

## CHAPTER 13

---

**DIVIDEND DISCOUNT MODELS**

In the strictest sense, the only cash flow you receive from a firm when you buy publicly traded stock is the dividend. The simplest model for valuing equity is the dividend discount model -- the value of a stock is the present value of expected dividends on it. While many analysts have turned away from the dividend discount model and viewed it as outmoded, much of the intuition that drives discounted cash flow valuation is embedded in the model. In fact, there are specific companies where the dividend discount model remains a useful tool for estimating value.

This chapter explores the general model as well as specific versions of it tailored for different assumptions about future growth. It also examines issues in using the dividend discount model and the results of studies that have looked at its efficacy.

**The General Model**

When an investor buys stock, she generally expects to get two types of cashflows - dividends during the period she holds the stock and an expected price at the end of the holding period. Since this expected price is itself determined by future dividends, the value of a stock is the present value of dividends through infinity.

$$\text{Value per share of stock} = \sum_{t=1}^{\infty} \frac{E(\text{DPS}_t)}{(1 + k_e)^t}$$

where,

$\text{DPS}_t$  = Expected dividends per share

$k_e$  = Cost of equity

The rationale for the model lies in the present value rule - the value of any asset is the present value of expected future cash flows discounted at a rate appropriate to the riskiness of the cash flows.

There are two basic inputs to the model - expected dividends and the cost on equity. To obtain the expected dividends, we make assumptions about expected future growth rates in earnings and payout ratios. The required rate of return on a stock is determined by its riskiness, measured differently in different models - the market beta in the CAPM, and the factor betas in the arbitrage and multi-factor models. The model is flexible enough to allow for time-varying discount rates, where the time variation is caused by expected changes in interest rates or risk across time.

**Versions of the model**

Since projections of dollar dividends cannot be made through infinity, several versions of the dividend discount model have been developed based upon different assumptions about future growth. We will begin with the simplest – a model designed to value stock in a stable-growth firm that pays out what it can afford in dividends and then look at how the model can be adapted to value companies in high growth that may be paying little or no dividends.

### ***I. The Gordon Growth Model***

The Gordon growth model can be used to value a firm that is in 'steady state' with dividends growing at a rate that can be sustained forever.

#### *The Model*

The Gordon growth model relates the value of a stock to its expected dividends in the next time period, the cost of equity and the expected growth rate in dividends.

$$\text{Value of Stock} = \frac{\text{DPS}_1}{k_e - g}$$

where,

DPS<sub>1</sub> = Expected Dividends one year from now (next period)

k<sub>e</sub> = Required rate of return for equity investors

g = Growth rate in dividends forever

#### *What is a stable growth rate?*

While the Gordon growth model is a simple and powerful approach to valuing equity, its use is limited to firms that are growing at a stable rate. There are two insights worth keeping in mind when estimating a 'stable' growth rate. First, since the growth rate in the firm's dividends is expected to last forever, the firm's other measures of performance (including earnings) can also be expected to grow at the same rate. To see why, consider the consequences in the long term of a firm whose earnings grow 6% a year forever, while its dividends grow at 8%. Over time, the dividends will exceed earnings. On the other hand, if a firm's earnings grow at a faster rate than dividends in the long term, the payout ratio, in the long term, will converge towards zero, which is also not a steady state. Thus, though the model's requirement is for the expected growth rate in dividends, analysts should be able to substitute in the expected growth rate in earnings and get precisely the same result, if the firm is truly in steady state.

The second issue relates to what growth rate is reasonable as a 'stable' growth rate. As noted in Chapter 12, this growth rate has to be less than or equal to the growth rate of the economy in which the firm operates. This does not, however, imply that analysts will always

agree about what this rate should be even if they agree that a firm is a stable growth firm for three reasons.

- Given the uncertainty associated with estimates of expected inflation and real growth in the economy, there can be differences in the benchmark growth rate used by different analysts, i.e., analysts with higher expectations of inflation in the long term may project a nominal growth rate in the economy that is higher.
- The growth rate of a company may not be greater than that of the economy but it can be less. Firms can become smaller over time relative to the economy.
- There is another instance in which an analyst may stray from a strict limit imposed on the 'stable growth rate'. If a firm is likely to maintain a few years of 'above-stable' growth rates, an approximate value for the firm can be obtained by adding a premium to the stable growth rate, to reflect the above-average growth in the initial years. Even in this case, the flexibility that the analyst has is limited. The sensitivity of the model to growth implies that the stable growth rate cannot be more than 1% or 2% above the growth rate in the economy. If the deviation becomes larger, the analyst will be better served using a two-stage or a three-stage model to capture the 'super-normal' or 'above-average' growth and restricting the Gordon growth model to when the firm becomes truly stable.

#### **Does a stable growth rate have to be constant over time?**

The assumption that the growth rate in dividends has to be constant over time is a difficult assumption to meet, especially given the volatility of earnings. If a firm has an average growth rate that is close to a stable growth rate, the model can be used with little real effect on value. Thus, a cyclical firm that can be expected to have year-to-year swings in growth rates, but has an average growth rate that is 5%, can be valued using the Gordon growth model, without a significant loss of generality. There are two reasons for this result. First, since dividends are smoothed even when earnings are volatile, they are less likely to be affected by year-to-year changes in earnings growth. Second, the mathematical effects of using an average growth rate rather than a constant growth rate are small.

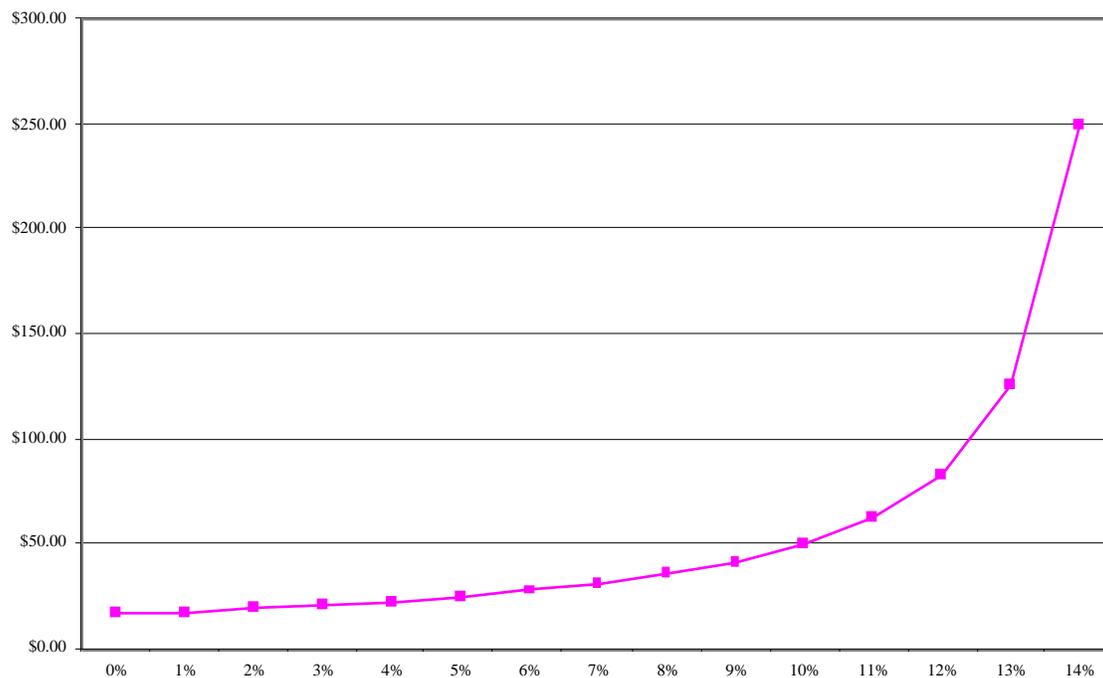
#### *Limitations of the model*

The Gordon growth model is a simple and convenient way of valuing stocks but it is extremely sensitive to the inputs for the growth rate. Used incorrectly, it can yield misleading or even absurd results, since, as the growth rate converges on the discount rate, the value goes to infinity. Consider a stock, with an expected dividend per share next period of \$2.50, a cost of equity of 15%, and an expected growth rate of 5% forever. The value of this stock is:

$$\text{Value} = \frac{2.50}{0.15 - 0.05} = \$ 25.00$$

Note, however, the sensitivity of this value to estimates of the growth rate in Figure 13.1.

Figure 13.1: Value Per Share and Expected Growth Rate



As the growth rate approaches the cost of equity, the value per share approaches infinity. If the growth rate exceeds the cost of equity, the value per share becomes negative.

This issue is tied to the question of what comprises a stable growth rate. If an analyst follows the constraints discussed in the previous chapter in estimating stable growth rates, this will never happen. In this example, for instance, an analyst who uses a 14% growth rate and obtains a \$250 value would have been violating a basic rule on what comprises stable growth.

*Works best for:*

In summary, the Gordon growth model is best suited for firms growing at a rate comparable to or lower than the nominal growth in the economy and which have well established dividend payout policies that they intend to continue into the future. The dividend payout of the firm has to be consistent with the assumption of stability, since stable

firms generally pay substantial dividends<sup>1</sup>. In particular, this model will under estimate the value of the stock in firms that consistently pay out less than they can afford and accumulate cash in the process.

 *.DDMst.xls*: This spreadsheet allows you to value a stable growth firm, with stable firm characteristics (beta and return on equity) and dividends that roughly match cash flows.

*Illustration 13.1: Value a regulated firm: Consolidated Edison in May 2001*

Consolidated Edison is the electric utility that supplies power to homes and businesses in New York and its environs. It is a monopoly whose prices and profits are regulated by the State of New York.

*Rationale for using the model*

- The firm is in stable growth; based upon size and the area that it serves. Its rates are also regulated. It is unlikely that the regulators will allow profits to grow at extraordinary rates.
- The firm is in a stable business and regulation is likely to restrict expansion into new businesses.
- The firm is in stable leverage.
- The firm pays out dividends that are roughly equal to FCFE.
  - Average Annual FCFE between 1996 and 2000 = \$551 million
  - Average Annual Dividends between 1996 and 2000 = \$506 million
  - Dividends as % of FCFE = 91.54%

*Background Information*

Earnings per share in 2000 = \$3.13

Dividend Payout Ratio in 1994 = 69.97%

Dividends per share in 2000 = \$2.19

Return on equity = 11.63%

*Estimates*

We first estimate the cost of equity, using a bottom-up levered beta for electric utilities of 0.90, a riskfree rate of 5.40% and a market risk premium of 4%.

Con Ed Beta = 0.90

Cost of Equity = 5.4% + 0.90\*4% = 9%

We estimate the expected growth rate from fundamentals.

Expected growth rate = (1- Payout ratio) Return on equity  
 = (1-0.6997)(0.1163) = 3.49%

---

<sup>1</sup> The average payout ratio for large stable firms in the United States is about 60%.

### Valuation

We now use the Gordon growth model to value the equity per share at Con Ed:

$$\begin{aligned} \text{Value of Equity} &= \frac{\text{Expected dividends next year}}{\text{Cost of equity} - \text{Expected growth rate}} \\ &= \frac{(\$2.19)(1.0349)}{0.09 - 0.0349} = \$41.15 \end{aligned}$$

Con Ed was trading for \$36.59 on the day of this analysis (May 14, 2001). Based upon this valuation, the stock would have been under valued.

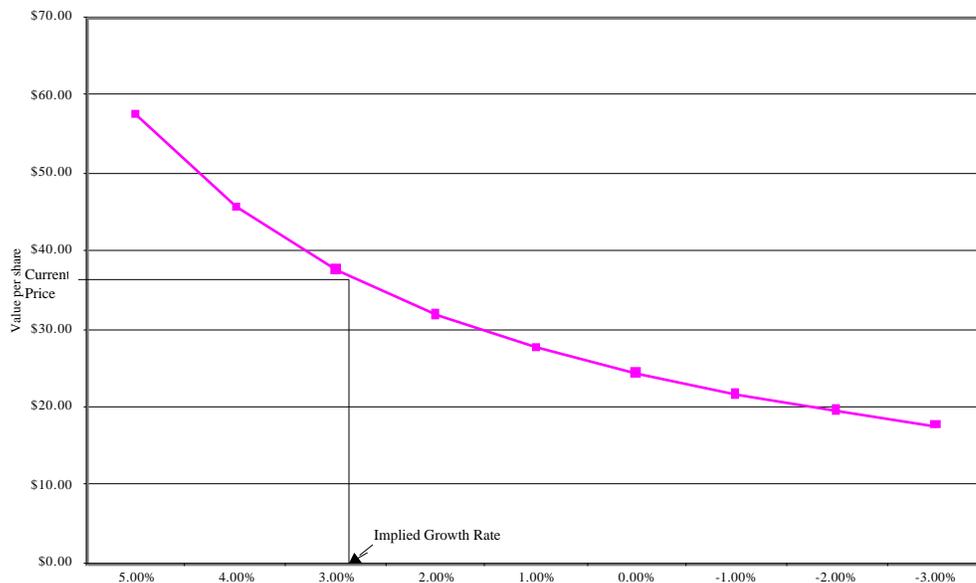
 *.DDMst.xlsx*: This spreadsheet allows you to value a stable growth firm, with stable firm characteristics (beta and return on equity) and dividends that roughly match cash flows.

### Implied Growth Rate

Our value for Con Ed is different from the market price and this is likely to be the case with almost any company that you value. There are three possible explanations for this deviation. One is that you are right and the market is wrong. While this may be the correct explanation, you should probably make sure that the other two explanations do not hold – that the market is right and you are wrong or that the difference is too small to draw any conclusions. [

To examine the magnitude of the difference between the market price and your estimate of value, you can hold the other variables constant and change the growth rate in your valuation until the value converges on the price. Figure 13.2 estimates value as a function of the expected growth rate (assuming a beta of 0.90 and current dividends per share of \$2.19).

Figure 13.2: Value per share versus Growth



Solving for the expected growth rate that provides the current price,

$$\$36.59 = \frac{\$2.19(1 + g)}{0.09 - g}$$

The growth rate in earnings and dividends would have to be 2.84% a year to justify the stock price of \$36.59. This growth rate is called an **implied growth rate**. Since we estimate growth from fundamentals, this allows us to estimate an implied return on equity.

$$\text{Implied return on equity} = \frac{\text{Implied growth rate}}{\text{Retention ratio}} = \frac{0.0284}{0.3003} = 9.47\%$$

*Illustration 13.2: Value a real estate investment trust: Vornado REIT*

Real estate investment trusts were created in the early 1970s by a law that allowed these entities to invest in real estate and pass the income, tax-free, to their investors. In return for the tax benefit, however, REITs are required to return at least 95% of their earnings as dividends. Thus, they provide an interesting case study in dividend discount model valuation. Vornado Realty Trust owns and has investments in real estate in the New York area including Alexander's, the Hotel Pennsylvania and other ventures.

*Rationale for using the model*

Since the firm is required to pay out 95% of its earnings as dividends, the growth in earnings per share will be modest,<sup>2</sup> making it a good candidate for the Gordon growth model.

*Background Information*

In 2000, Vornado paid dividends per share of \$2.12 on earnings per share of \$2.22. The estimated payout ratio is:

$$\text{Expected payout ratio} = \frac{2.12}{2.22} = 95.50\%$$

The firm had a return on equity of 12.29%.

*Estimates*

We use the average beta for real estate investment trusts of 0.69, a riskfree rate of 5.4% and a risk premium of 4% to estimate a cost of equity:

$$\text{Cost of equity} = 5.4\% + 0.69 (4\%) = 8.16\%$$

The expected growth rate is estimated from the dividend payout ratio and the return on equity:

---

<sup>2</sup> Growth in net income may be much higher, since REITs can still issue new equity for investing in new ventures.

Expected growth rate =  $(1 - 0.955) (0.1229) = 0.55\%$

*Valuation*

$$\text{Value per share} = \frac{2.12(1.0055)}{0.0816 - 0.0055} = \$28.03$$

It is particularly important with REITs that we steer away from net income growth, which may be much higher. On May 14, 2001, Vornado Realty was trading at \$36.57, which would make it overvalued.

## ***II. Two-stage Dividend Discount Model***

The two-stage growth model allows for two stages of growth - an initial phase where the growth rate is not a stable growth rate and a subsequent steady state where the growth rate is stable and is expected to remain so for the long term. While, in most cases, the growth rate during the initial phase is higher than the stable growth rate, the model can be adapted to value companies that are expected to post low or even negative growth rates for a few years and then revert back to stable growth.

*The Model*

The model is based upon two stages of growth, an extraordinary growth phase that lasts  $n$  years and a stable growth phase that lasts forever afterwards.

Extraordinary growth rate:  $g\%$  each year for  $n$  years  
Stable growth:  $g_n$  forever



Value of the Stock = PV of Dividends during extraordinary phase + PV of terminal price

$$P_0 = \sum_{t=1}^{t=n} \frac{DPS_t}{(1 + k_{e,hg})^t} + \frac{P_n}{(1 + k_{e,hg})^n} \text{ where } P_n = \frac{DPS_{n+1}}{(k_{e,st} - g_n)}$$

where,

$DPS_t$  = Expected dividends per share in year  $t$

$k_e$  = Cost of Equity (hg: High Growth period; st: Stable growth period)

$P_n$  = Price (terminal value) at the end of year  $n$

$g$  = Extraordinary growth rate for the first  $n$  years

$g_n$  = Steady state growth rate forever after year  $n$

In the case where the extraordinary growth rate ( $g$ ) and payout ratio are unchanged for the first  $n$  years, this formula can be simplified.

$$P_0 = \frac{DPS_0 * (1 + g) * \left[ 1 - \frac{(1 + g)^n}{(1 + k_{e,hg})^n} \right]}{k_{e,hg} - g} + \frac{DPS_{n+1}}{(k_{e,st} - g_n)(1 + k_{e,hg})^n}$$

where the inputs are as defined above.

### *Calculating the terminal price*

The same constraint that applies to the growth rate for the Gordon Growth Rate model, i.e., that the growth rate in the firm is comparable to the nominal growth rate in the economy, applies for the terminal growth rate ( $g_n$ ) in this model as well.

In addition, the payout ratio has to be consistent with the estimated growth rate. If the growth rate is expected to drop significantly after the initial growth phase, the payout ratio should be higher in the stable phase than in the growth phase. A stable firm can pay out more of its earnings in dividends than a growing firm. One way of estimating this new payout ratio is to use the fundamental growth model described in Chapter 12.

Expected Growth = Retention ratio \* Return on equity

Algebraic manipulation yields the following stable period payout ratio:

$$\text{Stable Payout ratio} = \frac{\text{Stable growth rate}}{\text{Stable period return on equity}}$$

Thus, a firm with a 5% growth rate and a return on equity of 15% will have a stable period payout ratio of 33.33%.

The other characteristics of the firm in the stable period should be consistent with the assumption of stability. For instance, it is reasonable to assume that a high growth firm has a beta of 2.0, but unreasonable to assume that this beta will remain unchanged when the firm becomes stable. In fact, the rule of thumb that we developed in the last chapter – that stable period betas should be between 0.8 and 1.2 – is worth repeating here. Similarly, the return on equity, which can be high during the initial growth phase, should come down to levels commensurate with a stable firm in the stable growth phase. What is a reasonable stable period return on equity? The industry average return on equity and the firm's own stable period cost of equity provide useful information to make this judgment.

### *Limitations of the model*

There are three problems with the two-stage dividend discount model – the first two would apply to any two-stage model and the third is specific to the dividend discount model.

- The first practical problem is in defining the length of the extraordinary growth period. Since the growth rate is expected to decline to a stable level after this period, the value of an investment will increase as this period is made longer. While we did develop criteria

that might be useful in making this judgment in Chapter 12, it is difficult in practice to convert these qualitative considerations into a specific time period.

- The second problem with this model lies in the assumption that the growth rate is high during the initial period and is transformed overnight to a lower stable rate at the end of the period. While these sudden transformations in growth can happen, it is much more realistic to assume that the shift from high growth to stable growth happens gradually over time.
- The focus on dividends in this model can lead to skewed estimates of value for firms that are not paying out what they can afford in dividends. In particular, we will underestimate the value of firms that accumulate cash and pay out too little in dividends.

*Works best for:*

Since the two-stage dividend discount model is based upon two clearly delineated growth stages, high growth and stable growth, it is best suited for firms which are in high growth and expect to maintain that growth rate for a specific time period, after which the sources of the high growth are expected to disappear. One scenario, for instance, where this may apply is when a company has patent rights to a very profitable product for the next few years and is expected to enjoy super-normal growth during this period. Once the patent expires, it is expected to settle back into stable growth. Another scenario where it may be reasonable to make this assumption about growth is when a firm is in an industry which is enjoying super-normal growth because there are significant barriers to entry (either legal or as a consequence of infra-structure requirements), which can be expected to keep new entrants out for several years.

The assumption that the growth rate drops precipitously from its level in the initial phase to a stable rate also implies that this model is more appropriate for firms with modest growth rates in the initial phase. For instance, it is more reasonable to assume that a firm growing at 12% in the high growth period will see its growth rate drops to 6% afterwards than it is for a firm growing at 40% in the high growth period.

Finally, the model works best for firms that maintain a policy of paying out most of residual cash flows – i.e, cash flows left over after debt payments and reinvestment needs have been met – as dividends.

*Illustration 13.3: Valuing a firm with the two-stage dividend discount model: Procter & Gamble*

Procter & Gamble (P&G) manufactures and markets consumer products all over the world. Some of its best known brand names include Pampers diapers, Tide detergent, Crest toothpaste and Vicks cough/cold medicines.

### *A Rationale for using the Model*

- *Why two-stage?* While P&G is a firm with strong brand names and an impressive track record on growth, it faces two problems. The first is the saturation of the domestic U.S. market, which represents about half of P&G's revenues. The second is the increased competition from generics across all of its product lines. We will assume that the firm will continue to grow but restrict the growth period to 5 years.
- *Why dividends?* P&G has a reputation for paying high dividends and it has not accumulated large amounts of cash over the last decade.

### *Background Information*

- Earnings per share in 2000 = \$3.00
- Dividends per share in 2000 = \$1.37
- Payout ratio in 2000 =  $\frac{1.37}{3.00} = 45.67\%$
- Return on Equity in 2000 = 29.37%

### *Estimates*

We will first estimate the cost of equity for P&G, based upon a bottom-up beta of 0.85 (estimated using the unlevered beta for consumer product firms and P&G's debt to equity ratio), a riskfree rate of 5.4% and a risk premium of 4%.

$$\text{Cost of equity} = 5.4\% + 0.85 (4\%) = 8.8\%$$

To estimate the expected growth in earnings per share over the five-year high growth period, we use the retention ratio in the most recent financial year (2000) but lower the return on equity to 25% from the current value.

$$\begin{aligned} \text{Expected growth rate} &= \text{Retention ratio} * \text{Return on Equity} \\ &= (1 - 0.4567)(0.25) = 13.58\% \end{aligned}$$

In stable growth, we will estimate that the beta for the stock will rise to 1, leading to a cost of equity of 9.40%.

$$\text{Cost of equity in stable growth} = 5.4\% + 1 (4\%) = 9.40\%$$

The expected growth rate will be assumed to be equal to the growth rate of the economy (5%) and the return on equity will drop to 15%, which is lower than the current industry average (17.4%) but higher than the cost of equity estimated above. The retention ratio in stable growth during the stable growth period is calculated.

$$\text{Retention ratio in stable growth} = \frac{g}{\text{ROE}} = \frac{5\%}{15\%} = 33.33\%$$

The payout ratio in stable growth is therefore 66.67%.

### *Estimating the value:*

The first component of value is the present value of the expected dividends during the high growth period. Based upon the current earnings (\$3.00), the expected growth rate (13.58%) and the expected dividend payout ratio (45.67%), the expected dividends can be computed for each year in the high growth period.

*Table 13.1: Expected Dividends per share: P&G*

<i>Year</i>	<i>EPS</i>	<i>DPS</i>	<i>Present Value</i>
1	\$3.41	\$1.56	\$1.43
2	\$3.87	\$1.77	\$1.49
3	\$4.40	\$2.01	\$1.56
4	\$4.99	\$2.28	\$1.63
5	\$5.67	\$2.59	\$1.70
Sum			\$7.81

The present value is computed using the cost of equity of 8.8% for the high growth period.

Cumulative Present Value of Dividends during high growth (@8.8%) = \$7.81

The present value of the dividends can also be computed in short hand using the following computation:

$$\text{PV of Dividends} = \frac{\$1.37(1.1358) - \frac{(1.1358)^5}{(1.088)^5}}{0.088 - 0.1358} = \$7.81$$

The price (terminal value) at the end of the high growth phase (end of year 5) can be estimated using the constant growth model.

$$\text{Terminal price} = \frac{\text{Expected Dividends per share}_{n+1}}{k_{e, \text{st}} - g_n}$$

$$\text{Expected Earnings per share}_6 = 3.00 * 1.1358^5 * 1.05 = \$5.96$$

$$\begin{aligned} \text{Expected Dividends per share}_6 &= \text{EPS}_6 * \text{Stable period payout ratio} \\ &= \$5.96 * 0.6667 = \$3.97 \end{aligned}$$

$$\text{Terminal price} = \frac{\text{Dividends}_6}{k_{e, \text{st}} - g} = \frac{\$3.97}{0.094 - 0.05} = \$90.23$$

The present value of the terminal price –is:

$$\text{PV of Terminal Price} = \frac{\$90.23}{(1.088)^5} = \$59.18$$

The cumulated present value of dividends and the terminal price can then be calculated.

$$P_0 = \frac{\$1.37(1.1358) \left[ 1 - \frac{(1.1358)^5}{(1.088)^5} \right]}{0.088 - 0.1358} + \frac{\$90.23}{(1.088)^5} = \$7.81 + \$59.18 = \$66.99$$

P&G was trading at \$63.90 at the time of this analysis on May 14, 2001.



*.DDM2st.xls*: This spreadsheet allows you to value a firm with a temporary period of high earnings followed by stable growth.

**A Trouble Shooting Guide: What is wrong with this valuation? DDM 2 St**

*If this is your 'problem'*

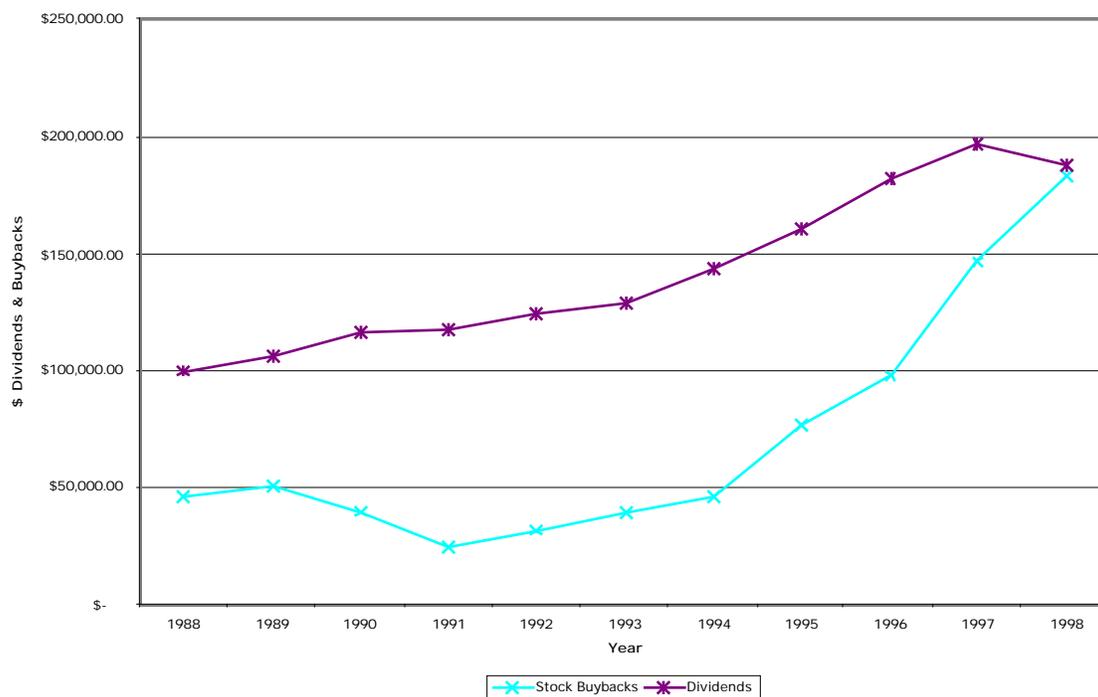
*this may be the s*

- If you get a extremely low value from the 2-stage DDM, the likely culprits are
  - the stable period payout ratio is too low for a stable firm (< 40%) If using fundame
  - the beta in the stable period is too high for a stable firm If entering direct
  - the use of the two-stage model when the three-stage model is more appropriate Use a beta close
- If you get an extremely high value,
  - the growth rate in the stable growth period is too high for stable firm Use a three-stag
  - Use a growth rat

### *Modifying the model to include stock buybacks*

In recent years, firms in the United States have increasingly turned to stock buybacks as a way of returning cash to stockholders. Figure 13.3 presents the cumulative amounts paid out by firms in the form of dividends and stock buybacks from 1988 to 1998.

Figure 13.3: Stock Buybacks and Dividends: Aggregate for US Firms - 1989-98



The trend towards stock buybacks is very strong, especially in the 1990s.

What are the implications for the dividend discount model? Focusing strictly on dividends paid as the only cash returned to stockholders exposes us to the risk that we might be missing significant cash returned to stockholders in the form of stock buybacks. The simplest way to incorporate stock buybacks into a dividend discount model is to add them on to the dividends and compute a modified payout ratio:

$$\text{Modified dividend payout ratio} = \frac{\text{Dividends} + \text{Stock Buybacks}}{\text{Net Income}}$$

While this adjustment is straightforward, the resulting ratio for any one year can be skewed by the fact that stock buybacks, unlike dividends, are not smoothed out. In other words, a firm may buy back \$ 3billion in stock in one year and not buy back stock for the next 3 years. Consequently, a much better estimate of the modified payout ratio can be obtained by looking at the average value over a four or five year period. In addition, firms may

sometimes buy back stock as a way of increasing financial leverage. We could adjust for this by netting out new debt issued from the calculation above:

$$\text{Modified dividend payout} = \frac{\text{Dividends} + \text{Stock Buybacks} - \text{Long Term Debt issues}}{\text{Net Income}}$$

Adjusting the payout ratio to include stock buybacks will have ripple effects on the estimated growth and the terminal value. In particular, the modified growth rate in earnings per share can be written as:

$$\text{Modified growth rate} = (1 - \text{Modified payout ratio}) * \text{Return on equity}$$

Even the return on equity can be affected by stock buybacks. Since the book value of equity is reduced by the market value of equity bought back, a firm that buys back stock can reduce its book equity (and increase its return on equity) dramatically. If we use this return on equity as a measure of the marginal return on equity (on new investments), we will overstate the value of a firm. Adding back stock buybacks in recent year to the book equity and re-estimating the return on equity can sometimes yield a more reasonable estimate of the return on equity on investments.

*Illustration 13.4: Valuing a firm with modified dividend discount mode: Procter & Gamble*

Consider our earlier valuation of Procter and Gamble where we used the current dividends as the basis for our projections. Note that over the last four years, P&G has had significant stock buybacks each period. Table 13.2 summarizes the dividends and buybacks over the period.

*Table 13.2: Dividends and Stock Buybacks: P&G*

	1997	1998	1999	2000	Total
Net Income	3415	3780	3763	3542	14500
Dividends	1329	1462	1626	1796	6213
Buybacks	2152	391	1881	-1021	3403
Dividends+Buybacks	3481	1853	3507	775	9616
Payout ratio	38.92%	38.68%	43.21%	50.71%	42.85%
Modified payout ratio	101.93%	49.02%	93.20%	21.88%	66.32%
Buybacks	1652	1929	2533	1766	
Net LT Debt issued	-500	1538	652	2787	
Buybacks net of debt	2152	391	1881	-1021	

Over the five-year period, P&G had significant buybacks but it also increased its leverage dramatically in the last three years. Summing up the total cash returned to stockholders over

the last 4 years, we arrive at a modified payout ratio of 66.32%. If we substitute this payout ratio into the valuation in Illustration 13.3, the expected growth rate over the next 5 years drops to 8.42%:

Expected growth rate = (1 - Modified payout ratio) ROE = (1 - 0.6632)(0.25) = 8.42%

We will still assume a five year high growth period and that the parameters in stable growth remain unchanged. The value per share can be estimated.

$$P_0 = \frac{\$3.00(0.6632)(1.0842) \left[ 1 - \frac{(1.0842)^5}{(1.0880)^5} \right]}{0.0880 - 0.0842} + \frac{\$71.50}{(1.0880)^5} = \$56.75$$

Note that the drop in growth rate in earnings during the high growth period reduces earnings in the terminal year, and the terminal value per share drops to \$71.50.

This value is lower than that obtained in Illustration 13.3 and it reflects our expectation that P&G does not have as many new profitable new investments (earning a return on equity of 25%).

#### *Valuing an entire market using the dividend discount model*

All our examples of the dividend discount model so far have involved individual companies, but there is no reason why we cannot apply the same model to value a sector or even the entire market. The market price of the stock would be replaced by the cumulative market value of all of the stocks in the sector or market. The expected dividends would be the cumulated dividends of all these stocks and could be expanded to include stock buybacks by all firms. The expected growth rate would be the growth rate in cumulated earnings of the index. There would be no need for a beta or betas, since you are looking at the entire market (which should have a beta of 1) and you could add the risk premium (or premiums) to the riskfree rate to estimate a cost of equity. You could use a two-stage model, where this growth rate is greater than the growth rate of the economy, but you should be cautious about setting the growth rate too high or the growth period too long because it will be difficult for cumulated earnings growth of all firms in an economy to run ahead of the growth rate in the economy for extended periods.

Consider a simple example. Assume that you have an index trading at 700 and that the average dividend yield of stocks in the index is 5%. Earnings and dividends can be expected to grow at 4% a year forever and the riskless rate is 5.4%. If you use a market risk premium of 4%, the value of the index can be estimated.

Cost of equity = Riskless rate + Risk premium = 5.4% + 4% = 9.4%

Expected dividends next year = (Dividend yield \* Value of the index)(1+ expected growth rate) = (0.05\*700) (1.04) = 36.4

$$\text{Value of the index} = \frac{\text{Expected dividends next year}}{\text{Cost of equity} - \text{Expected growth rate}} = \frac{36.4}{0.094 - 0.04} = 674$$

At its existing level of 700, the market is slightly over priced.

*Illustration 13.5: Valuing the S&P 500 using a dividend discount model: January 1, 2001*

On January 1, 2001, the S&P 500 index was trading at 1320. The dividend yield on the index was only 1.43%, but including stock buybacks increases the modified dividend yield to 2.50%. Analysts were estimating that the earnings of the stocks in the index would increase 7.5% a year for the next 5 years. Beyond year 5, the expected growth rate is expected to be 5%, the nominal growth rate in the economy. The treasury bond rate was 5.1% and we will use a market risk premium of 4%, leading to a cost of equity of 9.1%:

$$\text{Cost of equity} = 5.1\% + 4\% = 9.1\%$$

The expected dividends (and stock buybacks) on the index for the next 5 years can be estimated from the current dividends and expected growth of 7.50%.

$$\text{Current dividends} = 2.50\% \text{ of } 1320 = 33.00$$

	1	2	3	4	5
Expected Dividends =	\$35.48	\$38.14	\$41.00	\$44.07	\$47.38
Present Value =	\$32.52	\$32.04	\$31.57	\$31.11	\$30.65

The present value is computed by discounting back the dividends at 9.1%. To estimate the terminal value, we estimate dividends in year 6 on the index:

$$\text{Expected dividends in year 6} = \$47.38 (1.05) = \$49.74$$

$$\text{Terminal value of the index} = \frac{\text{Expected Dividends}_6}{r - g} = \frac{\$49.74}{0.091 - 0.05} = \$1213$$

$$\text{Present value of Terminal value} = \frac{\$1213}{1.091^5} = \$785$$

The value of the index can now be computed:

$$\text{Value of index} = \text{Present value of dividends during high growth} + \text{Present value of terminal value} = \$32.52 + \$32.04 + \$31.57 + \$31.11 + \$30.65 + \$785 = \$943$$

Based upon this, we would have concluded that the index was over valued at 1320.

***The Value of Growth***

Investors pay a price premium when they acquire companies with high growth potential. This premium takes the form of higher price-earnings or price-book value ratios. While no one will contest the proposition that growth is valuable, it is possible to pay too much for growth. In fact, empirical studies that show low price-earnings ratio stocks earning return premiums over high price-earnings ratio stocks in the long term supports the notion that investors overpay for growth. This section uses the two-stage dividend discount model to examine the value of growth and it provides a benchmark that can be used to compare the actual prices paid for growth.

### *Estimating the value of growth*

The value of the equity in any firm can be written in terms of three components:

$$P_0 = \frac{DPS_0 * (1 + g) * \left[ 1 - \frac{(1 + g)^n}{(1 + k_{e,hg})^n} \right]}{k_{e,hg} - g} + \frac{DPS_{n+1}}{(k_{e,st} - g_n)(1 + k_{e,hg})^n} - \frac{DPS_1}{(k_{e,st} - g_n)}$$

|-----|  
Extraordinary Growth

$$+ \frac{DPS_1}{(k_{e,st} - g_n)} - \frac{DPS_0}{k_{e,st}} + \frac{DPS_0}{k_{e,st}}$$

|-----|      |-----|  
Stable Growth      Assets in place

where

$DPS_t$  = Expected dividends per share in year  $t$

$k_e$  = Required rate of return

$P_n$  = Price at the end of year  $n$

$g$  = Growth rate during high growth stage

$g_n$  = Growth rate forever after year  $n$

Value of extraordinary growth = Value of the firm with extraordinary growth in first  $n$  years - Value of the firm as a stable growth firm<sup>3</sup>

Value of stable growth = Value of the firm as a stable growth firm - Value of firm with no growth

<sup>3</sup> The payout ratio used to calculate the value of the firm as a stable firm can be either the current payout ratio, if it is reasonable, or the new payout ratio calculated using the fundamental growth formula.

Assets in place = Value of firm with no growth

In making these estimates, though, we have to remain consistent. For instance, to value assets in place, you would have to assume that the entire earnings could be paid out in dividends, while the payout ratio used to value stable growth should be a stable period payout ratio.

*Illustration 13.6: The Value of Growth: P&G in May 2001*

In illustration 13.3, we valued P&G using a 2-stage dividend discount model at \$66.99. We first value the assets in place using current earnings (\$3.00) and assume that all earnings are paid out as dividends. We also use the stable growth cost of equity as the discount rates.

$$\text{Value of the assets in place} = \frac{\text{Current EPS}}{k_{e, \text{st}}} = \frac{\$3}{0.094} = \$31.91$$

To estimate the value of stable growth, we assume that the expected growth rate will be 5% and that the payout ratio is the stable period payout ratio of 66.67%:

$$\begin{aligned} \text{Value of stable growth} &= \frac{(\text{Current EPS})(\text{Stable Payout Ratio})(1 + g_n)}{k_{e, \text{st}} - g_n} - \$31.91 \\ &= \frac{(\$3.00)(0.6667)(1.05)}{0.094 - 0.05} - \$31.91 = \$15.81 \end{aligned}$$

$$\text{Value of extraordinary growth} = \$66.99 - \$31.91 - \$15.81 = \$19.26$$

*The Determinants of the Value of Growth*

1. *Growth rate during extraordinary period:* The higher the growth rate in the extraordinary period, the higher the estimated value of growth will be. If the growth rate in the extraordinary growth period had been raised to 20% for the Procter & Gamble valuation, the value of extraordinary growth would have increased from \$19.26 to \$39.45. Conversely, the value of high growth companies can drop precipitously if the expected growth rate is reduced, either because of disappointing earnings news from the firm or as a consequence of external events.
2. *Length of the extraordinary growth period:* The longer the extraordinary growth period, the greater the value of growth will be. At an intuitive level, this is fairly simple to illustrate. The value of \$19.26 obtained for extraordinary growth is predicated on the assumption that high growth will last for five years. If this is revised to last ten years, the value of extraordinary growth will increase to \$43.15.
3. *Profitability of projects:* The profitability of projects determines both the growth rate in the initial phase and the terminal value. As projects become more

profitable, they increase both growth rates and growth period, and the resulting value from extraordinary growth will be greater.

4. *Riskiness of the firm/equity* The riskiness of a firm determines the discount rate at which cashflows in the initial phase are discounted. Since the discount rate increases as risk increases, the present value of the extraordinary growth will decrease.

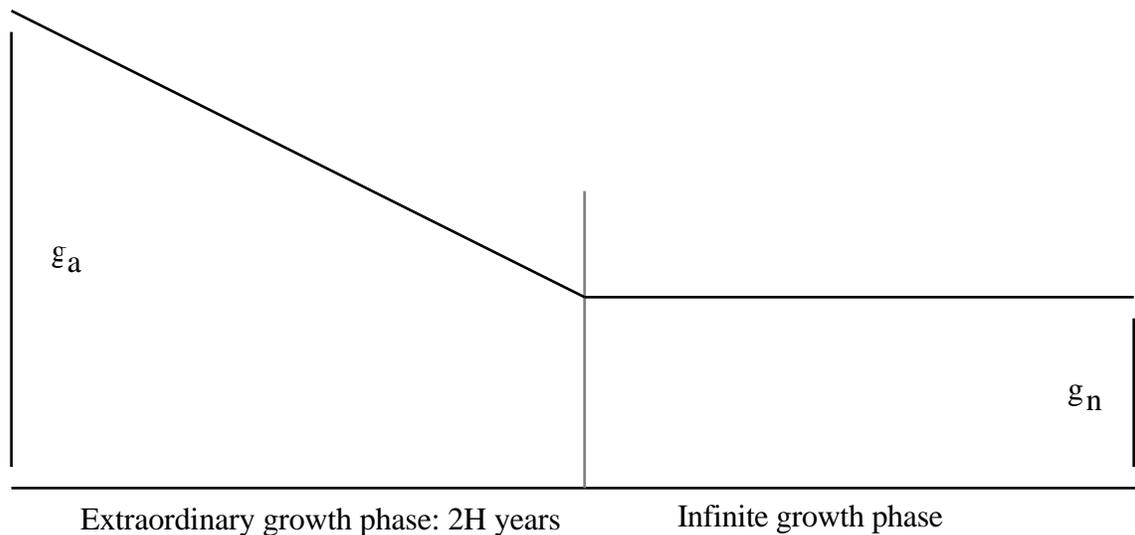
### III. The H Model for valuing Growth

The H model is a two-stage model for growth, but unlike the classical two-stage model, the growth rate in the initial growth phase is not constant but declines linearly over time to reach the stable growth rate in steady stage. This model was presented in Fuller and Hsia (1984).

#### The Model

The model is based upon the assumption that the earnings growth rate starts at a high initial rate ( $g_a$ ) and declines linearly over the extraordinary growth period (which is assumed to last  $2H$  periods) to a stable growth rate ( $g_n$ ). It also assumes that the dividend payout and cost of equity are constant over time and are not affected by the shifting growth rates. Figure 13.4 graphs the expected growth over time in the H Model.

Figure 13.4: Expected Growth in the H Model



The value of expected dividends in the H Model can be written as:

$$P_0 = \frac{DPS_0 * (1+g_n)}{(k_e - g_n)} + \frac{DPS_0 * H * (g_a - g_n)}{(k_e - g_n)}$$

Stable growth

Extraordinary growth

where,

$P_0$  = Value of the firm now per share,

$DPS_t$  = DPS in year t

$k_e$  = Cost of equity

$g_a$  = Growth rate initially

$g_n$  = Growth rate at end of 2H years, applies forever afterwards

### *Limitations*

This model avoids the problems associated with the growth rate dropping precipitously from the high growth to the stable growth phase, but it does so at a cost. First, the decline in the growth rate is expected to follow the strict structure laid out in the model -- it drops in linear increments each year based upon the initial growth rate, the stable growth rate and the length of the extraordinary growth period. While small deviations from this assumption do not affect the value significantly, large deviations can cause problems. Second, the assumption that the payout ratio is constant through both phases of growth exposes the analyst to an inconsistency -- as growth rates decline the payout ratio usually increases.

### *Works best for:*

The allowance for a gradual decrease in growth rates over time may make this a useful model for firms which are growing rapidly right now, but where the growth is expected to decline gradually over time as the firms get larger and the differential advantage they have over their competitors declines. The assumption that the payout ratio is constant, however, makes this an inappropriate model to use for any firm that has low or no dividends currently. Thus, the model, by requiring a combination of high growth and high payout, may be quite limited<sup>4</sup> in its applicability.

### *Illustration 13.7: Valuing with the H model: Alcatel*

Alcatel is a French telecommunications firm, paid dividends per share of 0.72 Ffr on earnings per share of 1.25 Ffr in 2000. The firm's earnings per share had grown at 12% over the prior 5 years but the growth rate is expected to decline linearly over the next 10 years to 5%, while the payout ratio remains unchanged. The beta for the stock is 0.8, the riskfree rate is 5.1% and the market risk premium is 4%.

---

<sup>4</sup> Proponents of the model would argue that using a steady state payout ratio for firms which pay little or no dividends is likely to cause only small errors in the valuation.

Cost of equity = 5.1% + 0.8\*4% = 8.30%

The stock can be valued using the H model:

$$\text{Value of stable growth} = \frac{(0.72)(1.05)}{0.083 - 0.05} = \$22.91$$

$$\text{Value of extraordinary growth} = \frac{(0.72)(10/2)(0.12 - 0.05)}{0.083 - 0.05} = 7.64$$

$$\text{Value of stock} = 22.91 + 7.64 = 30.55$$

The stock was trading at 33.40 Ffr in May 2001.

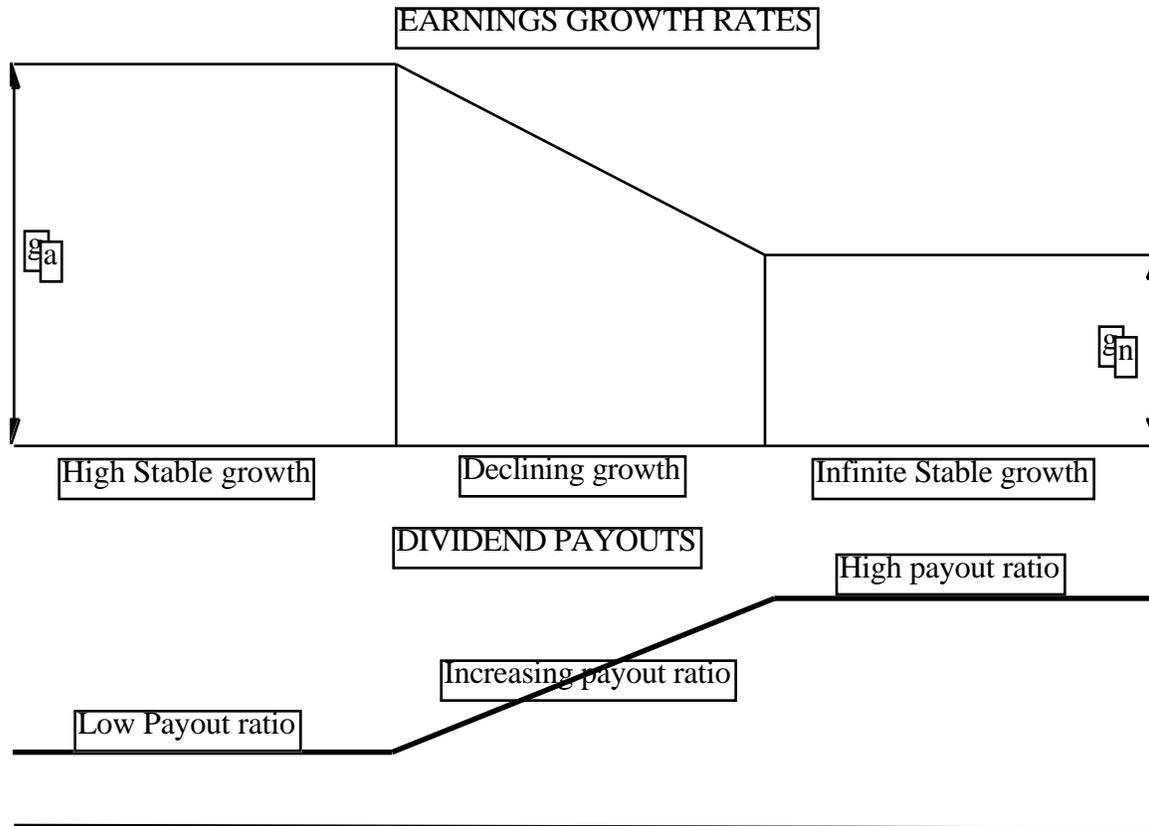
#### ***IV. Three-stage Dividend Discount Model***

The three-stage dividend discount model combines the features of the two-stage model and the H-model. It allows for an initial period of high growth, a transitional period where growth declines and a final stable growth phase. It is the most general of the models because it does not impose any restrictions on the payout ratio.

##### *The Model*

This model assumes an initial period of stable high growth, a second period of declining growth and a third period of stable low growth that lasts forever. Figure 13.5 graphs the expected growth over the three time periods.

*Figure 13.5: Expected Growth in the Three-Stage DDM*



The value of the stock is then the present value of expected dividends during the high growth and the transitional periods and of the terminal price at the start of the final stable growth phase.

$$P_0 = \sum_{t=1}^{t=n1} \frac{EPS_0 * (1+g_a)^t * a}{(1+k_{e,hg})^t} + \sum_{t=n1+1}^{t=n2} \frac{DPS_t}{(1+k_{e,t})^t} + \frac{EPS_{n2} * (1+g_n)^n}{(k_{e,st} - g_n)(1+r)^n}$$

High growth phase
Transition
Stable growth phase

where,

$EPS_t$  = Earnings per share in year t

$DPS_t$  = Dividends per share in year t

$g_a$  = Growth rate in high growth phase (lasts n1 periods)

$g_n$  = Growth rate in stable phase

$a$  = Payout ratio in high growth phase

$n$  = Payout ratio in stable growth phase

$k_e$  = Cost of equity in high growth (hg), transition (t) and stable growth (st)

*Assumptions*

This model removes many of the constraints imposed by other versions of the dividend discount model. In return, however, it requires a much larger number of inputs - year-specific payout ratios, growth rates and betas. For firms where there is substantial noise in the estimation process, the errors in these inputs can overwhelm any benefits that accrue from the additional flexibility in the model.

*Works best for:*

This model's flexibility makes it a useful model for any firm, which in addition to changing growth over time is expected to change on other dimensions as well - in particular, payout policies and risk. It is best suited for firms which are growing at an extraordinary rate now and are expected to maintain this rate for an initial period, after which the differential advantage of the firm is expected to deplete leading to gradual declines in the growth rate to a stable growth rate. Practically speaking, this may be the more appropriate model to use for a firm whose earnings are growing at very high rates<sup>5</sup>, are expected to continue growing at those rates for an initial period, but are expected to start declining gradually towards a stable rate as the firm become larger and loses its competitive advantages.

*Illustration 13.8: Valuing with the Three-stage DDM model: Coca Cola*

Coca Cola, the owner of the most valuable brand name in the world according to Interbrand, was able to increase its market value ten-fold in the 1980s and 1990s. While growth has leveled off in the last few years, the firm is still expanding both into other products and other markets.

*A Rationale for using the Three-Stage Dividend Discount Model*

- *Why three-stage?* Coca Cola is still in high growth, but its size and dominant market share will cause growth to slide in the second phase of the high growth period. The high growth period is expected to last 5 years and the transition period is expected to last an additional 5 years.
- *Why dividends?* The firm has had a track record of paying out large dividends to its stockholders, and these dividends tend to mirror free cash flows to equity.
- The financial leverage is stable.

*Background Information*

- Current Earnings / Dividends
  - Earnings per share in 2000 = \$1.56

---

<sup>5</sup> The definition of a 'very high' growth rate is largely subjective. As a rule of thumb, growth rates over 25% would qualify as very high when the stable growth rate is 6-8%.

- Dividends per share in 2000 = \$0.69
- Payout ratio in 2000 = 44.23%
- Return on Equity = 23.37%

### *Estimate*

#### *a. Cost of Equity*

We will begin by estimating the cost of equity during the high growth phase, expected. We use a bottom-up levered beta of 0.80 and a riskfree rate of 5.4%. We use a risk premium of 5.6%, significantly higher than the mature market premium of 4%, which we have used in the valuation so far, to reflect Coca Cola's exposure in Latin America, Eastern Europe and Asia. The cost of equity can then be estimated for the high growth period.

$$\text{Cost of equity}_{\text{high growth}} = 5.4\% + 0.8 (5.6\%) = 9.88\%$$

In stable growth, we assume that the beta will remain 0.80, but reduce the risk premium to 5% to reflect the expected maturing of many emerging markets.

$$\text{Cost of equity}_{\text{stable growth}} = 5.4\% + 0.8 (5.0\%) = 9.40\%$$

During the transition period, the cost of equity will linearly decline from 9.88% in year 5 to 9.40% in year 10.

#### *b. Expected Growth and Payout Ratios*

The expected growth rate during the high growth phase is estimated using the current return on equity of 23.37% and payout ratio of 44.23%.

$$\text{Expected growth rate} = \text{Retention ratio} * \text{Return on equity} = (1-0.4423)(0.2337) = 13.03\%$$

During the transition phase, the expected growth rate declines linearly from 13.03% to a stable growth rate of 5.5%. To estimate the payout ratio in stable growth, we assume a return on equity of 20% for the firm:

$$\text{Stable period payout ratio} = 1 - \frac{g}{\text{ROE}} = 1 - \frac{5.5\%}{20\%} = 72.5\%$$

During the transition phase, the payout ratio adjusts upwards from 44.23% to 72.5% in linear increments.

### *Estimating the Value*

These inputs are used to estimate expected earnings per share, dividends per share and costs of equity for the high growth, transition and stable periods. The present values are also shown in the last column table 13.3.

*Table 13.3: Expected EPS, DPS and Present Value: Coca Cola*

<i>Year</i>	<i>Expected Growth</i>	<i>EPS</i>	<i>Payout ratio</i>	<i>DPS</i>	<i>Cost of Equity</i>	<i>Present Value</i>
-------------	------------------------	------------	---------------------	------------	-----------------------	----------------------

High Growth Stage						
1	13.03%	\$1.76	44.23%	\$0.78	9.88%	\$0.71
2	13.03%	\$1.99	44.23%	\$0.88	9.88%	\$0.73
3	13.03%	\$2.25	44.23%	\$1.00	9.88%	\$0.75
4	13.03%	\$2.55	44.23%	\$1.13	9.88%	\$0.77
5	13.03%	\$2.88	44.23%	\$1.27	9.88%	\$0.79
Transition Stage						
6	11.52%	\$3.21	49.88%	\$1.60	9.78%	\$0.91
7	10.02%	\$3.53	55.54%	\$1.96	9.69%	\$1.02
8	8.51%	\$3.83	61.19%	\$2.34	9.59%	\$1.11
9	7.01%	\$4.10	66.85%	\$2.74	9.50%	\$1.18
10	5.50%	\$4.33	72.50%	\$3.14	9.40%	\$1.24

(Note: Since the costs of equity change each year, the present value has to be calculated using the cumulated cost of equity. Thus, in year 7, the present value of dividends is:

$$\text{PV of year 7 dividend} = \frac{\$1.96}{(1.0988)^5(1.0978)(1.0969)} = \$1.02$$

The terminal price at the end of year 10 can be calculated based upon the earnings per share in year 11, the stable growth rate of 5%, a cost of equity of 9.40% and the payout ratio of 72.5% -

$$\text{Terminal price} = \frac{\$4.33(1.055)(0.725)}{0.094 - 0.055} = \$84.83$$

The components of value are as follows:

Present Value of dividends in high growth phase:\$ 3.76

Present Value of dividends in transition phase:\$ 5.46

Present Value of terminal price at end of transition:\$ 33.50

Value of Coca Cola Stock :\$ 42.72

Coca Cola was trading at \$46.29 in May 21, 2001.

 .DDM3st.xls: This spreadsheet allows you to value a firm with a period of high growth followed by a transition period where growth declines to a stable growth rate.



**What is wrong with this model? (3 stage DDM)**

*If this is your problem*

*this may*

- If you are getting too low a value from this model,
  - the stable period payout ratio is too low for a stable firm (< 40%) If using fundame
  - the beta in the stable period is too high for a stable firm If entering direct
- If you get an extremely high value,
  - the growth rate in the stable growth period is too high for stable firm Use a beta close
  - the period of growth (high + transition) is too high Use a growth rat
  - Use shorter high

## **Issues in using the Dividend Discount Model**

The dividend discount model's primary attraction is its simplicity and its intuitive logic. There are many analysts, however, who view its results with suspicion because of limitations that they perceive it to possess. The model, they claim, is not really useful in valuation, except for a limited number of stable, high-dividend paying stocks. This section examines some of the areas where the dividend discount model is perceived to fall short.

### ***(a) Valuing non-dividend paying or low dividend paying stocks***

The conventional wisdom is that the dividend discount model cannot be used to value a stock that pays low or no dividends. It is wrong. If the dividend payout ratio is adjusted to reflect changes in the expected growth rate, a reasonable value can be obtained even for non-dividend paying firms. Thus, a high-growth firm, paying no dividends currently, can still be valued based upon dividends that it is expected to pay out when the growth rate declines. If the payout ratio is not adjusted to reflect changes in the growth rate, however, the dividend discount model will underestimate the value of non-dividend paying or low-dividend paying stocks.

### ***(b) Is the model too conservative in estimating value?***

A standard critique of the dividend discount model is that it provides too conservative an estimate of value. This criticism is predicated on the notion that the value is determined by more than the present value of expected dividends. For instance, it is argued that the dividend discount model does not reflect the value of 'unutilized assets'. There is no reason, however, that these unutilized assets cannot be valued separately and added on to the value from the dividend discount model. Some of the assets that are supposedly ignored by the dividend discount model, such as the value of brand names, can be dealt with simply within the context of the model.

A more legitimate criticism of the model is that it does not incorporate other ways of returning cash to stockholders (such as stock buybacks). If you use the modified version of the dividend discount model, this criticism can also be countered.

### ***(c) The contrarian nature of the model***

The dividend discount model is also considered by many to be a contrarian model. As the market rises, fewer and fewer stocks, they argue, will be found to be undervalued using the dividend discount model. This is not necessarily true. If the market increase is due to an improvement in economic fundamentals, such as higher expected growth in the economy and/or lower interest rates, there is no reason, a priori, to believe that the values

from the dividend discount model will not increase by an equivalent amount. If the market increase is not due to fundamentals, the dividend discount model values will not follow suit, but that is more a sign of strength than weakness. The model is signaling that the market is overvalued relative to dividends and cashflows and the cautious investor will pay heed.

### **Tests of the Dividend Discount Model**

The ultimate test of a model lies in how well it works at identifying undervalued and overvalued stocks. The dividend discount model has been tested and the results indicate that it does, in the long term, provide for excess returns. It is unclear, however, whether this is because the model is good at finding undervalued stocks or because it proxies for well-know empirical irregularities in returns relating to price-earnings ratios and dividend yields.

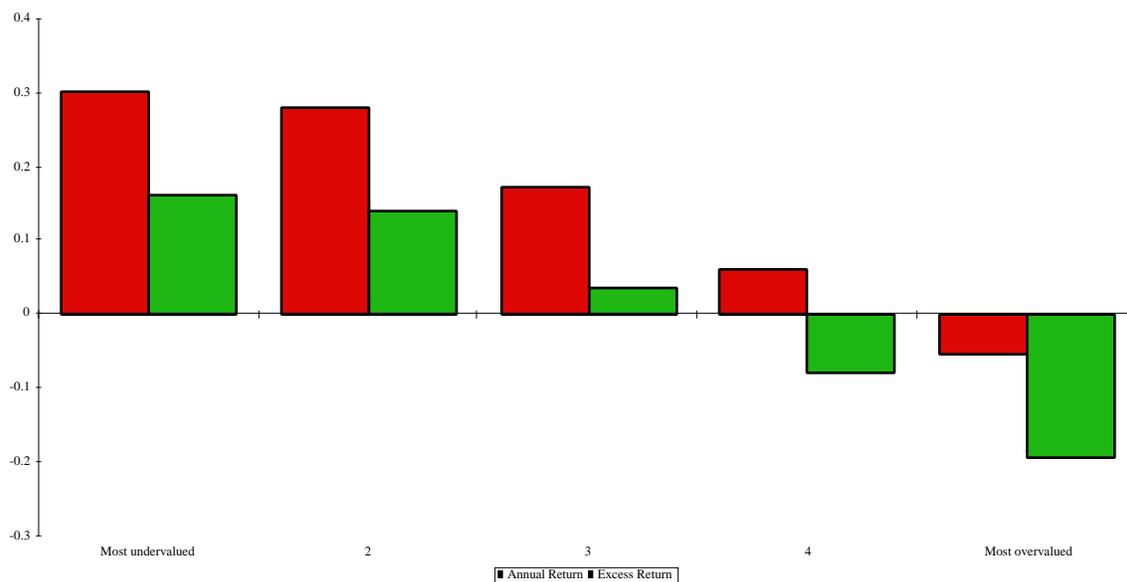
#### ***A Simple Test of the Dividend Discount model***

A simple study of the dividend discount model was conducted by Sorensen and Williamson, where they valued 150 stocks from the S&P 400 in December 1980, using the dividend discount model. They used the difference between the market price at that time and the model value to form five portfolios based upon the degree of under or over valuation. They made fairly broad assumptions in using the dividend discount model.

- (a) The average of the earnings per share between 1976 and 1980 was used as the current earnings per share.
- (b) The cost of equity was estimated using the CAPM.
- (c) The extraordinary growth period was assumed to be five years for all stocks and the I/B/E/S consensus forecast of earnings growth was used as the growth rate for this period.
- (d) The stable growth rate, after the extraordinary growth period, was assumed to be 8% for all stocks.
- (e) The payout ratio was assumed to be 45% for all stocks.

The returns on these five portfolios were estimated for the following two years (January 1981-January 1983) and excess returns were estimated relative to the S&P 500 Index using the betas estimated at the first stage and the CAPM. Figure 13.6 illustrates the excess returns earned by the portfolio that was undervalued by the dividend discount model relative to both the market and the overvalued portfolio.

Figure 13.6 Performance of the Dividend Discount Model: 1981-83



The undervalued portfolio had a positive excess return of 16% per annum between 1981 and 1983, while the overvalued portfolio had a negative excess return of 15% per annum during the same time period. Other studies which focus only on the dividend discount model come to similar conclusions. In the long term, undervalued (overvalued) stocks from the dividend discount model outperform (under perform) the market index on a risk adjusted basis.

### *Caveats on the use of the dividend discount model*

The dividend discount model provides impressive results in the long term. There are, however, three considerations in generalizing the findings from these studies.

#### *The dividend discount model does not beat the market every year*

The dividend discount model outperforms the market over five-year time periods, but there have been individual years where the model has significantly under performed the market. Haugen reports on the results of a fund that used the dividend discount model to analyze 250 large capitalization firms and to classify them into five quintiles from the first quarter of 1979 to the last quarter of 1991. The betas of these quintiles were roughly equal. The valuation was done by six analysts who estimated an extraordinary growth rate for the initial high growth phase, the length of the high growth phase and a transitional phase for each of the firms. The returns on the five portfolios as well as the returns on all 250 stocks and the S&P 500 from 1979 to 1991 are reported in Table 13.4.

*Table 13.4: Returns on Quintiles: Dividend Discount Model*

Quintile							
	Under Valued	2	3	4	Over Valued	250 Stocks	S&P 500
1979	35.07%	25.92%	18.49%	17.55%	20.06%	23.21%	18.57%
1980	41.21%	29.19%	27.41%	38.43%	26.44%	31.86%	32.55%
1981	12.12%	10.89%	1.25%	-5.59%	-8.51%	28.41%	24.55%
1982	19.12%	12.81%	26.72%	28.41%	35.54%	24.53%	21.61%
1983	34.18%	21.27%	25.00%	24.55%	14.35%	24.10%	22.54%
1984	15.26%	5.50%	6.03%	-4.20%	-7.84%	3.24%	6.12%
1985	38.91%	32.22%	35.83%	29.29%	23.43%	33.80%	31.59%
1986	14.33%	11.87%	19.49%	12.00%	20.82%	15.78%	18.47%
1987	0.42%	4.34%	8.15%	4.64%	-2.41%	2.71%	5.23%
1988	39.61%	31.31%	17.78%	8.18%	6.76%	20.62%	16.48%
1989	26.36%	23.54%	30.76%	32.60%	35.07%	29.33%	31.49%
1990	-17.32%	-8.12%	-5.81%	2.09%	-2.65%	-6.18%	-3.17%
1991	47.68%	26.34%	33.38%	34.91%	31.64%	34.34%	30.57%
1979-91	1253%	657%	772%	605%	434%	722%	654%

The undervalued portfolio earned significantly higher returns than the overvalued portfolio and the S&P 500 for the 1979-91 period, but it under performed the market in five of the twelve years and the overvalued portfolio in four of the twelve years.

*Is the model just a proxy for low PE ratios and dividend yields?*

The dividend discount model weights expected earnings and dividends in near periods more than earnings and dividends in far periods., It is biased towards finding low price-earnings ratio stocks with high dividend yields to be undervalued and high price-earnings ratio stocks with low or no dividend yields to be overvalued. Studies of market efficiency indicate that low PE ratio stocks have outperformed (in terms of excess returns) high PE ratio stocks over extended time periods. Similar conclusions have been drawn about high-dividend yield stocks relative to low-dividend yield stocks. Thus, the valuation findings of the model are consistent with empirical irregularities observed in the market.

It is unclear how much the model adds in value to investment strategies that use PE ratios or dividend yields to screen stocks. Jacobs and Levy (1988b) indicate that the marginal gain is relatively small.

*Attribute*

*Average Excess Return per Quarter: 1982-87*

Dividend Discount Model	0.06% per quarter
Low P/E Ratio	0.92% per quarter
Book/Price Ratio	0.01% per quarter
Cashflow/Price	0.18% per quarter
Sales/Price	0.96% per quarter
Dividend Yield	-0.51% per quarter

This suggests that using low PE ratios to pick stocks adds 0.92% to your quarterly returns, whereas using the dividend discount model adds only a further 0.06% to quarterly returns. If, in fact, the gain from using the dividend discount model is that small, screening stocks on the basis of observables (such as PE ratio or cashflow measures) may provide a much larger benefit in terms of excess returns.

#### *The tax disadvantages from high dividend stocks*

Portfolios created with the dividend discount model are generally characterized by high dividend yield, which can create a tax disadvantage if dividends are taxed at a rate greater than capital gains or if there is a substantial tax timing<sup>6</sup> liability associated with dividends. Since the excess returns uncovered in the studies presented above are pre-tax to the investor, the introduction of personal taxes may significantly reduce or even eliminate these excess returns.

In summary, the dividend discount model's impressive results in studies looking at past data have to be considered with caution. For a tax-exempt investment, with a long time horizon, the dividend discount model is a good tool, though it may not be the only one, to pick stocks. For a taxable investor, the benefits are murkier, since the tax consequences of the strategy have to be considered. For investors with shorter time horizons, the dividend discount model may not deliver on its promised excess returns, because of the year-to-year volatility in its performance.

### **Conclusion**

When you buy stock in a publicly traded firm, the only cash flow you receive directly from this investment are expected dividends. The dividend discount model builds on this simple proposition and argues that the value of a stock then has to be the present value of expected dividends over time. Dividend discount models can range from simple growing perpetuity models such as the Gordon Growth model, where a stock's value is a function of

---

<sup>6</sup> Investors do not have a choice of when they receive dividends, whereas they have a choice on the timing of capital gains.

its expected dividends next year, the cost of equity and the stable growth rate, to complex three stage models, where payout ratios and growth rates change over time.

While the dividend discount model is often criticized as being of limited value, it has proven to be surprisingly adaptable and useful in a wide range of circumstances. It may be a conservative model that finds fewer and fewer undervalued firms as market prices rise relative to fundamentals (earnings, dividends, etc.) but that can also be viewed as a strength. Tests of the model also seem to indicate its usefulness in gauging value, though much of its effectiveness may be derived from its finding low PE ratio, high dividend yield stocks to be undervalued.

*Problems*

1. Respond true or false to the following statements relating to the dividend discount model:
  - A. The dividend discount model cannot be used to value a high growth company that pays no dividends.
  - B. The dividend discount model will undervalue stocks, because it is too conservative.
  - C. The dividend discount model will find more undervalued stocks, when the overall stock market is depressed.
  - D. Stocks that are undervalued using the dividend discount model have generally made significant positive excess returns over long time periods (five years or more).
  - E. Stocks which pay high dividends and have low price-earnings ratios are more likely to come out as undervalued using the dividend discount model.

2. Ameritech Corporation paid dividends per share of \$3.56 in 1992 and dividends are expected to grow 5.5% a year forever. The stock has a beta of 0.90 and the treasury bond rate is 6.25%.

- a. What is the value per share, using the Gordon Growth Model?
- b. The stock was trading for \$80 per share. What would the growth rate in dividends have to be to justify this price?

3. Church & Dwight, a large producer of sodium bicarbonate, reported earnings per share of \$1.50 in 1993 and paid dividends per share of \$0.42. In 1993, the firm also reported the following:

Net Income = \$30 million

Interest Expense = \$0.8 million

Book Value of Debt = \$7.6 million

Book Value of Equity = \$160 million

The firm faced a corporate tax rate of 38.5%. (The market value debt to equity ratio is 5%.) The treasury bond rate is 7%.

The firm expected to maintain these financial fundamentals from 1994 to 1998, after which it was expected to become a stable firm with an earnings growth rate of 6%. The firm's financial characteristics were expected to approach industry averages after 1998. The industry averages were as follows:

Return on Capital = 12.5%

Debt/Equity Ratio = 25%

Interest Rate on Debt = 7%

Church and Dwight had a beta of 0.85 in 1993 and the unlevered beta was not expected to change over time.

- a. What is the expected growth rate in earnings, based upon fundamentals, for the high-growth period (1994 to 1998)?
  - b. What is the expected payout ratio after 1998?
  - c. What is the expected beta after 1998?
  - d. What is the expected price at the end of 1998?
  - e. What is the value of the stock, using the two-stage dividend discount model?
  - f. How much of this value can be attributed to extraordinary growth? to stable growth?
4. Oneida Inc, the world's largest producer of stainless steel and silverplated flatware, reported earnings per share of \$0.80 in 1993 and paid dividends per share of \$0.48 in that year. The firm was expected to report earnings growth of 25% in 1994, after which the growth rate was expected to decline linearly over the following six years to 7% in 1999. The stock was expected to have a beta of 0.85. (The treasury bond rate was 6.25%)
- a. Estimate the value of stable growth, using the H Model.
  - b. Estimate the value of extraordinary growth, using the H Model.
  - c. What are the assumptions about dividend payout in the H Model?
5. Medtronic Inc., the world's largest manufacturer of implantable biomedical devices, reported earnings per share in 1993 of \$3.95 and paid dividends per share of \$0.68. Its earnings were expected to grow 16% from 1994 to 1998, but the growth rate was expected to decline each year after that to a stable growth rate of 6% in 2003. The payout ratio was expected to remain unchanged from 1994 to 1998, after which it would increase each year to reach 60% in steady state. The stock was expected to have a beta of 1.25 from 1994 to 1998, after which the beta would decline each year to reach 1.00 by the time the firm becomes stable. (The treasury bond rate was 6.25%)
- a. Assuming that the growth rate declines linearly (and the payout ratio increases linearly) from 1999 to 2003, estimate the dividends per share each year from 1994 to 2003.
  - b. Estimate the expected price at the end of 2003.
  - c. Estimate the value per share, using the three-stage dividend discount model.