

Corporate Finance

Dividend and Dividend Policy

Chapter 14

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Dividend Irrelevance

- Investors can create their own dividends. Consequently, firm value will not be affected by dividend payments.

Example

Stellar, Inc. has decided to invest \$10 million in a new project with a NPV of \$20 million, but it has not made an announcement. The company has \$10 million in cash to finance the new project. Stellar has 10 million shares of stock outstanding, selling for \$24 each, and no debt. Hence, its aggregate value is \$240 million prior to the announcement (\$24 per share).

There are two alternatives:

1. Pay no dividend and finance the project with cash. The value of each share rises to \$26 following the announcement. Each shareholder can sell $0.0385 (= 1/26)$ shares to obtain a \$1 dividend, leaving them with 0.9615 shares value at \$25 (26×0.9615). Hence the shareholder has one share worth \$26, or one share worth \$25 plus \$1 in cash.
2. Pay a dividend of \$1 per share, sell \$10million worth of new shares to finance the project.

Example (Cont'd)

After the company announces the new project and pays the \$1 dividend, each share will be worth \$25. To raise the \$10 million needed for the project, the company must sell 400,000 ($= 10,000,000/25$) shares. Immediately following the share issue, Stellar will have 10,400,000 shares trading for \$25 each, giving the company an aggregate value of $25 \times 10,400,000 = \$260$ million. If a shareholder does not want the \$1 dividend, he can buy 0.04 shares ($1/25$). Hence, the shareholder has one share worth \$25 and \$1 in dividends, or 1.04 shares worth \$26 in total.

Cash Dividends and Dividend Payment

- Dividend
 - Payment made out of a firm's earnings to its owners, in the form of either cash or shares.
- Distribution
 - Payment made by a firm to its owners from sources other than current or accumulated retained earnings.

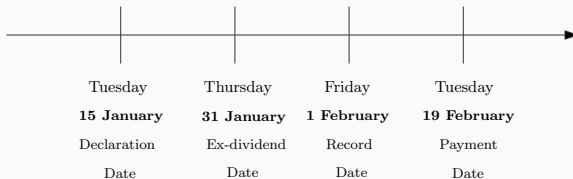
Cash Dividends

- Dividends come in several different forms. The basic types of cash dividends are:
 - Regular Cash Dividends: Cash payment made by a firm to its owners in the ordinary course of business, usually made twice a year.
 - Extra Cash Dividend: Indication that the *extra* amount may not be repeated in the future.
 - Special Cash Dividend: Similar to extra dividend, but definitely won't be repeated.
 - Liquidating Dividend: Some or all of the business has been sold.

Dividend Payment Chronology

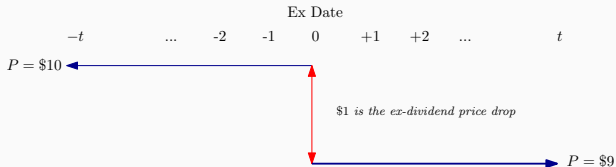
1. Declaration Date: Date on which the board of directors passes a resolution to pay a dividend.
2. Ex-dividend Date: If you buy the share before this date, you are entitled to the dividend.
3. Date of Record: Date by which holders must be on record to receive a dividend.
4. Date of Payment: Date that the dividend cheques are mailed or deposited directly to shareholders' bank accounts.

Dividend Payment Chronology Cont'd



Cash Dividends

- Price behaviour around the ex-dividend date for a \$1 cash dividend:



Some Real-world Factors Favouring a Low Payout

- Taxes: Individuals in upper income tax brackets might prefer lower dividend payouts, with the immediate tax benefits, to higher capital gains.
- Flotation Costs: Low payouts can decrease the amount of capital that needs to be raised, thereby lowering flotation costs.
- Dividend Restrictions: Debt contracts might limit the percentage of income that can be paid out as dividends.
- Desire for Current Income: It is argued that some groups of people are willing to pay a premium to get a higher dividend yield (even if it is taxed).

Some Real-world Factors Favouring a High Payout

- Tax and legal benefits from high dividends.
 - Corporate Investors: As a result of the tax-free status of dividends, high-dividend, low-capital-gains shares may be more appropriate for companies to hold.
 - Tax-exempt Investors: They do not have to worry about differential treatment between dividends and capital gains.

The Clientele Effect

- Argument that shares attract particular groups, based on dividend yield and the resulting tax effects.
 - Some investors prefer low dividend payouts and will buy shares in those companies that offer low dividend payouts.
 - Some investors prefer high dividend payouts and will buy shares in those companies that offer high dividend payouts.
- What do you think will happen if a firm changes its policy from one of high payout to one of low payout, or from one of low payout to one of high payout?
- If this is the case, does dividend policy matter?

Share Repurchase

- A firm's purchase of its own shares. Also, share buyback.
 - Tender Offer: Company states a purchase price and a desired number of shares.
 - Open Market: Company buys shares in the open market.
- Repurchase returns cash from the firm to the shareholders. In this, repurchase is similar to a cash dividend.

Example (Cash dividends versus repurchase)

Market Value Statement of Financial Position (before paying out excess cash)			
Excess cash	\$ 300 000	Debt	\$ 0
Other assets	<u>700 000</u>	Equity	<u>1 000 000</u>
Total	<u>\$1 000 000</u>	Total	<u>\$ 1 000 000</u>

Share Repurchase Cont'd

Example (Cash dividends versus repurchase)

Market Value Statement of Financial Position (after paying out excess cash)			
Excess cash	\$ 0	Debt	\$ 0
Other assets	<u>700 000</u>	Equity	<u>700 000</u>
Total	<u><u>\$700 000</u></u>	Total	<u><u>\$700 000</u></u>

Market Value Statement of Financial Position (after share purchase)			
Excess cash	\$ 0	Debt	\$ 0
Other assets	<u>700 000</u>	Equity	<u>700 000</u>
Total	<u><u>\$700 000</u></u>	Total	<u><u>\$700 000</u></u>

Share Repurchase Cont'd

- A repurchase and a cash dividend are the same thing in a world without taxes and transaction costs.
- In the real world there are some accounting differences between a share repurchase and a cash dividend, but the most important difference is in the tax treatment.
- Share repurchase allows investors to decide if they want the current cash flow and associated tax consequences.
- In our current tax structure, repurchases may be more desirable owing to the options and structuring provided to shareholders.

Share Repurchase and EPS

- A share repurchase is beneficial because earnings per share increase.
- The value of the share was not affected by the EPS change.
- The PE ratio was exactly the same when we compared a cash dividend with a repurchase.
- The increase in EPS is just an accounting adjustment that reflects (correctly) the change in the number of shares outstanding.

Corporations Smooth Dividends

- Dividend cuts are frequently viewed as very bad news by market participants, and as a result:
 - Companies only cut dividends when there is no other acceptable alternative.
 - Companies are also reluctant to increase dividends unless they are sure the new dividend level can be sustained.
- Dividend paying companies tend to raise dividends only after earnings have risen, and they don't increase or cut dividends in response to temporary earnings fluctuations.

Share Splits

- An increase in a firm's shares outstanding without any change in owners' equity.
- These are essentially the same as a share dividend, except expressed as a ratio.
- Share price is reduced when the share splits.
- Common explanation for split is to return price to a more desirable trading range.
- The logic tell us that share splits and bonus issues can be one of the following:
 - Leave the value of the firm unaffected;
 - Increase its value;
 - Decrease its value.

Reverse Share Splits

- Share split under which a firm's number of shares outstanding is reduced.
- Reasons:
 - Transaction costs may be less for investors.
 - Liquidity might be improved.
 - Too low a price not considered respectable.
 - Exchange minimum price per share requirements