Distributions to Shareholders: Dividends and Share Repurchases

- Theories of investor preferences
- Signaling effects
- Dividend reinvestment plans
- Stock dividends and stock splits
- Stock repurchases

What is “dividend policy”?

- It’s the decision to pay out earnings versus retaining and reinvesting them. Includes these elements:
  1. High or low payout?
  2. Stable or irregular dividends?
  3. How frequent?
  4. Do we announce the policy?

Do investors prefer high or low payouts? There are three theories:

- Dividends are irrelevant: Investors don’t care about payout.
- Bird in the hand: Investors prefer a high payout.
- Tax preference: Investors prefer a low payout, hence growth.

Dividend Irrelevance Theory

- Investors are indifferent between dividends and retention-generated capital gains. If they want cash, they can sell stock. If they don't want cash, they can use dividends to buy stock.
- Modigliani-Miller support irrelevance.
- Theory is based on unrealistic assumptions (no taxes or brokerage costs), hence may not be true. Need empirical test.

Bird-in-the-Hand Theory

- Investors think dividends are less risky than potential future capital gains, hence they like dividends.
- If so, investors would value high payout firms more highly, i.e., a high payout would result in a high P_0.

Tax Preference Theory

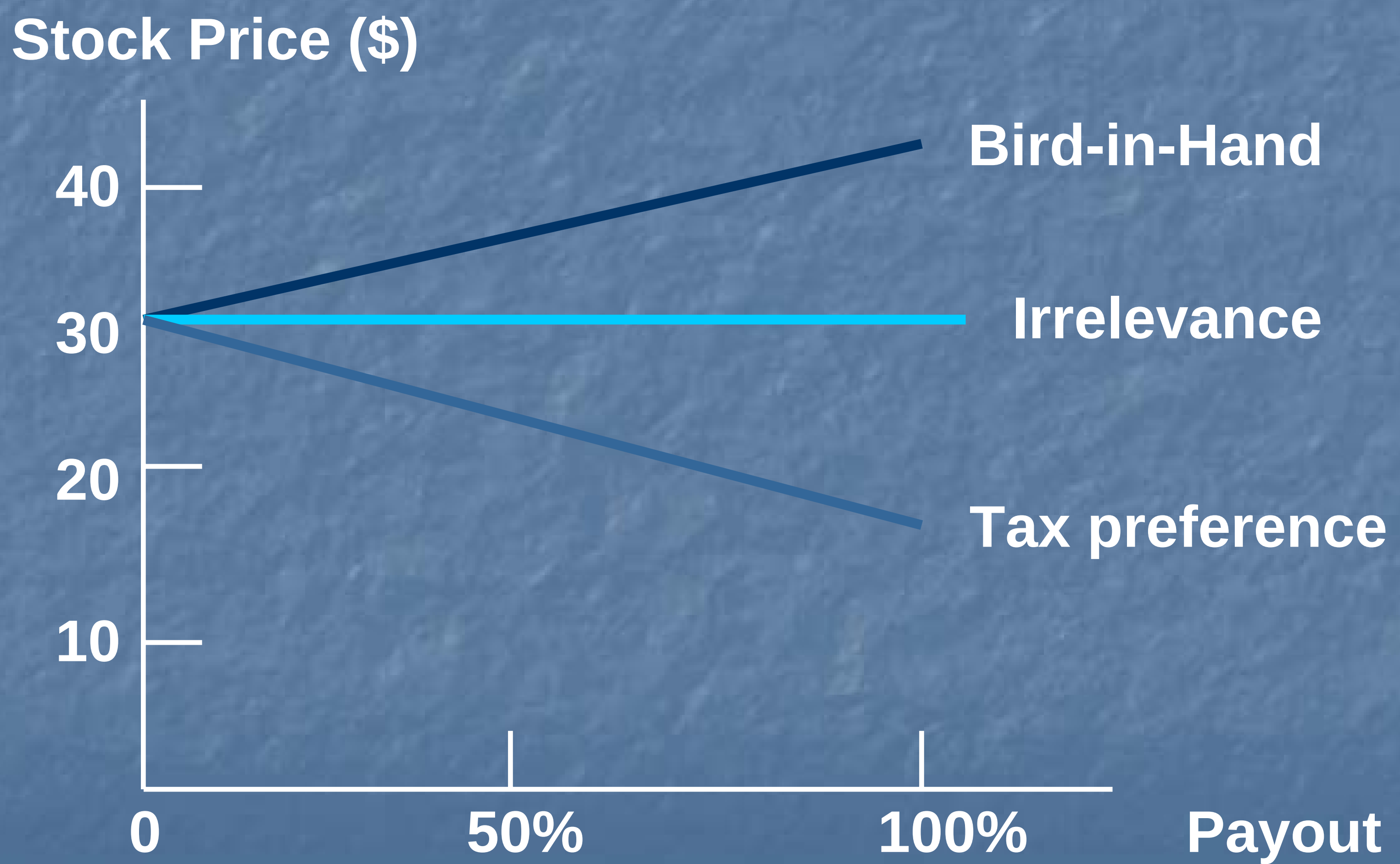
- Retained earnings lead to long-term capital gains, which are taxed at lower rates than dividends: 20% vs. up to 39.6%. Capital gains taxes are also deferred.
- This could cause investors to prefer firms with low payouts, i.e., a high payout results in a low P_0.

Implications of 3 Theories for Managers

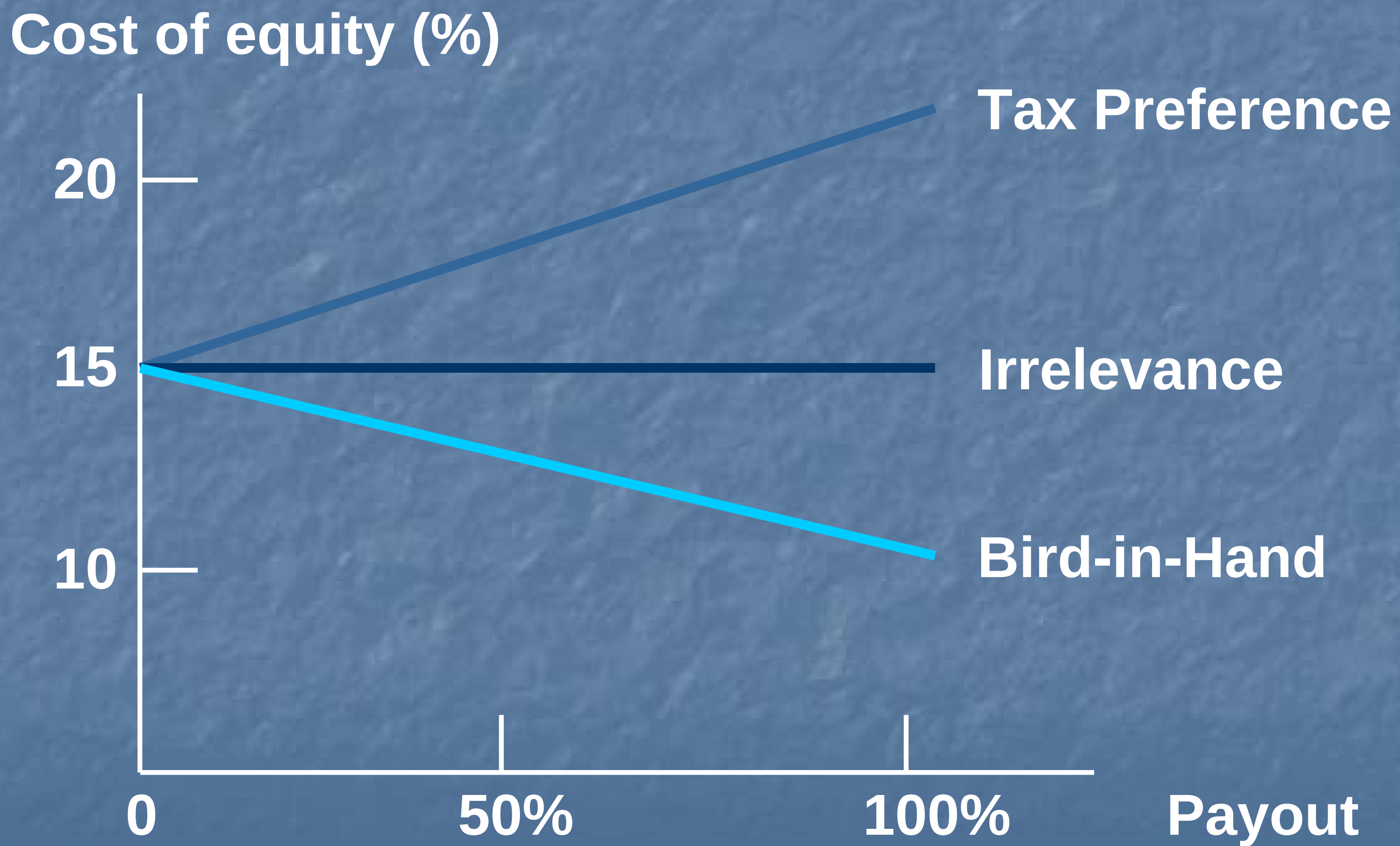
Theory	Implication
Irrelevance	Any payout OK
Bird in the hand	Set high payout
Tax preference	Set low payout

But which, if any, is correct?

Possible Stock Price Effects



Possible Cost of Equity Effects



Which theory is most correct?

- Empirical testing has not been able to determine which theory, if any, is correct.
- Thus, managers use judgment when setting policy.
- Analysis is used, but it must be applied with judgment.

What's the "information content," or "signaling," hypothesis?

- Managers hate to cut dividends, so won't raise dividends unless they think raise is sustainable. So, investors view dividend increases as *signals* of management's view of the future.
- Therefore, a stock price increase at time of a dividend increase could reflect higher expectations for future EPS, not a desire for dividends.

What’s the “clientele effect”?

- Different groups of investors, or clienteles, prefer different dividend policies.
- Firm’s past dividend policy determines its current clientele of investors.
- Clientele effects impede changing dividend policy. Taxes & brokerage costs hurt investors who have to switch companies.

Setting Dividend Policy

- Forecast capital needs over a planning horizon, often 5 years.
- Set a target capital structure.
- Estimate annual equity needs.
- Set target payout based on the residual model.
- Generally, some dividend growth rate emerges. Maintain target growth rate if possible, varying capital structure somewhat if necessary.

Dividend Payout Ratios for Selected Industries

Industry	Payout ratio
Banking	38.29
Computer Software Services	13.70
Drug	38.06
Electric Utilities (Eastern U. S.)	67.09
Internet	n/a
Semiconductors	24.91
Steel	51.96
Tobacco	55.00
Water utilities	67.35

*None of the internet companies paid a dividend.

Stock Repurchases

Repurchases: Buying own stock back from stockholders.

Reasons for repurchases:

- As an alternative to distributing cash as dividends.
- To dispose of one-time cash from an asset sale.
- To make a large capital structure change.

Advantages of Repurchases

- Stockholders can tender or not.
- Helps avoid setting a high dividend that cannot be maintained.
- Repurchased stock can be used in take-overs or resold to raise cash as needed.
- Income received is capital gains rather than higher-taxed dividends.
- Stockholders may take as a positive signal--management thinks stock is undervalued.

Disadvantages of Repurchases

- May be viewed as a negative signal (firm has poor investment opportunities).
- IRS could impose penalties if repurchases were primarily to avoid taxes on dividends.
- Selling stockholders may not be well informed, hence be treated unfairly.
- Firm may have to bid up price to complete purchase, thus paying too much for its own stock.

Stock Dividends vs. Stock Splits

- Stock dividend: Firm issues new shares in lieu of paying a cash dividend. If 10%, get 10 shares for each 100 shares owned.
- Stock split: Firm increases the number of shares outstanding, say 2:1. Sends shareholders more shares.

- **Both stock dividends and stock splits increase the number of shares outstanding, so "the pie is divided into smaller pieces."**
- **Unless the stock dividend or split conveys information, or is accompanied by another event like higher dividends, *the stock price falls so as to keep each investor's wealth unchanged*.**
- **But splits/stock dividends may get us to an "optimal price range."**

When should a firm consider splitting its stock?

- There's a widespread belief that the *optimal price range* for stocks is \$20 to \$80.
- Stock splits can be used to keep the price in the optimal range.
- Stock splits generally occur when management is confident, so are interpreted as *positive signals*.