CHAPTER 18. DIVIDEND POLICY

I. How dividends are paid out.

• Dividend policy is defined as the tradeoff between retaining earnings on the one hand and paying out cash on the other hand.

• You can't pay out your "par" capital as a dividend...

→ State law protects the firm's creditors (i.e., bondholders) from paying excessive dividend.

[Extreme case : selling all the assets and payout all the proceeds as a dividend]

• Paying a dividend reduces the amount of R/E.

• Many firms have automatic dividend reinvestment plan (so call DRIP), under which the new shares are issued at a 5% discount from the market price.

→ It saves the underwriting costs of a regular share issue.

• Share repurchases as an alternative to dividends...

→ Happens when cash resources have generally outrun good capital investment opportunities.

[i.e., a firm has accumulated large amounts of unwanted cash]

→ Happens when the firm wants to change the capital strucuture by replacing equity with debt.

• Major methods of repurchases

1. Acquisition in the open market
2. By a general tender offer to shareholders.
3. By direct negotiations with a major shareholder.
   [i.e., Greenmail : Shares are repurchased by the target of the takeover at a price which makes the hostile bidder happy to agree to leave the target alone]
   → Deprive the shareholders of the value.

• Reasons for repurchases

A. Information or Signalling Hypothesis
   - No Profitable use for internally generated funds.
   - Firm believe that stock is undervalued.
   - Mixed results (positive or negative)

B. Dividend or Personal Taxation Hypothesis
   - In order to let the S/Holders benefit from the preferential tax treatment of repurchases relative to dividend.

C. Leverage Hypothesis.
   -Tax subsidy connected with the deductibility of interest payments. This subsidy is passed on to the shareholders.

D. Bondholder Expropriation Hypothesis.
   - Repurchase reduces the assets of the firm and therefore the value of the claims of the bondholders.
   - This plausibility of this hypothesis is weakened by the existence of the law and by the bond covenants.

II. How firms decide on dividend payments.

- Procedure for Dividend Payment [Page 461, Figure 18.1]
    1. Declaration date
    2. Ex-Dividend date : traded ex-dividend on and after 2nd business day before record date.
    3. Record Date
    4. Payment Date

- Lintner's finding on dividends : (page 481. 18.9)

    1. Firms have long-run target dividend payout ratios
    2. Changes much more important than levels
    3. Transitory earnings don't lead to dividend changes
    4. Managers are reluctant to reverse a recent change in dividends

- Partial adjustment model : Explained in the Text book in page 482.

- The Information Contents of the Dividend

    Dividend increases are good news → signal managerial optimism.
    Dividend increases usually lead to stock price increases
    → That is not because dividend increases create value but because they signal future prosperity.

- Clientele Effect : Individual with different tax brackets and Corporation.

III. Dividend Controversy

1. Right wing: increasing payouts raise value [Bird-in-the-hand Theory]
2. Middle of the road: who cares about dividend policy? [MM dividend theory-Homemade div]
3. Left wing: increasing payouts lowers value [Tax Preference Theory]

- **MIDDLE OF THE ROAD** : Franco Modigliani and Merton Miller [MM Model]
    - The firm value is determined by its basic earning power [or by the income produced by its assets], not by how this income is split between dividends and R/E.
    - Homemade dividends.
        - Ex.) if a firm does not pay dividends, a S/Holders who wants a 5% dividend can "create" it by selling 5% of his stock.
    - Homemade dividends.
    - If companies could increase their value by increasing dividends, wouldn't they have done so already?

· **THE RIGHT WING:**
- Investors value a dollar of expected dividends more highly than a dollar of expected capital gains because the dividend yield component is less risky than the "g" component in the Gordon's model.
- Dividends carry information that the firm truly is healthy.
- Investors don't fully trust managers to handle the firm's free cash flow--but here dividend policy has an impact because it eliminates negative NPV investments.

· **THE LEFT WING:**

→ Effects of a shift in dividend policy when dividends are taxed more heavily than capital gains.
[The high payout stock must sell at a lower price to provide the same after-tax rate of return]

	No-Dividend Firm	High-Dividend Firm	
Next Year's Price	$112.50	$102.50	
Dividend	$0	$10.00	
Total Pretax Payoff	$112.50	$112.50	
Today's Stock Price	$100	$X	: $96.67
Captal Gain	$12.50	$(102.5-X)	
Tax on Div.(50%)	$0	$5.00	
Tax on C.Gain (20%)	$2.50	$(102.5-X)*0.2	
After-Tax Income	$10.00	$(10)*0.5+(102.5-X)*0.8	
After-Tax R.of Ret.	$10/100 x 100=10%	$[(10)*0.5+(102.5-X)*0.8] / X = 10%	

Moral: Cut your dividends and expropriate a piece of the government's share of the corporation by playing the angles of the tax system.

But the tax reform act of 1986 equalized the tax rates (now only a small gap exists).

• Suggested Homework Problems

Q1 – Q7