Dividend Policy

FINA 614

Cash Dividends

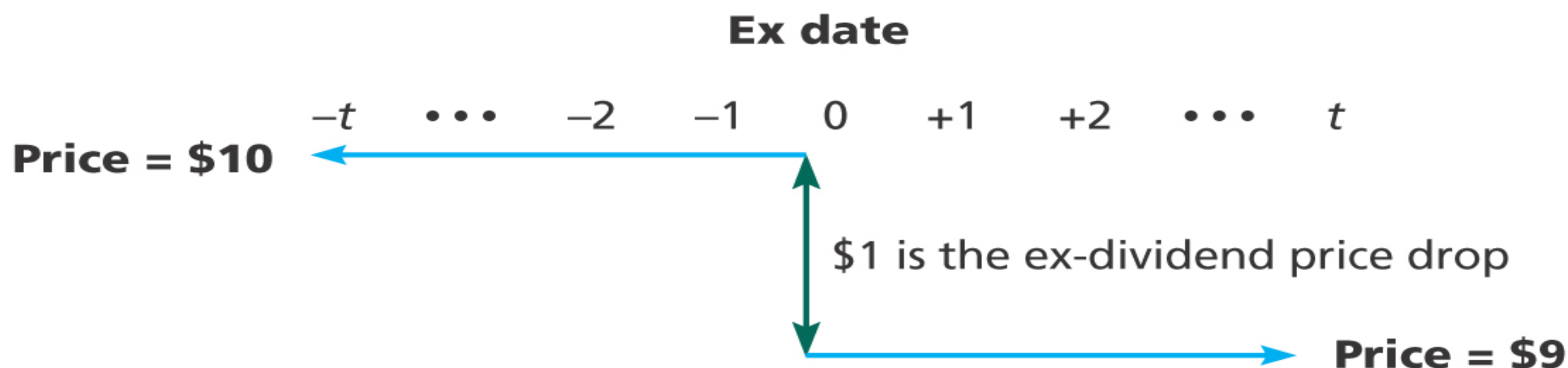
- Regular cash dividend – cash payments made directly to stockholders, usually each quarter
- Extra cash dividend – indication that the "extra" amount may not be repeated in the future
- Liquidating dividend – some or all of the business has been sold

Dividend Payment

- Declaration Date – Board declares the dividend and it becomes a liability of the firm
- Ex-dividend Date
  - Occurs two business days before date of record
  - If you buy stock on or after this date, you will not receive the dividend
  - Stock price generally drops by about the amount of the dividend
- Date of Record – Holders of record are determined and they will receive the dividend payment
- Date of Payment – cheques are mailed

Figure 17.2 – Dividend Payment Chronology

Figure 17.3 – Price Behaviour Around Ex-dividend Date



The stock price will fall by the amount of the dividend on the ex date (Time 0). If the dividend is $1 per share, the price will be $10 – 1 = $9 on the ex date:

Before ex date (Time –1), dividend = $0	Price = $10
On ex date (Time 0), dividend = $1	Price = $9

Does Dividend Policy Matter?

- Dividends matter – the value of the stock is based on the present value of expected future dividends
- Dividend policy may not matter
  - Dividend policy is the decision to pay dividends versus retaining funds to reinvest in the firm
  - In theory, if the firm reinvests capital now, it will grow and can pay higher dividends in the future

Illustration of Irrelevance

- Consider a firm that can either pay out dividends of \$10,000 per year for each of the next two years or can pay \$9,000 in one year, reinvest the other \$1,000 into the firm and then pay \$11,120 in two years. Investors require a 12% return.
  - Market Value with constant dividend = \$16,900.51
  - Market Value with reinvestment = \$16,900.51
- If the company will earn the required return, then it doesn't matter when it pays the dividends

Homemade Dividends

- Dividend policy is irrelevant when there are no taxes or other market imperfections
- Shareholders can effectively undo the firm's dividend strategy
- The shareholder who receives a dividend that is greater than desired can reinvest the excess
- The shareholder who receives a dividend that is smaller than desired can sell extra shares of stock

Low Payout Please

- Why might a low payout be desirable?
- Individuals in upper income tax brackets might prefer lower dividend payouts, with the immediate tax consequences, in favor of higher capital gains
- Flotation costs – low payouts can decrease the amount of capital that needs to be raised, thereby lowering total flotation costs
- Dividend restrictions – debt contracts might limit the percentage of income that can be paid out as dividends

Alternatives to Paying a Dividend

- Select additional capital budgeting projects
- Repurchase shares
- Acquire other companies
- Purchase financial assets

High Payout Please

- Why might a high payout be desirable?
- Desire for current income
  - Individuals in low tax brackets
- Uncertainty resolution – no guarantee that the higher future dividends will materialize
- Taxes
  - Dividend exclusion for corporations
  - Tax-exempt investors don't have to worry about differential treatment between dividends and capital gains

Dividends and Signals

- Asymmetric information – managers have more information about the health of the company than investors
- Changes in dividends convey information

Dividend Increases

– Management believes higher dividend can be sustained
– Expectation of higher future dividends, increasing present value
– Signal of a healthy, growing firm

Dividend Decreases

- Management believes it can no longer sustain the current level of dividends
- Expectation of lower dividends indefinitely; decreasing present value
- Signal of a firm that is having financial difficulties

Clientele Effect

- Some investors prefer low dividend payouts and will buy stock in those companies that offer low dividend payouts
- Some investors prefer high dividend payouts and will buy stock in those companies that offer high dividend payouts
- Investors will self-select into the stocks have their preferred payout policy
- Managers should focus on capital budgeting decisions and ignore investor preferences

Implications of the Clientele Effect

- What do you think will happen if a firm changes its policy from a high payout to a low payout?
- What do you think will happen if a firm changes its policy from a low payout to a high payout?
- If this is the case, does dividend POLICY matter?

Residual Dividend Policy

- Determine capital budget
- Determine target capital structure
- Finance investments with a combination of debt and equity in line with the target capital structure
  - Remember that retained earnings are equity
  - If additional equity is needed, issue new shares
- If there are excess earnings, then pay the remainder out in dividends

Example – Residual Dividend Policy

- Given
  - Need $5 million for new investments
  - Target capital structure: D/E = 2/3
  - Net Income = $4 million
- Finding dividend
  - 40% financed with debt (2 million)
  - 60% financed with equity (3 million)
  - NI – equity financing = $4 million - $3 million = $1 million, paid out as dividends

Compromise Dividend Policy

- Goals, ranked in order of importance
  - Avoid cutting back on positive NPV projects to pay a dividend
  - Avoid dividend cuts
  - Avoid the need to sell equity
  - Maintain a target debt/equity ratio
  - Maintain a target dividend payout ratio
- Companies want to accept positive NPV projects, while avoiding negative signals

Stock Repurchase

- Company buys back its own shares of stock
  - Tender offer – company states a purchase price and a desired number of shares
  - Open market – buys stock in the open market
- Similar to a cash dividend in that it returns cash from the firm to the stockholders
- This is another argument for dividend policy irrelevance in the absence of taxes or other imperfections

Real-World Considerations

- Stock repurchase allows investors to decide if they want the current cash flow and associated tax consequences
- The Income Tax Act requires investors to report a deemed dividend equal to the excess of the amount repurchased over book value
- This removes the tax advantage of stock repurchases over dividends

Information Content of Stock Repurchases

- Stock repurchases sends a positive signal that management believes that the current price is low
- Tender offers send a more positive signal than open market repurchases because the company is stating a specific price
- The stock price often increases when repurchases are announced

Stock Dividends

- Pay additional shares of stock instead of cash
- Increases the number of outstanding shares
- If you own 100 shares and the company declared a 10% stock dividend, you would receive an additional 10 shares

Stock Splits

- Stock splits – essentially the same as a stock dividend except expressed as a ratio
  - For example, a 2 for 1 stock split is the same as a 100% stock dividend
- Stock price is reduced when the stock splits
- Common explanation for split is to return price to a “more desirable trading range”