Chapter 17: Payout policies

Some abbreviations:

Pcum = cum-dividend stock price

Pex = ex-dividend stock price

Prep = stock price with share repurchases

Distributions to shareholders

Payout policy is the way a firm chooses between the alternative ways to pay cash out to shareholders. A firm can retain its free cash flows or pay out its free cash flow.

- If a firm decides to retain its free cash flow, it has the opportunity to invest in new projects or to accumulate, which is an increase of the cash reserves.
- If the firm decides to pay out its free cash flow it can do this through either a dividend or a share repurchase.

We will focus on the opportunity to pay dividends and to repurchase shares.

The amount of dividend is set by the public company's board of directors. This board also decides when the payment will occur. There are four important dates:

1. The declaration date: the date on which a public company's board of directors authorizes the payment of a dividend.
2. The record date: the specific date set by a public company's board of directors such that the firm will pay a dividend to all shareholders of record on this date.
3. The ex-dividend rate: a date, two days prior to a dividend's record date, on or after which anyone buying the stock will not be eligible for the dividend.
4. The payable date or distribution date: a date, generally within a month after the record date, on which a firm mails dividend checks to its registered stockholders.

A firm may pay a one time special dividend: a one-time dividend payment a firm makes that is usually much larger than a regular dividend.

Usually, dividends are a cash outflow for the firm, paid out of current earnings. A return of capital is when a firm, instead of paying dividends out of current earnings (or accumulated retained earnings), pays dividends from other sources, such as paid-in capital or the liquidation of assets.

A liquidating dividend is a return of capital to shareholders from a business operation that is being terminated.

An alternative way to pay cash to investors is through a share purchase or buyback. With a share repurchase, a firm uses cash to buy shares of its own outstanding stock.

Three possible transaction types for a share repurchase:

1. Open market repurchase: when a firm repurchases its own shares by buying them on the open market over time. This is the most common way firms use to repurchase their shares. Buying the shares can take a year and the firm is not obligated to repurchase the full amount it originally stated.
2. A tender offer: a public announcement of an offer to all existing security holders to buy back a specified amount of outstanding securities at a prespecified price over a short time period, generally 20 days. The price is often set at a substantial premium to the current market price. A related method is the Dutch auction: a share repurchase method in which shareholders indicate how many shares they are willing to sell at each price. The firm then pays the lowest price at which it can buy back its desired number of shares.
3. A targeted repurchase: when a firm purchases shares directly from a specific shareholder; the purchase price is negotiated directly with the seller. A greenmail is when a firm avoids a threat of a takeover and removal of its management by a major shareholder by buying out the shareholder, often at a large premium over the current market price.

Dividends versus share repurchases

We will see that in a perfect capital market, the method of payment (dividend payments or share repurchases) does not matter. A firm has got three options to pay out an excess cash to shareholders:

1. Pay a dividend with excess cash
2. Repurchase shares instead of paying a dividend
3. Raise additional cash to pay an even larger dividend today and in the future

All three options will be discussed in detail below.

Alternative policy 1:

pay a dividend with excess cash. The board declares the dividend and sets a record date and the ex-dividend date, which is before the record date.

Just before the ex-dividend date, the stock is said to trade cum-dividend: when a stock trades before the ex-dividend date, anyone who buys the stock is entitled to the dividend.

P_{cum} = current dividend + PV (future dividends)

P_{ex} = PV (future dividends)

In a perfect capital market, when a dividend is paid, the share price drops by the amount of the dividend when the stock begins to trade ex-dividend.

Alternative policy 2: share repurchases.

1. In perfect capital markets, an open market share repurchase has no effect on the stock price. The stock price is the same as the cum-dividend price if a dividend were paid instead. By not paying a dividend and repurchasing shares instead, the firm is able to raise dividens per share in the future.

2. In perfect capital markets, investors are indifferent between the firm distributing funds via dividends or share repurchases. By reinvesting dividends or selling shares, they can replicate either payout method on their own.

Alternative policy 3: high dividend (equity issue).

To raise more cash, a firm can decide to issue equity. In this case, the initial value is unchanged by this policy and increasing the dividend has no benefit to shareholders.

The result of these three policies is the Modigliani and Miller dividend relevance:

MM dividend relevance: in perfect capital markets, holding fixed the investment policy of a firm, the firm's choice of dividend policy is irrelevant and does not affect the initial share price. However, in reality markets are not perfect and market imperfections affect the dividend policy of a firm.

Tax disadvantages

The influence of taxes (as an important market imperfection) on the decision of a firm to pay dividends or repurchase shares is great. Shareholders have to pay taxes on dividends they receive and taxes on capital gains when they sell their shares. Because dividends are taxed at a higher rate than capital gains, shareholders will prefer share repurchases to dividends.

There is a tax advantage for share repurchases over dividends because long-term investors can defer the capital gains tax until they sell their shares. It seems that the optimal dividend policy, when the dividend tax rate exceeds the capital gain tax rate, is to pay no dividends at all. But dividends remain a key form of payouts to shareholders.

Dividend puzzle: when firms continue to issue dividends despite their tax disadvantage. Because taxes rates differ by income, by jurisdiction and by whether the stock is held in a retirement account, the tax disadvantage differs between investors. The result is that different groups of investors prefer different payout policies.

Tax rates on dividends and capital gains differ across investors for a variety of reasons:

1. Different income levels
2. Different investment horizons
3. Tax jurisdiction
4. Type of investor of investment account

Investors have varying preferences regarding dividends, because their tax rate differs:

1. Long-term investors would prefer share repurchases to dividend payments, because they are more heavily taxed on dividends (about 53% of the investors).
2. One-year investors, pension funds and other non-taxed investors prefer a payout policy that closely matches their cash needs because they have no tax preference for share repurchases over dividends (about 46% of the investors).
3. Corporations enjoy a tax advantage associated with dividends due to the 70% exclusion rule (about 1% of the investors)

The different tax preferences across investor create clientele effects. This is when the dividend policy of a firm reflects the tax preferences of its investor clientele.

Payout versus retention of cash

Insight from Modigliani and Miller regarding policy irrelevance in perfect capital markets;

MM payout irrelevance: in perfect capital markets, if a firm invests excess cash flows in financial securities, the firm's choice of payout versus retention is irrelevant and does not affect the initial value of the firm.

From this irrelevance, it is clear that the decision of whether to retain cash depends on market imperfections:

- Taxes and cash retention: corporate taxes make it costly for a firm to retain excess cash. Cash can be seen as equivalent to negative leverage. This implies a tax disadvantage to holding cash.
- Investor tax adjustments: even after adjusting for investor taxes, there remains a substantial tax disadvantage for the firm to retaining excess cash under most tax regimes.
- Issuance and distress costs: even though there is a tax disadvantage to retaining cash, some firms accumulate cash balances. These balances help firms to minimize the transaction costs of raising new capital when they have future potential cash needs. However, there is no benefit to shareholders from firms holding cash in excess of future investment needs.
- Agency costs of retaining cash: agency costs may arise as managers may be tempted to spend excess cash on inefficient investments and perks, in addition to the tax disadvantage of holding cash. Without pressure from shareholders, managers may choose to horde cash to spend in this way or as a means of reducing a firm's leverage and increasing their job security. Dividends and share repurchases help minimize the agency problem of wasteful spending when a firm has excess cash.

Signaling

The market imperfection asymmetric information may also affect the payout policy. When managers have got better information than investors, their payout decisions may signal this information.

Dividend smoothing is the practice of maintaining relatively constant dividends. In general, firms try to maintain dividends constant and dividends are much less volatile than earnings. Firms raise their dividends only when they perceive a long-term sustainable increase in the expected level of future earnings, and cut them only as a last resort. Firms can keep their dividends smooth at almost any level by adjusting the number of shares they repurchase or issue and the amount of cash they retain.

The firm's dividend choice will contain information regarding management's expectations of future earnings, if firms smooth dividends.

1. A firm increases its dividend: this is a positive signal to investors that management expects to be able to afford the higher dividend for the foreseeable future.
2. A firm cuts the dividend: this is a signal that managers have given up hope that earnings will rebound in the near term and so need to reduce the dividend to save cash.

The dividend signaling hypothesis: the idea that dividend changes reflect managers' views about a firm's future earnings prospects.

Furthermore, an increase in the dividend might also signal a lack of investment opportunities. Conversely, a firm might cut its dividend to exploit new positive-NPV-investment opportunities.

Share repurchases may also signal managers' information to the market. Share repurchases may be used to signal positive information, as repurchases are more attractive if management believes the stock is under-valued at its current price.

Several important differences distinguish share repurchases and dividends:

- Managers are much less committed to share repurchases than to dividend payments.
- Firms do not smooth their repurchase activity from year to year, as they do with dividends.
- The cost of a share repurchase depends on the market price of the stock.

Dividends, splits and spin-offs

Stock dividend or stock split: when a company issues a dividend in shares of stock rather than in cash to its shareholders. Because a firm does not pay out any cash to its shareholders, the total market value of the firm's assets and liabilities (and of its equity) is unchanged.

The only thing that will change is the number of share outstanding. For this reason, the stock price will fall because the same total equity value is now divided over a larger number of shares. In contrast to cash dividends, stock dividends are not taxed.

The typical motivation for a stock split is to keep the share price in a range thought to be attractive to small investors. A spin-off is when a firm sells a subsidiary by selling shares as a non-cash special dividend in the subsidiary alone.

Advice

When making payout policy decisions, a financial manager should consider the following:

1. Try to maximize the after-tax payout to shareholders (use the difference in taxes on dividends and on repurchase).
2. Repurchases and special dividends are useful for making large, infrequent distributions to shareholders.
3. Only set regular dividend levels that you are confident the firm can maintain because the increase of a regular dividend is seen by shareholders as an implicit commitment to maintain this level of regular payout indefinitely.
4. Regular dividends send a stronger signal of financial strength to shareholder than infrequent distributions such as repurchases.
5. Be aware of future investment plans. It is expensive to make a large distribution and then raise capital to fund a project, because transaction costs are associated with these actions. Making a smaller distribution and funding the project internally would be better.