

CHAPTER 14

Distributions to Shareholders: Dividends and Repurchases

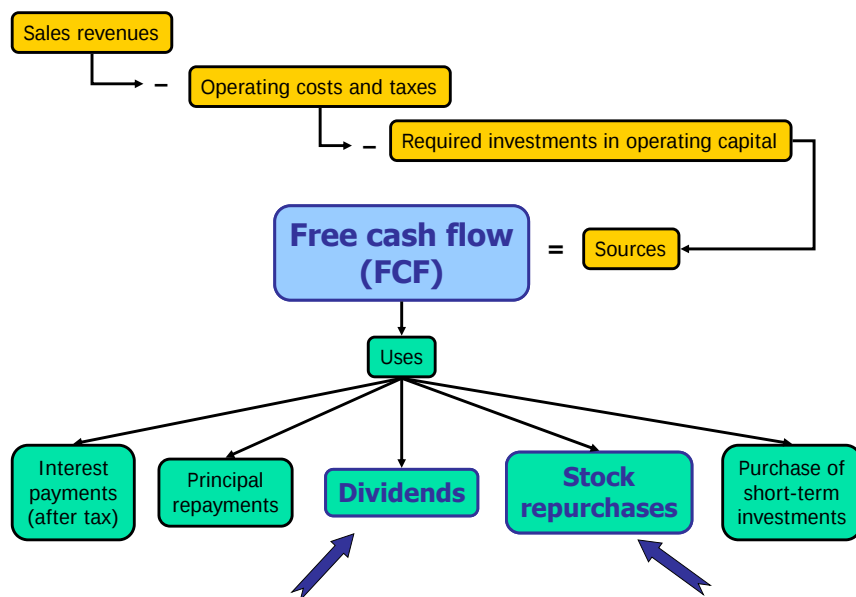
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Topics in Chapter

- Theories of investor preferences
- Signaling effects
- Residual model
- Stock repurchases
- Stock dividends and stock splits

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Free Cash Flow: Distributions to Shareholders



What is “distribution policy”?

- The distribution policy defines:
 - The level of cash distributions to shareholders
 - The form of the distribution (dividend vs. stock repurchase)
 - The stability of the distribution

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Distributions Patterns Over Time

- The percent of total payouts as a percentage of net income has been stable at around 26%-28%.
 - Dividend payout rates have fallen, stock repurchases have increased.
 - Repurchases now total more dollars in distributions than dividends.
- A smaller percentage of companies now pay dividends. When young companies first begin making distributions, it is usually in the form of repurchases.
- Dividend payouts have become more concentrated in a smaller number of large, mature firms.

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Dividend Yields for Asian Companies

TABLE 14-1A Dividend Payout for Asian Companies (2010)

COMPANY	COUNTRY	INDUSTRY	CURRENCY	DIVIDEND PAYOUT	DIVIDEND YIELD
Starhub	Singapore	Telecommunications	SGD	131%	7.07%
Maxis	Malaysia	Telecommunications	MYR	90%	5.83%
Singapore Press Holdings	Singapore	Media	SGD	87%	4.06%
DBS Holdings	Singapore	Banking	SGD	62%	2.80%
Singapore Airlines	Singapore	Airlines	SGD	59%	4.10%
United Overseas Bank	Singapore	Banking	SGD	50%	3.01%
Taiwan Semiconductor Manufacturing	Taiwan	Semiconductors	TWD	47%	4.19%
China Mobile	Hong Kong	Telecommunications	HKD	44%	4.04%
Indian Oil	India	Oil and Gas	INR	42%	0.83%
Hutchison Whampoa	Hong Kong	Conglomerate	HKD	41%	2.26%
Toyota	Japan	Auto	JPY	38%	1.51%
ICBC	China	Banking	HKD	35%	3.82%
China Life Insurance	China	Insurance	HKD	34%	1.82%
CNOOC	Hong Kong	Oil and Gas	HKD	33%	2.73%
PTT	Thailand	Oil and Gas	THB	30%	2.94%
China Railway Construction	Hong Kong	Railway	HKD	29%	2.10%
Panasonic	Japan	Electronics	JPY	28%	1.08%
Sun Hung Kai Properties	Hong Kong	Real Estate	HKD	20%	2.45%
Sinopec	China	Oil and Gas	HKD	16%	0.87%
Hon Hai Precision	Taiwan	Electronics	TWD	13%	1.08%
Reliance Industries	India	Oil and Gas	INR	13%	0.92%
Samsung Electronics	South Korea	Electronics	KRW	11%	1.19%
LG Electronics	South Korea	Electronics	KRW	2%	0.24%

Source: Thomson One Datastream

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Do investors prefer high or low payouts?

- There are three dividend theories:
 - Dividends are irrelevant: Investors don't care about payout.
 - Dividend preference, or bird-in-the-hand: Investors prefer a high payout.
 - Tax effect: Investors prefer a low payout.

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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.
- Implies payout policy has no effect on stock value or the required return on stock.
- Theory is based on unrealistic assumptions (no taxes or brokerage costs).

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Dividend Preference (Bird-in-the-Hand) Theory

- Investors might think dividends (i.e., the bird-in-the-hand) are less risky than potential future capital gains.
- Also, high payouts help reduce agency costs by depriving managers of cash to waste and causing managers to have more scrutiny by going to the external capital markets more often.
- Therefore, investors would value high payout firms more highly and would require a lower return to induce them to buy its stock.

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Tax Effect Theory

- Low payouts mean higher capital gains. Capital gains taxes are deferred until they are realized, so they are taxed at a lower effective rate than dividends.
- This could cause investors to require a higher pre-tax return to induce them to buy a high payout stock, which would result in a lower stock price.

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Which theory is most correct?

- Some research suggests that high payout companies have higher required returns on stock, supporting the tax effect hypothesis.
- But other research using an international sample shows that in countries with poor investor protection (where agency costs are most severe), high payout companies are valued more highly than low payout companies.
- Empirical testing has produced mixed results.

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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 due to a change in payout policy.

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What's the “information content,” or “signaling,” hypothesis?

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

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What's the “residual distribution model”?

- Find the reinvested earnings needed for the capital budget.
- Pay out any leftover earnings (the residual) as either dividends or stock repurchases.
- This policy minimizes flotation and equity signaling costs, hence minimizes the WACC.

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Using the Residual Model to Calculate Distributions Paid

$$\text{Distr.} = \text{Net income} - \left(\left(\text{Target equity ratio} \right) \left(\text{Total capital budget} \right) \right)$$

$$\text{Distr.} = \text{Net income} - \text{Required equity}$$

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Investment Opportunities and Residual Dividends

- Fewer good investments would lead to smaller capital budget, hence to a higher dividend payout.
- More good investments would lead to a lower dividend payout.

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Advantages and Disadvantages of the Residual Dividend Policy

- Advantages: Minimizes new stock issues and flotation costs.
- Disadvantages: Results in variable dividends, sends conflicting signals, increases risk, and doesn't appeal to any specific clientele.
- Conclusion: Consider residual policy when setting target payout, but don't follow it rigidly.

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The Procedures of a Dividend Payment: An Example

- November 11: Board declares a quarterly dividend of \$0.50 per share to holders of record as of December 10.
- December 7: Dividend goes *with* stock.
- December 8: Ex-dividend date.
- December 10: Holder of record date.
- December 31: Payment date to holders of record.

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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.
 - To use when employees exercise stock options.

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The Procedures of a Repurchase

- Firm announces intent to repurchase stock.
- Three ways to purchase:
 - Have broker/trustee purchase on open market over period of time.
 - Make a tender offer to shareholders.
 - Make a block (targeted) repurchase.
- Firm doesn't have to complete its announced intent to repurchase.

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A repurchase has no effect on stock price!

- The announcement of an intended repurchase might send a signal that affects stock price, and the previous events that led to cash available for a distribution affect stock price, but the *actual* repurchase has no impact on stock price because:
 - If investors thought that the repurchase would increase the stock price, they would all purchase stock the day before, which would drive up its price.
 - If investors thought that the repurchase would decrease the stock price, they would all sell short the stock the day before, which would drive down the stock price.

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Key Points

- ST investments fall because they are used to repurchase stock.
- Stock price is unchanged by actual repurchase.
- Value of equity falls from \$1,600 to \$1,550 because firm no longer owns the ST investments.
- Wealth of shareholders remains at \$1,600 because shareholders now directly own the \$50 that was previously held by firm in ST investments.

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Advantages of Repurchases

- Stockholders can choose to sell or not.
- Helps avoid setting a high dividend that cannot be maintained.
- Income received is capital gains rather than higher-taxed dividends.
- Stockholders may take as a positive signal--management thinks stock is undervalued.

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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.

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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.

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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.

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- 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.”

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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.

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What's a “dividend reinvestment plan (DRIP)”?

- A dividend reinvestment plan (DRIP) allows stockholders to have the company automatically use dividends to purchase additional shares.
- Popular because they allow stockholders to acquire additional shares without brokerage