benefit of stock splits is that they can send a positive signal to investors about the outlook that management has for the future and this, in turn, can lead to a higher stock price.**
  - **Management is unlikely to want to split the stock of a company two-for-one or three-for-one if it expects the stock price to decline.**

Stock Dividends and Stock Splits

- REASONS FOR STOCK DIVIDENDS AND SPLITS
  - **It is only likely to split the stock when it is confident that the stock's current market price is not too high.**
  - **Reverse stock splits may be undertaken to satisfy exchange requirements.**
  - **The New York Stock Exchange generally requires listed shares to trade for more than $5, and the NASDAQ requires shares to trade for at least $1.**

Setting a Dividend Payout

- WHAT MANAGERS TELL US
  - **The best-known survey of dividend policy was published in 1956, more than fifty years ago, by John Lintner. The survey asked managers at 28 industrial firms how they set their firms' dividend policies.**

Setting a Dividend Payout

- WHAT MANAGERS TELL US
  - **The key conclusions from the Lintner study are as follows:**

    Firms tend to have long-term target payout ratios.

    Dividend changes follow shifts in long-term sustainable earnings.

    Managers focus more on dividend changes than on the absolute level (dollar amount) of the dividend.

    Managers are reluctant to make dividend changes that might have to be reversed.

Setting a Dividend Payout

- WHAT MANAGERS TELL US
  - A more recent study, by Brav, Graham, Harvey and Michaely, published in 2005, updates Lintner's findings.
  - The link between earnings and dividends is weaker today than when Lintner conducted his survey.
  - They found that rather than setting a target level for repurchases, managers tend to repurchase shares using cash that is left over after investment spending.

Setting a Dividend Payout

- WHAT MANAGERS TELL US
  - **In addition, many managers prefer repurchases because repurchase programs are more flexible than dividend programs and because they can be used to time the market by repurchasing shares when management considers a company's stock price too low.**

Setting a Dividend Payout

- WHAT MANAGERS TELL US
  - Finally, the managers who were interviewed appeared to believe that institutional investors do not prefer dividends over repurchases or vice-versa.
  - In other words, the choice between these two methods of distributing value does not have much of an effect on who owns the company's stock.

Setting a Dividend Payout

- PRACTICAL CONSIDERATIONS IN SETTING A DIVIDEND PAYOUT
  - **A company's dividend policy is largely a policy about how the excess value in a company is distributed to its stockholders.**
  - **It is extremely important that managers choose their firms' dividend polices in a way that enables them to continue to make the investments necessary for the firm to compete in its product markets.**

Setting a Dividend Payout

- PRACTICAL CONSIDERATIONS IN SETTING A DIVIDEND PAYOUT
  - **Managers should consider several practical questions when selecting a dividend policy:**
    - Over the long term, how much does the company's level of earnings (cash flows from operations) exceed its investment requirements? How certain is this level?
    - Does the firm have enough financial reserves to maintain the dividend payout in periods when earnings are down or investment requirements are up?

Setting a Dividend Payout

- PRACTICAL CONSIDERATIONS IN SETTING A DIVIDEND PAYOUT
  - **Managers should consider several practical questions when selecting a dividend policy:**
    - Does the firm have sufficient financial flexibility to maintain dividends if unforeseen circumstances wipe out its financial reserves when earnings are down?
    - Can the firm quickly raise equity capital if necessary?
    - If the company chooses to finance dividends by selling equity, will the increased number of stockholders have implications for the control of the company?