CHAPTER 22: RETURNING CASH TO STOCKHOLDERS

22-1
1. Signaling effects: A regular dividend should send out a stronger positive signal than either a special dividend or a stock buyback.

2. Tax effects: A stock buyback may have less negative tax consequences for some investors in the stock than dividends.

3. Sustainability: A regular dividend presumes that the firm will have similar cash flows in the future to sustain the dividend.

22-2
An equity repurchase will generally provide a smaller signaling benefit than a regular dividend because it is viewed as an one-time occurrence. A regular dividend on the other hand brings with it the expectation of similar dividends in the future. A special dividend is also a one-time occurrence and should provide no signaling advantages over equity repurchases.

22-3
Yes. The surplus could be used to buy back shares and reduce the number of shares outstanding. Then, the company can maintain its dividends per share and still lower total dividend payments. If the firm does not have attractive projects, this may be the optimal way to use the windfall.

22-4
A targeted repurchase where the shares of an unwelcome stockholder are bought back at a price greater than the current market price will hurt other stockholders because of the premium paid over the market price.

22-5
a. No. The earnings per share will increase only if the return on assets exceeds the after tax cost of borrowing.

b. No. The risk will increase as leverage increases and the stock price may go down even with higher EPS.

c. If the increase in earnings per share more than offsets the higher risk from increased leverage, the price will go up.

22-6

a. Current market value of debt = current market value of stock = $42 * 1 million = $42 million
After $5 million of debt is retired, total debt becomes $37 million
EPS = (15,000,000 - 37,000,000*10%) (1 - 40%) / (1,000,000 - 100,000) = $7.53

b. Current EPS = (15,000,000 - 42,000,000 *10%) (1 - 40%) / 1,000,000 = $6.48
Current P/E ratio = $42 / $6.48 = 6.48
The new price would be $7.53*6.48 or $48.79 per share. It is lower than the tendering price of $50. The management would probably argue that the P/E ratio would be higher, leading to a higher price.

c. It the stocks are bought back at the ongoing market price, it is less likely that the market would believe the argument made by the management that the stock is underpriced.

d. The answer to (b) and (c) may differ if the management is allowed to tender shares. The prices would go down because the market may conclude that the management is trying to unload its shares.

22-7

a. The firm should buy back shares. The net taxes paid, even by investors who sell, will be at the capital gains rate.

b. Corporations are exempt from having to pay taxes on 70% of the dividends that they receive from other corporations. This may make dividends more attractive them, relative to stock buybacks.

22-8

a.

	Without Borrowing	**With Borrowing**
EBIT	20	20
Interest Exp.	0	4.8
EBT	20	15.2
Taxes	10	7.6
Net Income	10	7.6
No. of Shares	100,000	60,000
EPS	100	126.67

b. The interest rate on debt would have to be 12.5% for the EPS effect to disappear.

22-9

Forward contracts to buy equity are riskier than announcements of buybacks because they represent legal obligations to buy stock at a stated price. The firm does not have the option to back down.

22-10
I would recommend a split up of the firm into tobacco and food companies. A major barrier to such an action might be covenants in bond agreements protecting bondholders who might be hurt by such an action.

22-11
No. The split off will not solve the problem-because incumbent management (which is the problem) is still running the firm. I would recommend breaking up the firm and selling its component parts to outsiders, or a split off where incumbent management explicitly disavows control in the split off entities.

22-12
There may be several factors behind the positive reaction to spin offs. First, the spun off division may be worth more as an independent entity than as part of a larger company (a reverse synergy argument). Second, the spun off division may be freer to pursue plans it could not pursue as part of the larger entity, either because of regulatory concerns or corporate culture. Finally, the very act of the spin off may force analysts to look at the value of the spun off entity and realize that they have been undervaluing it.

22-13
a. No. Given the preponderance of investment that is institutional investment and the fact that the price is only $50 (rather than $400 or $500), I do not believe that this action is going to increase the investor base for the company.

b. While I would expect an initial positive reaction to the split, this increase will be sustained only if the firm follows up with positive news that confirms the signal sent by the split - i.e., that higher earnings and stock prices will follow.

22-14
At $75 per share, a typical investor would be able to buy $5,000/75 or 66 shares.
The commissions = $29 + 0.025*66 + 15 = $45.65
At $25 per share, a typical investor would be able to buy $5,000/25 or 200 shares.
The commissions = $29 + 0.025*100 + 0.015*100 = $33.00
Indeed, it is less expensive for the typical investor to buy the stock after split.

22-15
Existing stockholders are not affected unless they sell the shares.

22-16

A reverse split might bring the stock price back up to a level where transactions costs are less of a burden - especially when transactions costs include the bid-ask spread paid on the stock.

22-17
I would expect the stock price reaction to be negative. A stock dividend is a cosmetic event with no cash flows associated with it and cannot replace a cash dividend.

22-18
The positive reaction can be explained by several factors. First, the action suggested that the management of the firm was aware that they had a problem and were willing to deal with it. Second, the split up units had more independence and were no longer burdened by the policies and practices of the other units. Third, it allowed each of the split up units to reveal their assets and earning power separately making it easier to value the component parts.

22-19
Spinning of the non-regulated businesses may relieve them of the burden of having to worry about the consequences of their actions for the regulated parent company. It will also allow them to set dividend and financing policy which is more consistent with their own interests.

22-20
Spin offs and splitoffs may make it easier to value firms since they isolate the assets of the entity being valued. It is easier to estimate risk parameters for the entity if it is traded separately. This benefit should be greatest when complex firms with financial statements that are difficult to break down and analyze.

22-21
The spin off will add to the value of the firm only if the corporate costs are excessive or unnecessary, and thus can be reduced or eliminated without hurting the divisional profitability. If on the other hand, the corporate costs represent costs that would now have to be borne by the independent divisions, the spin off should not increase value.

22-22
No. I do not think Nabisco's stockholders will be satisfied. While one of the objectives for the spin off - separating the contaminated tobacco division from the food division - may have been accomplished, the other - removing management that they view as incompetent - would not.