

Returning Cash to the Owners: Dividend Policy

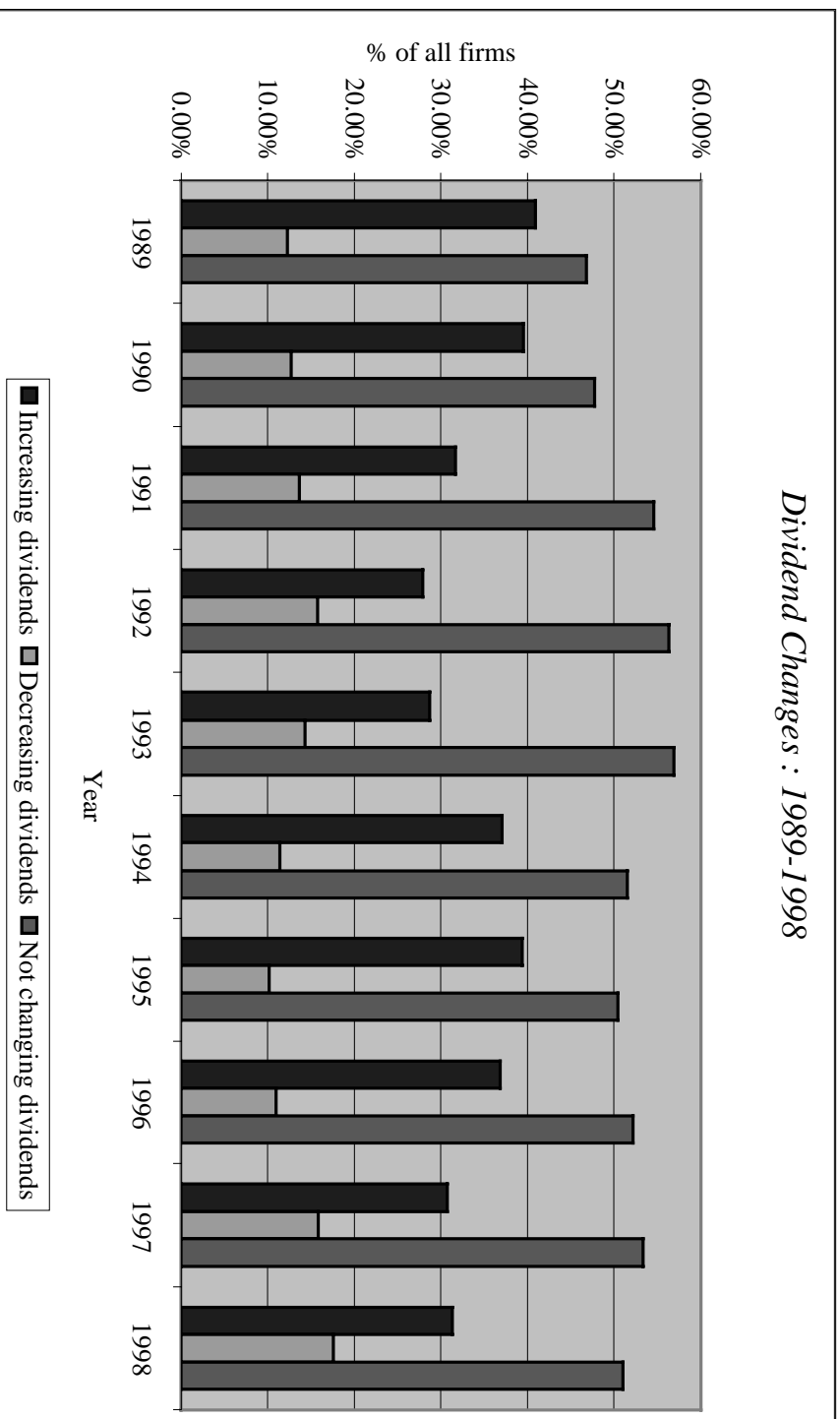
Aswath Damodaran

First Principles

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
 - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners' funds (equity) or borrowed money (debt)
 - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.
- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
 - The form of returns - dividends and stock buybacks - will depend upon the stockholders' characteristics.

Objective: Maximize the Value of the Firm

Dividends are sticky



Dividends tend to follow earnings

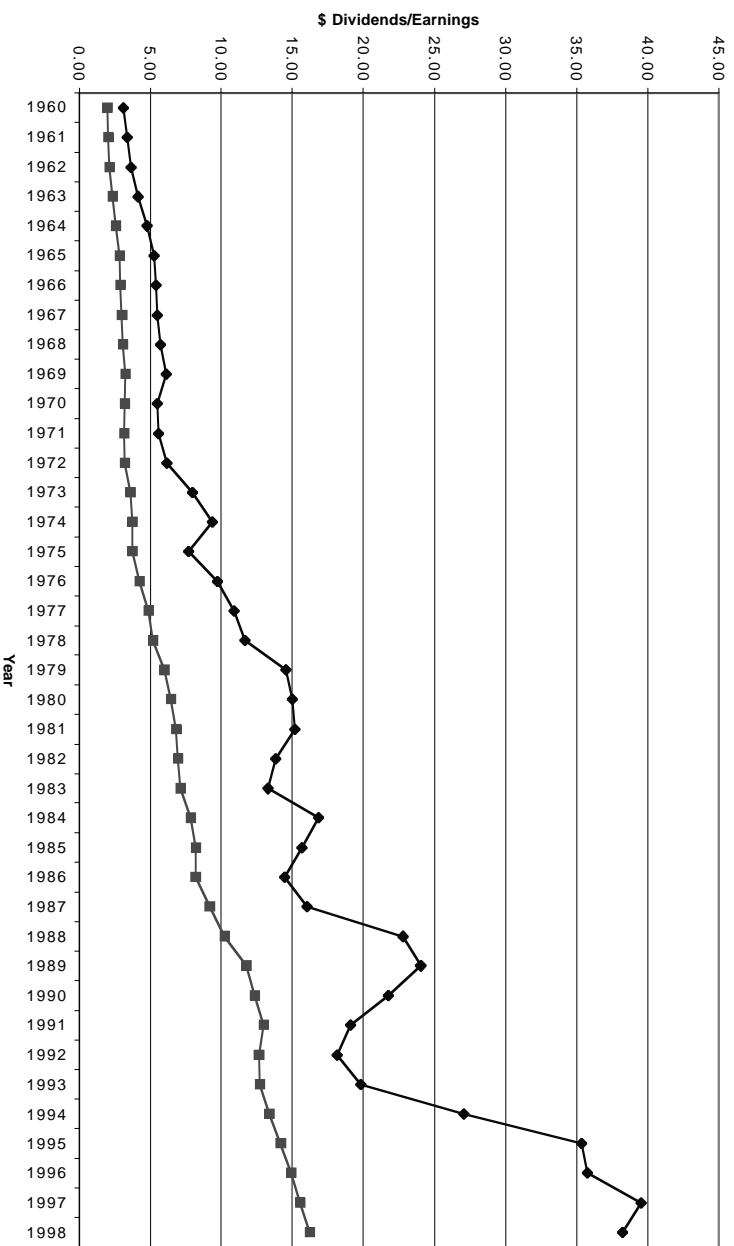
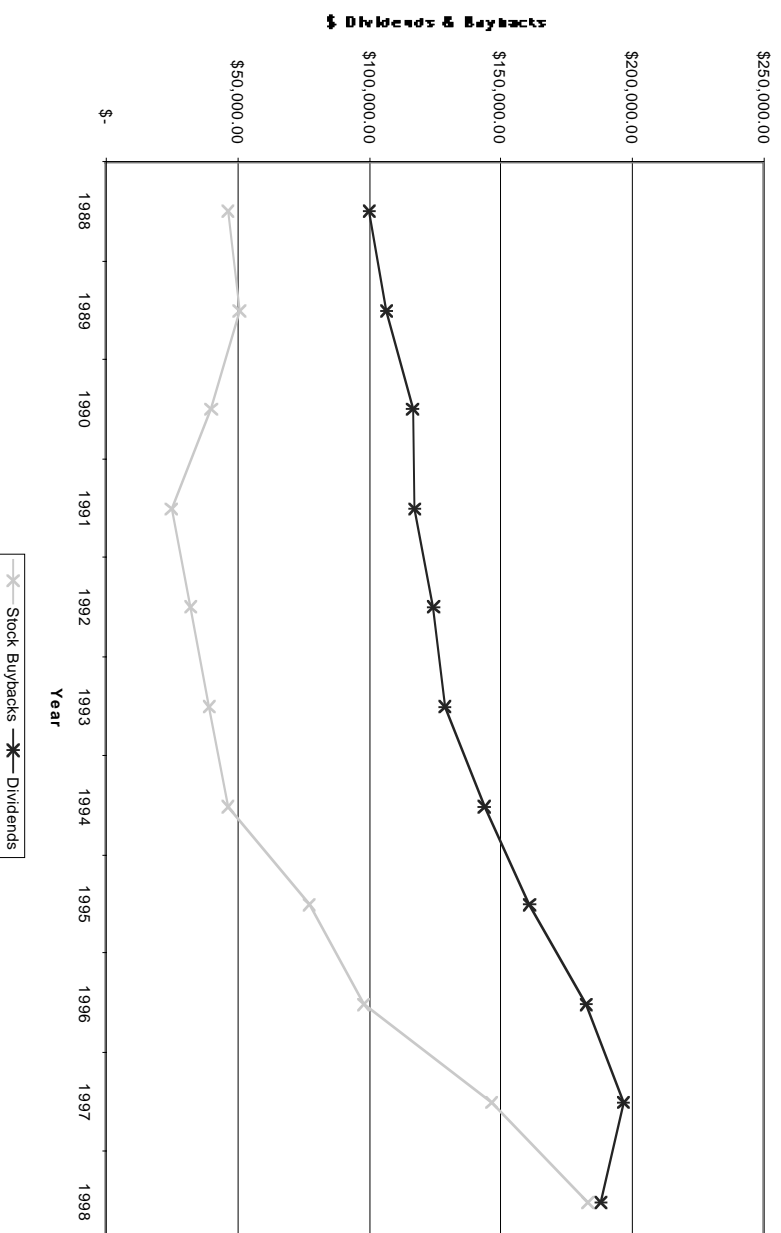


Figure 2.1.5: Dividends and Earnings at US Firms: 1960 - 1998

More and more firms are buying back stock, rather than pay dividends....

Figure 22.1: Stock Buybacks and Dividends: Aggregate for US Firms - 1989-98



Measures of Dividend Policy

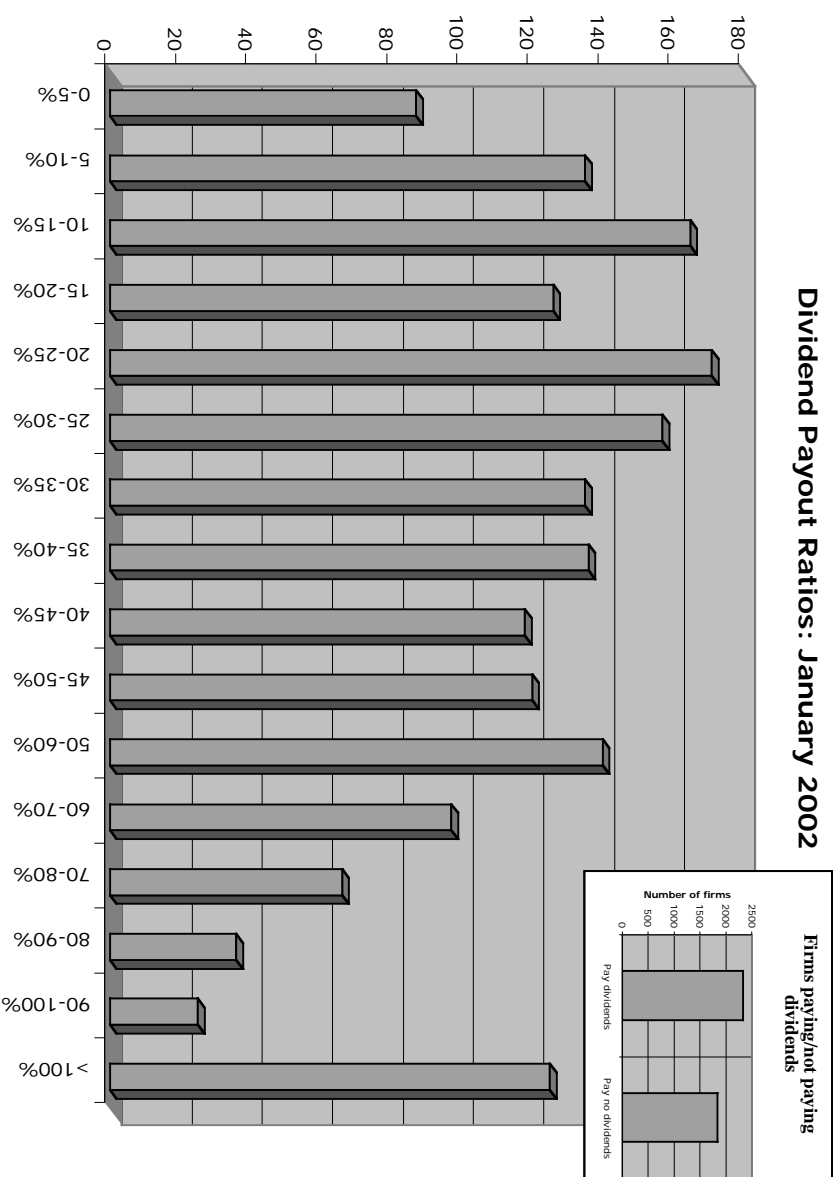
- Dividend Payout:

- measures the percentage of earnings that the company pays in dividends
- = Dividends / Earnings

- Dividend Yield :

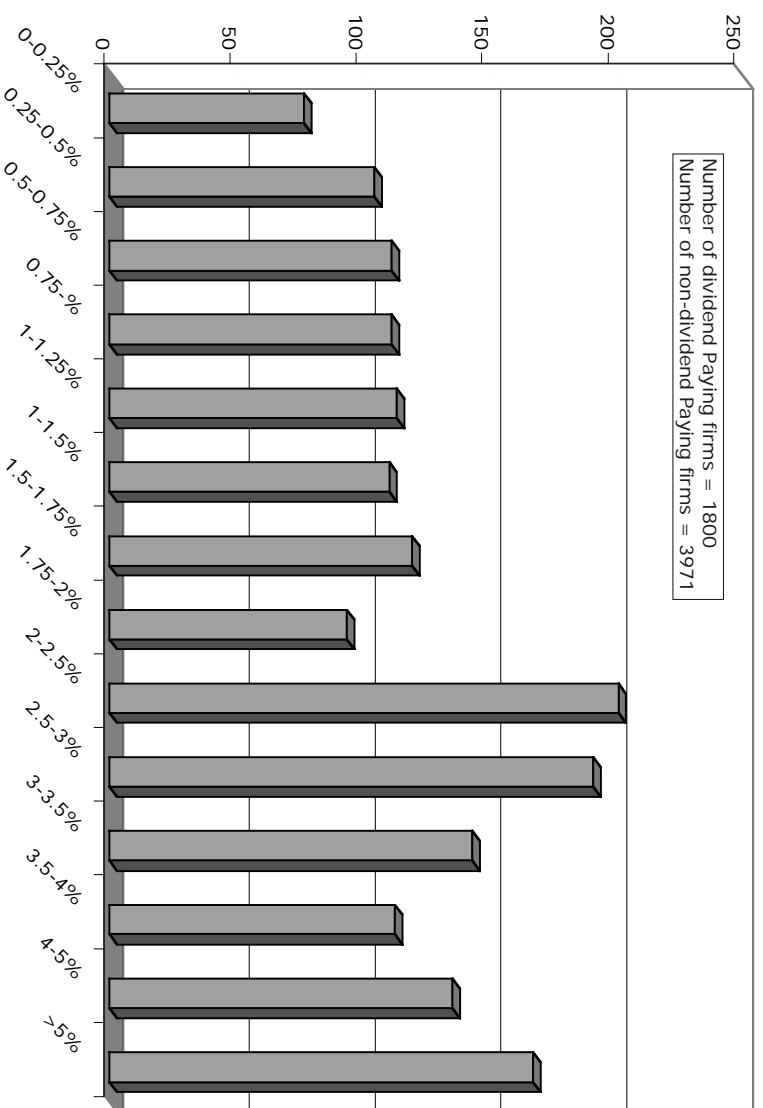
- measures the return that an investor can make from dividends alone
- = Dividends / Stock Price

Dividend Payout Ratios: January 2002



Dividend Yields in the United States: January 2002

Dividend Yields: January 2002



Three Schools Of Thought On Dividends

- 1. If
 - (a) there are no tax disadvantages associated with dividends
 - (b) companies can issue stock, at no cost, to raise equity, whenever needed
 - **Dividends do not matter, and dividend policy does not affect value.**
- 2. If dividends have a tax disadvantage,
 - **Dividends are bad, and increasing dividends will reduce value**
- 3. If stockholders like dividends, or dividends operate as a signal of future prospects,
 - **Dividends are good, and increasing dividends will increase value**

The balanced viewpoint

- If a company has excess cash, and few good projects ($NPV > 0$), returning money to stockholders (dividends or stock repurchases) is GOOD.
- If a company does not have excess cash, and/or has several good projects ($NPV > 0$), returning money to stockholders (dividends or stock repurchases) is BAD.

Why do firms pay dividends?

- The Miller-Modigliani Hypothesis: **Dividends do not affect value**

- Basis:

- If a firm's investment policy (and hence cash flows) don't change, the value of the firm cannot change with dividend policy. If we ignore personal taxes, investors have to be indifferent to receiving either dividends or capital gains.

- Underlying Assumptions:

- (a) There are no tax differences between dividends and capital gains.
- (b) If companies pay too much in cash, they can issue new stock, with no flotation costs or signaling consequences, to replace this cash.
- (c) If companies pay too little in dividends, they do not use the excess cash for bad projects or acquisitions.

The Tax Response: Dividends are taxed more than capital gains

- Basis:
 - Dividends are taxed more heavily than capital gains. A stockholder will therefore prefer to receive capital gains over dividends.
- Evidence:
 - Examining ex-dividend dates should provide us with some evidence on whether dividends are perfect substitutes for capital gains.

Price Behavior on Ex-Dividend Date

Let P_b = Price before the stock goes ex-dividend

P_a = Price after the stock goes ex-dividend

D = Dividends declared on stock

t_o , t_{cg} = Taxes paid on ordinary income and capital gains respectively



Cashflows from Selling around Ex-Dividend Day

- The cash flows from selling before then are-
 $P_b - (P_b - P) t_{cg}$
- The cash flows from selling after the ex-dividend day are-
 $P_a - (P_a - P) t_{cg} + D(1-t_o)$

Since the average investor should be indifferent between selling before the ex-dividend day and selling after the ex-dividend day -

$$P_b - (P_b - P) t_{cg} = P_a - (P_a - P) t_{cg} + D(1-t_o)$$

Moving the variables around, we arrive at the following:

Price Change, Dividends and Tax Rates

$$\frac{P_b - P_a}{D} = \frac{(1-t_o)}{(1-t_{cg})}$$

If		
$P_b - P_a = D$	then	$t_o = t_{cg}$
$P_b - P_a < D$	then	$t_o > t_{cg}$
$P_b - P_a > D$	then	$t_o < t_{cg}$

The Evidence on Ex-Dividend Day Behavior

	<i>Ordinary Income</i>	<i>Capital Gains</i>	$(P_b - P_d) / D$
Before 1981	70 %	28 %	0.78 (1966-69)
1981-85	50 %	20 %	0.85
1986-1990	28 %	28 %	0.90
1991-1993	33 %	28 %	0.92
1994.	39.6 %	28 %	0.90

Dividend Arbitrage

- Assume that you are a tax exempt investor, and that you know that the price drop on the ex-dividend day is only 90% of the dividend. How would you exploit this differential?
- Invest in the stock for the long term
- Sell short the day before the ex-dividend day, buy on the ex-dividend day
- Buy just before the ex-dividend day, and sell after.
- _____

Example of dividend capture strategy with tax factors

- XYZ company is selling for \$50 at close of trading May 3. On May 4, XYZ goes ex-dividend; the dividend amount is \$1. The price drop (from past examination of the data) is only 90% of the dividend amount.
- The transactions needed by a tax-exempt U.S. pension fund for the arbitrage are as follows:
 - 1. Buy 1 million shares of XYZ stock cum-dividend at \$50/share.
 - 2. Wait till stock goes ex-dividend; Sell stock for \$49.10/share (50 - 1* 0.90)
 - 3. Collect dividend on stock.
- Net profit = - 50 million + 49.10 million + 1 million = \$0.10 million

The wrong reasons for paying dividends

The bird in the hand fallacy

- **Argument:** Dividends now are more certain than capital gains later. Hence dividends are more valuable than capital gains.

- **Counter:** The appropriate comparison should be between dividends today and price appreciation today. (The stock price drops on the ex-dividend day.)

The excess cash hypothesis

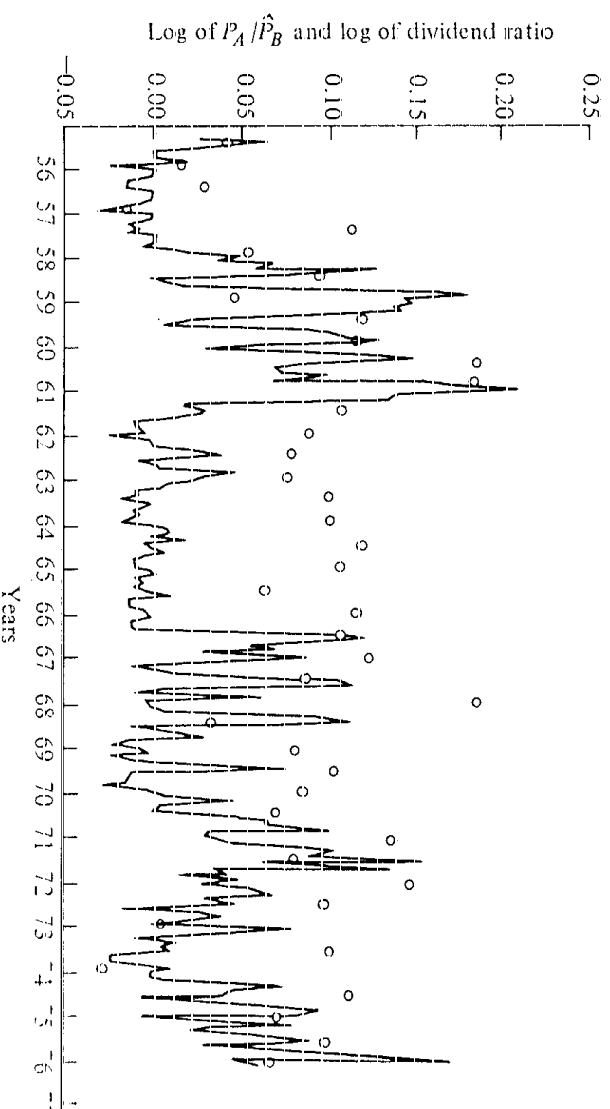
- **Argument:** The firm has excess cash on its hands this year, no investment projects this year and wants to give the money back to stockholders.

- **Counter:** So why not just repurchase stock? If this is a one-time phenomenon, the firm has to consider future financing needs. Consider the cost of issuing new stock:

The Cost of Raising Funds

- Issuing new equity is much more expensive than raising new debt for companies that are already publicly traded, in terms of transactions costs and investment banking fees
- Raising small amounts is much more expensive than raising large amounts, for both equity and debt. Making a small equity issue (say \$ 25-\$ 50 million might be prohibitively expensive)

Are firms perverse? Some evidence that they are not



The natural log of P_A / P_B (the connected monthly observations) and the natural log of the semi-annual ratio of Series A to Series B dividends (the unconnected O's) for the period 1956–1976. P_B is the price per share of Series B stock with dividends reinvested during each half-year prior to payment of the semi-annual Series A dividend. The unconnected points representing the log of the dividend ratio are placed in the figure at the end of the half-years to which they refer.

FIGURE 14.3

Evidence from Canadian Firms

<i>Company</i>	<i>Premium for Cash dividend over Stock Dividend Shares</i>
Consolidated Bathurst	19.30%
Danfasco	13.30%
Dome Petroleum	0.30%
Imperial Oil	12.10%
Newfoundland Light & Power	1.80%
Royal Trustco	17.30%
Stelco	2.70%
TransAlta	1.10%
Average	7.54%

A clientele based explanation

- **Basis:** Investors may form clienteles based upon their tax brackets. Investors in high tax brackets may invest in stocks which do not pay dividends and those in low tax brackets may invest in dividend paying stocks.

- **Evidence:** A study of 914 investors' portfolios was carried out to see if their portfolio positions were affected by their tax brackets. The study found that
 - (a) Older investors were more likely to hold high dividend stocks and
 - (b) Poorer investors tended to hold high dividend stocks

Results from Regression: Clientele Effect

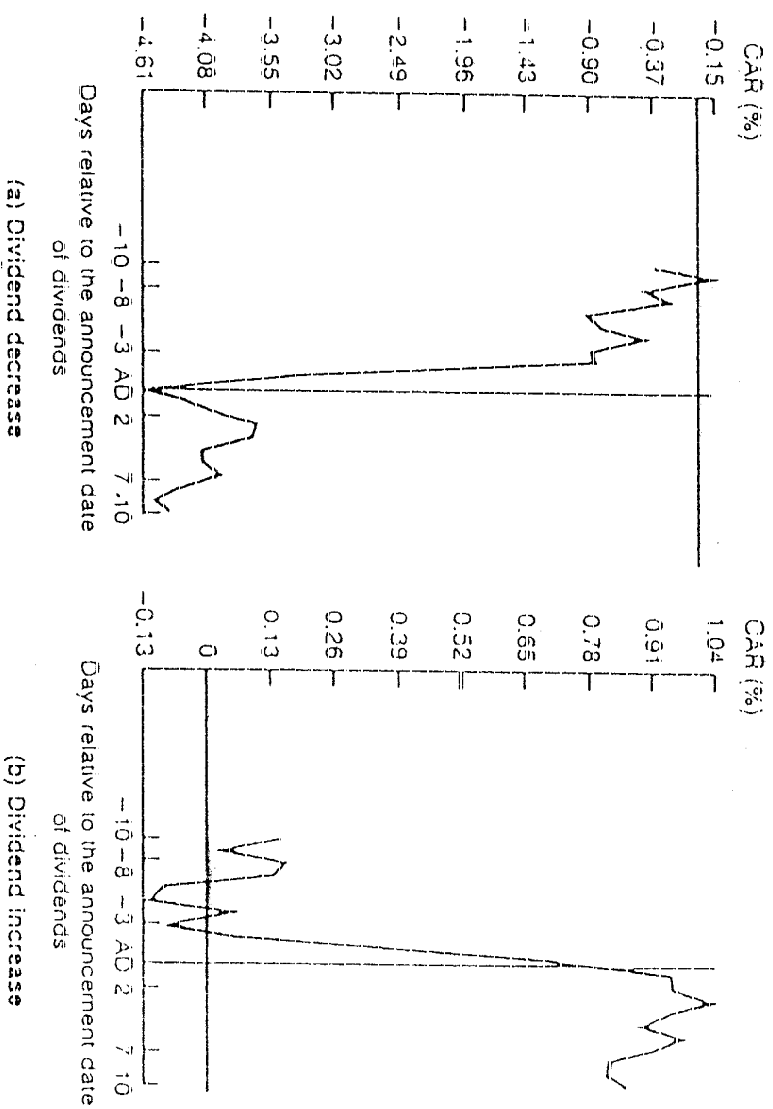
$$\text{Dividend Yield}_t = a + b \beta_t + c \text{Age}_t + d \text{Income}_t + e \text{Differential Tax Rate}_t + \epsilon_t$$

Variable	Coefficient	Implies
Constant	4.22%	
Beta Coefficient	-2.145	Higher beta stocks pay lower dividends.
Age/100	3.131	Firms with older investors pay higher dividends.
Income/1000	-3.726	Firms with wealthier investors pay lower dividends.
Differential Tax Rate	-2.849	If ordinary income is taxed at a higher rate than capital gains, the firm pays less dividends.

Dividend Policy and Clientele

- Assume that you run a phone company, and that you have historically paid large dividends. You are now planning to enter the telecommunications and media markets. Which of the following paths are you most likely to follow?
- Courageously announce to your stockholders that you plan to cut dividends and invest in the new markets.
- Continue to pay the dividends that you used to, and defer investment in the new markets.
- Continue to pay the dividends that you used to, make the investments in the new markets, and issue new stock to cover the shortfall
- Other

The Signaling Hypothesis



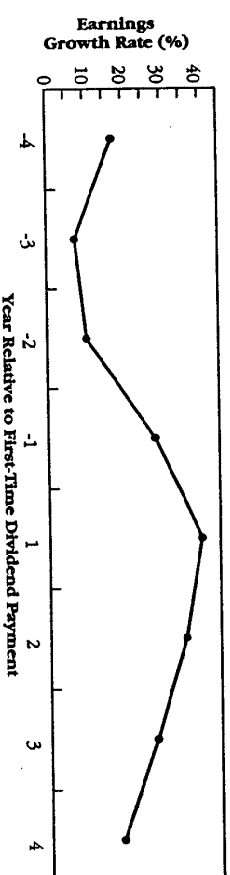
An Alternative Story.. Dividends as Negative Signals

TABLE 1
EARNINGS GROWTH RATES
IN YEARS SURROUNDING
FIRST-TIME
DIVIDEND PAYMENTS BY
131 FIRMS IN THE
PERIOD 1970 TO 1979*

Year Relative to Dividend Initiation	Number of Firms	Mean Earnings Growth Rate	Median Earnings Growth Rate
-4	130	14.9%	17.4%
-3	129	-7.1	7.6
-2	128	12.9	10.5
-1	131	42.7**	28.0
1	130	55.0**	40.2
2	130	22.0**	35.9
3	130	35.0**	28.2
4	128	3.5	19.5

* In our original research we compute earnings performance as earnings changes standardized by stock prices. Here we convert these values to earnings growth rates by assuming that the average price earnings ratio for the sample firms is ten.
** Significantly different from zero at the 10% level or lower.

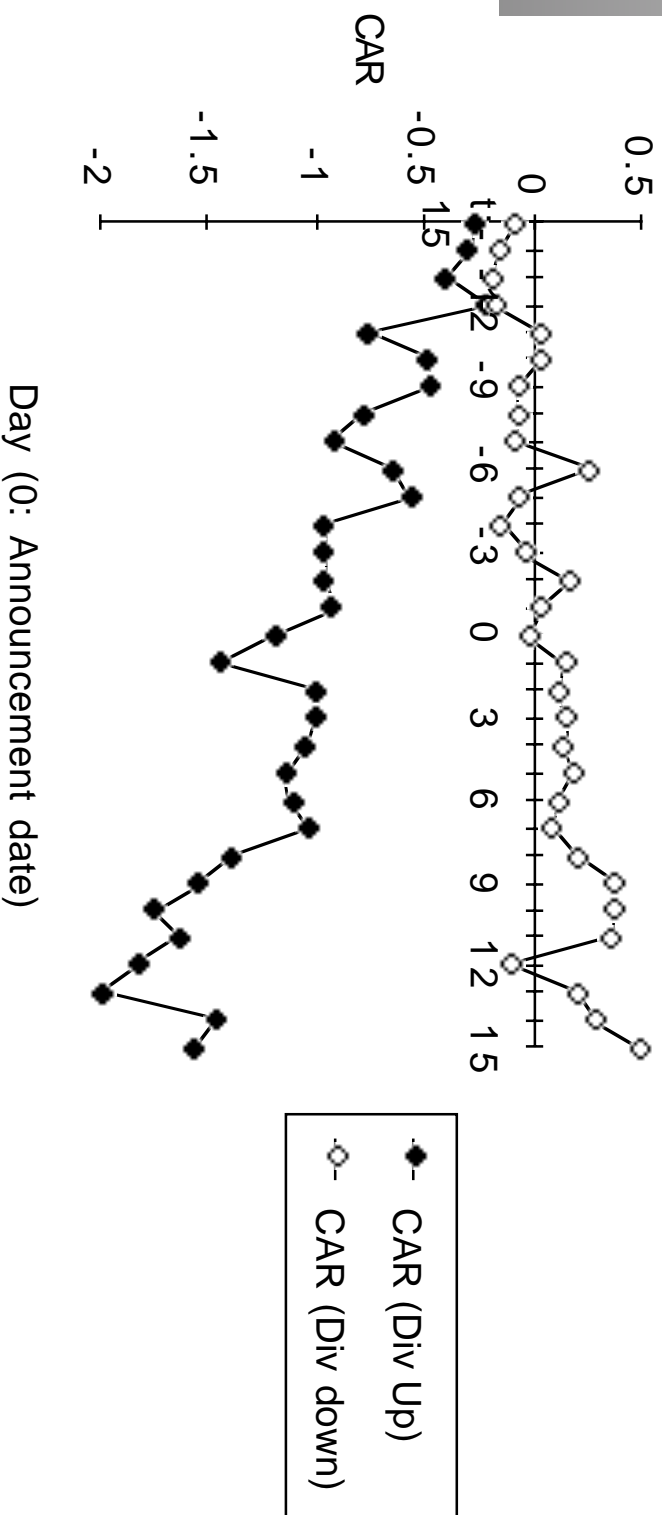
FIGURE 1
MEDIAN EARNINGS
GROWTH RATES IN YEARS
SURROUNDING FIRST-TIME
DIVIDEND PAYMENTS*



*In our original research we compare earnings performance as earnings changes standardized by stock prices. Here we convert these values to earnings growth rates by assuming that the average price-earnings ratio for the sample firms is ten.

The Wealth Transfer Hypothesis

EXCESS RETURNS ON STRAIGHT BONDS AROUND DIVIDEND CHANGES



Management Beliefs about Dividend Policy

- A firm's dividend payout ratio affects its stock price.
- Dividend payments operate as a signal to financial markets
- Dividend announcements provide information to financial markets.
- Investors think that dividends are safer than retained earnings
- Investors are not indifferent between dividends and price appreciation.
- Stockholders are attracted to firms that have dividend policies that they like.

Determinants of Dividend Policy

- *Investment Opportunities*: More investment opportunities - > Lower Dividends
- *Stability in earnings*: More stable earnings -> Higher Dividends
- *Alternative sources of capital*: More alternative sources -> Higher Dividends
- *Constraints*: More constraints imposed by bondholders and lenders -> Lower Dividends
- *Signaling Incentives*: More options to supply information to financial markets - Lower need to pay dividends as signal
- *Stockholder characteristics*: Older, poorer stockholders -> Higher dividends

Questions to Ask in Dividend Policy Analysis

- How much could the company have paid out during the period under question?
- How much did the company actually pay out during the period in question?
- How much do I trust the management of this company with excess cash?
 - How well did they make investments during the period in question?
 - How well has my stock performed during the period in question?

A Measure of How Much a Company Could have Afforded to Pay out: FCFE

- The Free Cashflow to Equity (FCFE) is a measure of how much cash is left in the business after non-equity claimholders (debt and preferred stock) have been paid, and after any reinvestment needed to sustain the firm's assets and future growth.

Net Income

+ Depreciation & Amortization

= Cash flows from Operations to Equity Investors

- Preferred Dividends

- Capital Expenditures

- Working Capital Needs

- Principal Repayments

+ Proceeds from New Debt Issues

= Free Cash flow to Equity

Estimating FCFE when Leverage is Stable

Net Income

$$\begin{aligned} & - (1 - \delta) \text{ (Capital Expenditures - Depreciation)} \\ & - (1 - \delta) \text{ Working Capital Needs} \\ & = \text{Free Cash flow to Equity} \end{aligned}$$

δ = Debt/Capital Ratio

For this firm,

- Proceeds from new debt issues = Principal Repayments + δ (Capital Expenditures - Depreciation + Working Capital Needs)

An Example: FCFE Calculation

- Consider the following inputs for Microsoft in 1996. In 1996, Microsoft's FCFE was:

- Net Income = \$2,176 Million
- Capital Expenditures = \$494 Million
- Depreciation = \$ 480 Million
- Change in Non-Cash Working Capital = \$ 35 Million
- Debt Ratio = 0%

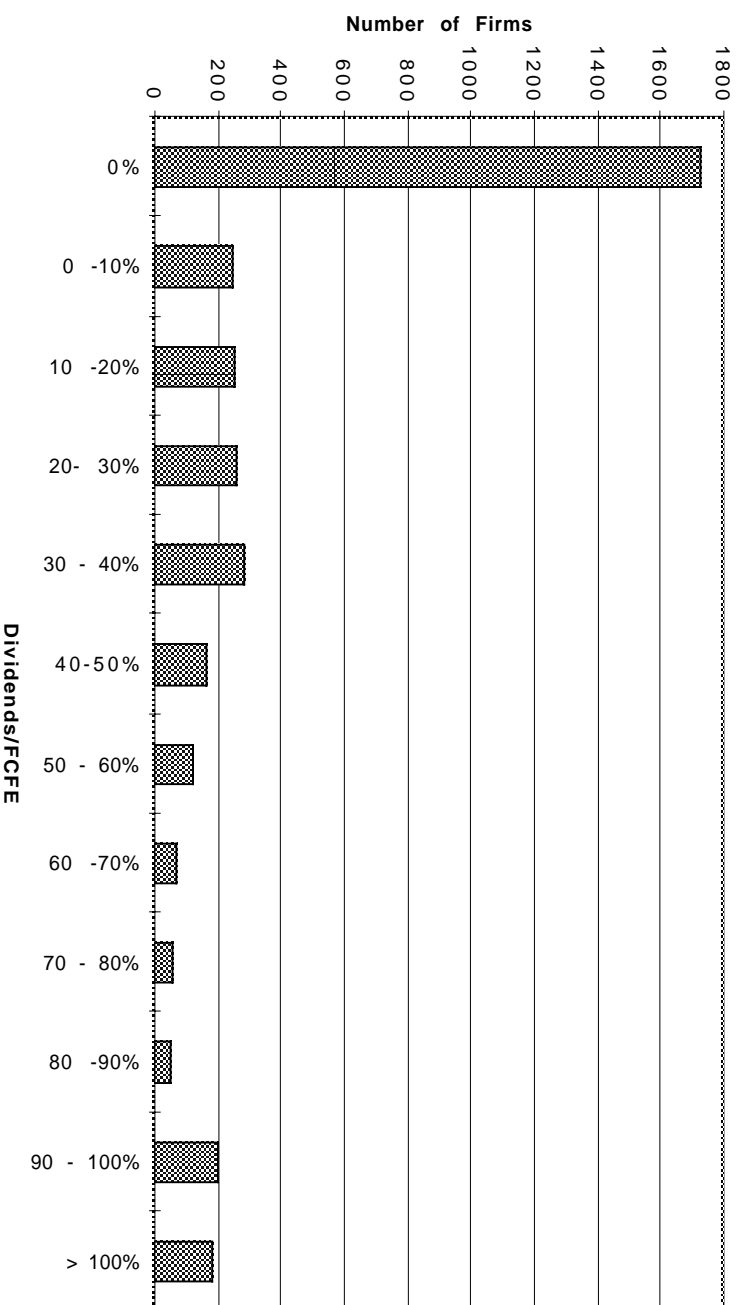
- $$\begin{aligned} \text{FCFE} &= \text{Net Income} - (\text{Cap ex} - \text{Depr}) (1-\text{DR}) - \text{Chg WC} (1-\text{DR}) \\ &= \$ 2,176 \quad - (494 - 480) (1-0) \quad - \$ 35 (1-0) \\ &= \$ 2,127 \text{ Million} \end{aligned}$$

Microsoft: Dividends?

- By this estimation, Microsoft could have paid \$ 2,127 Million in dividends/stock buybacks in 1996. They paid no dividends and bought back no stock. Where will the \$2,127 million show up in Microsoft's balance sheet?

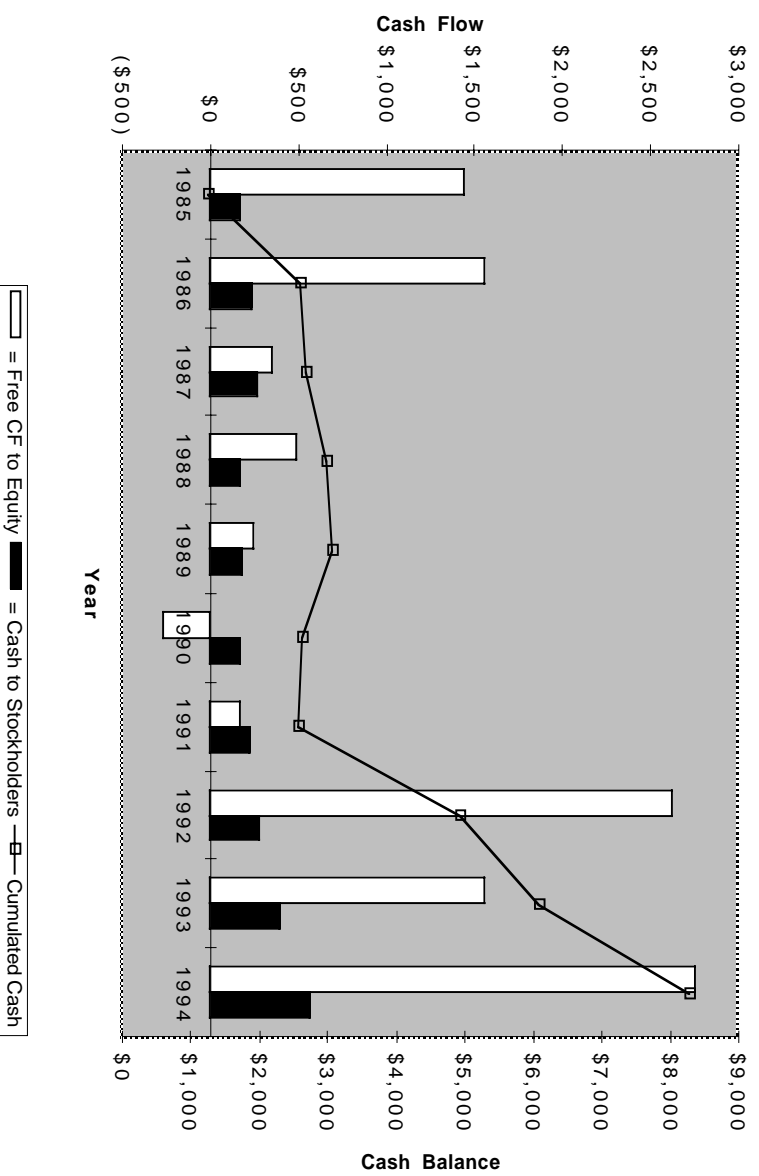
Dividends versus FCFE: U.S.

Figure 11.1: Dividends/FCFE : NYSE Firms in 1996



The Consequences of Failing to pay FCFE

Chrysler: FCFE, Dividends and Cash Balance





Application Test: Estimating your firm's FCFE

In General,

Net Income

- + Depreciation & Amortization
- Capital Expenditures
- Change in Non-Cash Working Capital
- Preferred Dividend
- Principal Repaid
- + New Debt Issued

= FCFE

Compare to

Dividends (Common)

+ Stock Buybacks

If cash flow statement used
Net Income

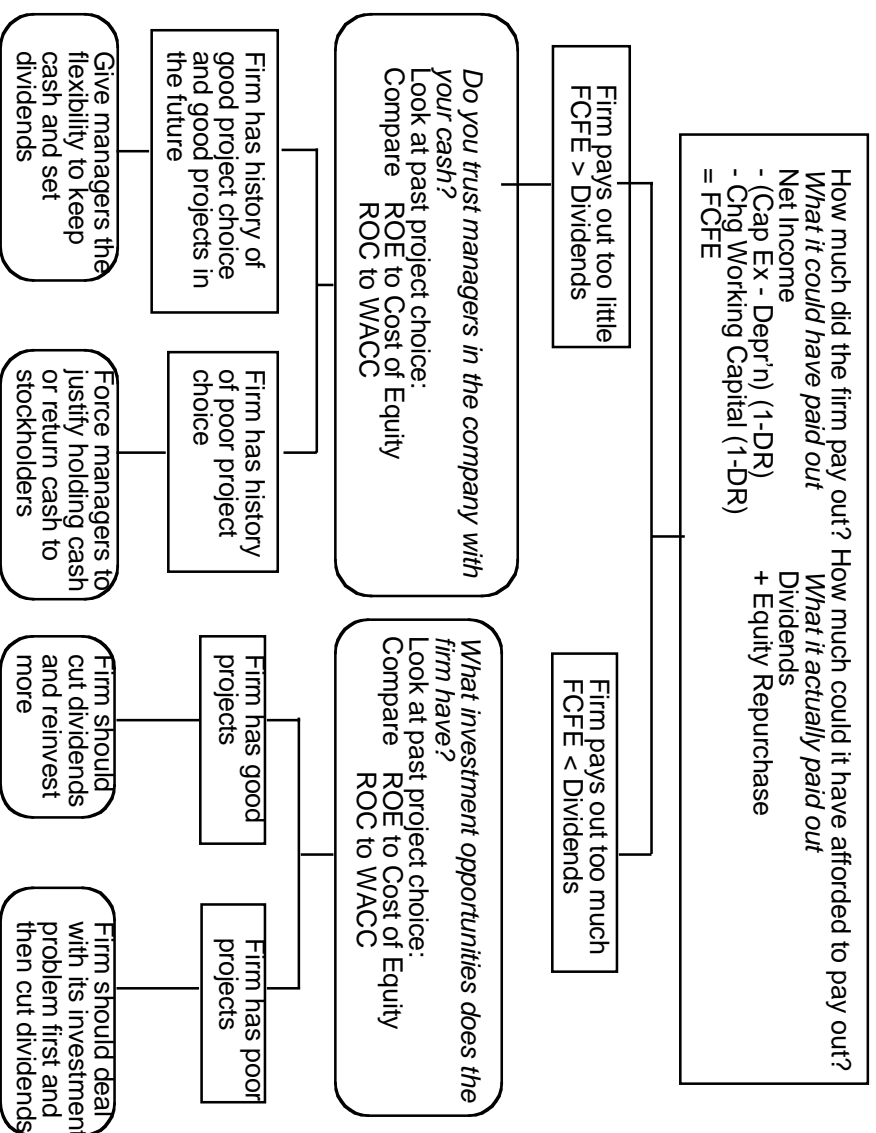
- + Depreciation & Amortization
- + Capital Expenditures
- + Changes in Non-cash WC
- + Preferred Dividend
- + Increase in LT Borrowing
- + Decrease in LT Borrowing
- + Change in ST Borrowing

= FCFE

-Common Dividend

- Decrease in Capital Stock
- + Increase in Capital Stock

A Practical Framework for Analyzing Dividend Policy



A Dividend Matrix

FCFE - Dividends

<p><i>Significant pressure on managers to pay cash out</i></p> <p>Cash Surplus</p>	<p><i>Maximum Flexibility in Dividend Policy</i></p> <p>Good Projects</p>
<p>Poor Projects</p> <p><i>Investment and Dividend problems; cut dividends but also check project choice</i></p> <p>Cash Deficit</p>	<p>Reduce cash payout to stockholders</p>

ROC - WACC

Disney: An analysis of FCFE from 1992-1996

Year	Net Income	(Cap Ex- Depr) (1- Debt Ratio)	Chg in WC (1-Debt Ratio)	FCFE
1992	\$817	\$173	(\$81)	\$725
1993	\$889	\$328	\$160	\$402
1994	\$1,110	\$469	\$498	\$143
1995	\$1,380	\$325	\$206	\$849
1996*	\$1,214	\$466	(\$470)	\$1,218
Avg	\$1,082	\$352	\$63	\$667

(The numbers for 1996 are reported without the Capital Cities Acquisition)

The debt ratio used to estimate the free cash flow to equity was estimated as follows = $\text{Net Debt Issues} / (\text{Net Cap Ex} + \text{Change in Non-cash WC})$

Disney's Dividends and Buybacks from 1992 to 1996

Year	FCFE	Dividends + Stock Buybacks
1992	\$725	\$105
1993	\$402	\$160
1994	\$143	\$724
1995	\$849	\$529
1996	\$1,218	\$733
Average	\$667	\$450

Disney: Dividends versus FCFE

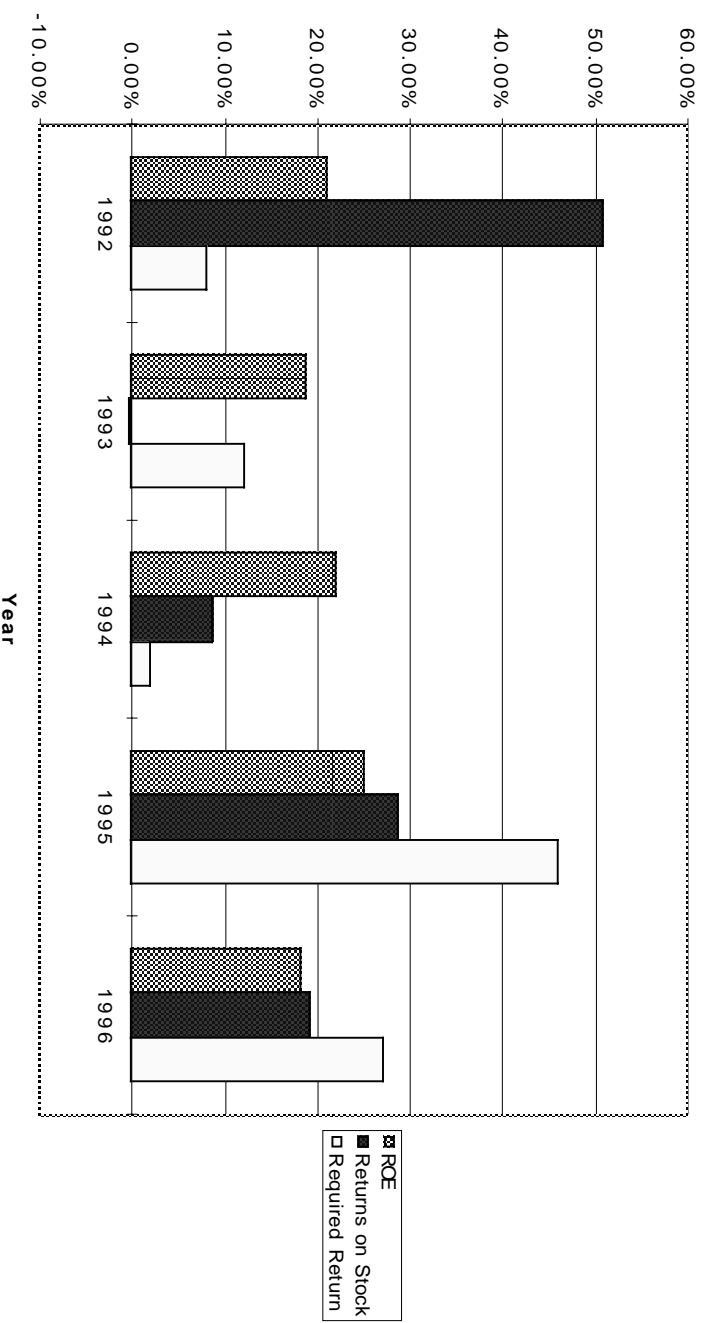
- Disney paid out \$ 217 million less in dividends (and stock buybacks) than it could afford to pay out. How much cash do you think Disney accumulated during the period?

Can you trust Disney's management?

- During the period 1992-1996, Disney had
 - an average return on equity of 21.07% on projects taken
 - earned an average return on 21.43% for its stockholders
 - a cost of equity of 19.09%
- Disney has taken good projects and earned above-market returns for its stockholders during the period.
- If you were a Disney stockholder, would you be comfortable with Disney's dividend policy?
 - Yes
 - No

Disney: Return Performance Trends

Returns on Equity, Stock and Required Returns - Disney



The Bottom Line on Disney Dividends

- Disney could have afforded to pay more in dividends during the period of the analysis.
- It chose not to, and used the cash for the ABC acquisition.
- The excess returns that Disney earned on its projects and its stock over the period provide it with some dividend flexibility. The trend in these returns, however, suggests that this flexibility will be rapidly depleted.
- The flexibility will clearly not survive if the ABC acquisition does not work out.

Aracruz: Dividends and FCFE: 1994-1996

	<i>1994</i>	<i>1995</i>	<i>1996</i>
Net Income	BR248.21	BR326.42	BR47.00
- (Cap. Exp - Depr)*(1-DR)	BR174.76	BR197.20	BR14.96
- Δ Working Capital*(1-DR)	(BR47.74)	BR15.67	(BR23.80)
= Free CF to Equity	BR121.19	BR113.55	BR55.84
Dividends	BR80.40	BR113.00	BR27.00
+ Equity Repurchases	BR 0.00	BR 0.00	BR 0.00
= Cash to Stockholders	BR80.40	BR113.00	BR27.00

Aracruz: Investment Record

	1994	1995	1996
<i>Project Performance Measures</i>			
ROE	19.98%	16.78%	2.06%
Required rate of return	3.32%	28.03%	17.78%
Difference	16.66%	-11.25%	-15.72%
<i>Stock Performance Measure</i>			
Returns on stock	50.82%	-0.28%	8.65%
Required rate of return	3.32%	28.03%	17.78%
Difference	47.50%	-28.31%	-9.13%

Aracruz: Its your call..

- Assume that you are a large stockholder in Aracruz. They have a history of paying less in dividends than they have available in FCFE and have accumulated a cash balance of roughly 1 billion BR (25% of the value of the firm). Would you trust the managers at Aracruz with your cash?

- Yes
- No

Mandated Dividend Payouts

- There are many countries where companies are mandated to pay out a certain portion of their earnings as dividends. Given our discussion of FCFE, what types of companies will be hurt the most by these laws?
- Large companies making huge profits
- Small companies losing money
- High growth companies that are losing money
- High growth companies that are making money

BP: Dividends- 1983-92

	1	2	3	4	5	6	7	8	9	10
Net Income	\$1,256.00	\$1,626.00	\$2,309.00	\$1,098.00	\$2,076.00	\$2,140.00	\$2,542.00	\$2,946.00	\$712.00	\$947.00
-(Cap. Exp - Depn)*(1-DR)	\$1,499.00	\$1,281.00	\$1,737.50	\$1,600.00	\$580.00	\$1,184.00	\$1,090.50	\$1,975.50	\$1,545.50	\$1,100.00
θ Working Capital*(1-DR)	\$369.50	(\$286.50)	\$678.50	\$82.00	(\$2,268.00)	(\$984.50)	\$429.50	\$1,047.50	(\$305.00)	(\$415.00)
= Free CF to Equity	(\$612.50)	\$631.50	(\$107.00)	(\$584.00)	\$3,764.00	\$1,940.50	\$1,022.00	(\$77.00)	(\$528.50)	\$262.00
Dividends	\$831.00	\$949.00	\$1,079.00	\$1,314.00	\$1,391.00	\$1,961.00	\$1,746.00	\$1,895.00	\$2,112.00	\$1,685.00
+ Equity Repurchases										
= Cash to Stockholders	\$831.00	\$949.00	\$1,079.00	\$1,314.00	\$1,391.00	\$1,961.00	\$1,746.00	\$1,895.00	\$2,112.00	\$1,685.00
<i>Dividend Ratios</i>										
Payout Ratio	66.16%	58.36%	46.73%	119.67%	67.00%	91.64%	68.69%	64.32%	296.63%	177.93%
Cash Paid as % of FCFE	-135.67%	150.28%	-1008.41%	-225.00%	36.96%	101.06%	170.84%	-2461.04%	-399.62%	643.13%
<i>Performance Ratios</i>										
<i>I. Accounting Measure</i>										
ROE	9.58%	12.14%	19.82%	9.25%	12.43%	15.60%	21.47%	19.93%	4.27%	7.66%
Required rate of return	19.77%	6.99%	27.27%	16.01%	5.28%	14.72%	26.87%	-0.97%	25.86%	7.12%
Difference	-10.18%	5.16%	-7.45%	-6.76%	7.15%	0.88%	-5.39%	20.90%	-21.59%	0.54%

BP: Summary of Dividend Policy

	<i>Summary of calculations</i>			
	<i>Average</i>	<i>Standard Deviation</i>	<i>Maximum</i>	<i>Minimum</i>
<i>Free CF to Equity</i>	\$571.10	\$1,382.29	\$3,764.00	(\$612.50)
<i>Dividends</i>	\$1,496.30	\$448.77	\$2,112.00	\$831.00
<i>Dividends+Repurchases</i>	\$1,496.30	\$448.77	\$2,112.00	\$831.00
<i>Dividend Payout Ratio</i>	84.77%			
<i>Cash Paid as % of FCFE</i>	262.00%			
<i>ROE - Required return</i>	-1.67%	11.49%	20.90%	-21.59%

BP: Just Desserts!

B.P.'s Shares Plummet After Dividend Is Slashed

By MATTHEW L. WALD

British Petroleum said yesterday that it would cut its dividend by 25 percent, take a pre-tax restructuring charge of \$1.67 billion for the second quarter of 1991 and report a net profit of 10 percent for its worldwide operations. The news came five weeks after Robert S. Horton, B.P.'s chairman, resigned under pressure from the company's outside directors.

Analysts anticipated a dividend cut by the company, but the writ's sharp decline has surprised investors at the low end of their expectations. In response, shares of the company's American depository rights, each of which represents 13 shares of the London-based company, dropped 24.5 percent, to \$41.75, in the New York Stock Exchange, with 138 million shares traded.

The Royal Dutch/Shell group also reported a disappointing quarter yesterday, with earnings on a replacement cost basis — excluding gains or losses on treasury holdings — of \$888 million, down 21 percent.

Adding to the gloom at B.P. was the announcement that the company would cut its dividend by 25 percent. "Several interesting conditions are expected to remain difficult, particularly for the downstream of acid chemicals businesses, with growth prospects for the world's oil industry very poor," Horton said in a statement. "Restrictions on manufacturing operations for refining and marketing operations, as distinct from oil production, have increased. Domestic margins in the United States would be lower than the year, he predicted, when then Mr. Trask

also offered that gasoline must be priced at a profit of 10 percent above the seasonal heating oil of 40¢ a gallon, he said.

The crude oil market, he predicted, would remain balanced unless OPEC cuts, which would prevent the market from reaching a price advantage of any kind.

The giant British oil company bet on rising oil prices.

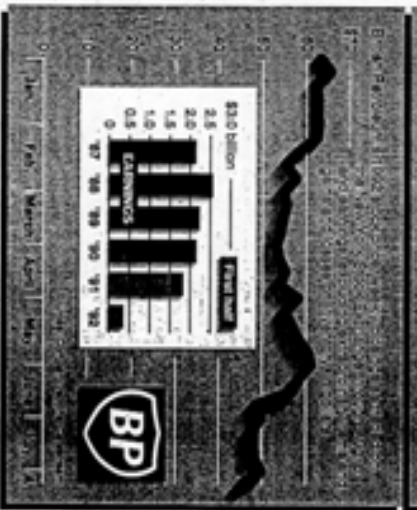
increase in oil prices, but the company's oil production in the United States is declining. B.P. is the largest producer in Alaska.

The company's production in Europe remains flat, but its production in the second quarter declined to \$112 million from \$115 million, while investment on a replacement-cost basis, James J. McCreary, an analyst at Standard C. Herrington, said yesterday.

Analysts attributed B.P.'s problems to the company's acquisitions in the last few years and heavy capital spending. "The company's investment program is recent history," Trask said.

McCreary said, "Check your investment program and profits have gone to hell." McCreary, who worked for Standard Oil of Ohio, said that B.P.

Britain's Oil Colossus



after B.P. acquired Solbin, said that the company's investment program is recent history. "The company's investment program is recent history," Trask said. "Check your investment program and profits have gone to hell." McCreary, who worked for Standard Oil of Ohio, said that B.P.

as it was recording a depreciation charge of \$1.67 billion for the second quarter of 1991. "Several interesting conditions are expected to remain difficult, particularly for the downstream of acid chemicals businesses, with growth prospects for the world's oil industry very poor," Horton said in a statement. "Restrictions on manufacturing operations for refining and marketing operations, as distinct from oil production, have increased. Domestic margins in the United States would be lower than the year, he predicted, when then Mr. Trask

Continued on Page D1.

The Limited: Summary of Dividend Policy: 1983-1992

	<i>Summary of calculations</i>			
	<i>Average</i>	<i>Standard Deviation</i>	<i>Maximum</i>	<i>Minimum</i>
<i>Free CF to Equity</i>	(\$34.20)	\$109.74	\$96.89	(\$242.17)
<i>Dividends</i>	\$40.87	\$32.79	\$101.36	\$5.97
<i>Dividends+Repurchases</i>	\$40.87	\$32.79	\$101.36	\$5.97
<i>Dividend Payout Ratio</i>	18.59%			
<i>Cash Paid as % of FCFE</i>	-119.52%			
<i>ROE - Required return</i>	1.69%	19.07%	29.26%	-19.84%

Growth Firms and Dividends

- High growth firms are sometimes advised to initiate dividends because its increases the potential stockholder base for the company (since there are some investors - like pension funds - that cannot buy stocks that do not pay dividends) and, by extension, the stock price. Do you agree with this argument?

Yes

No

Why?



Application Test: Assessing your firm's dividend policy

- Compare your firm's dividends to its FCFE, looking at the last 5 years of information.
- Based upon your earlier analysis of your firm's project choices, would you encourage the firm to return more cash or less cash to its owners?
- If you would encourage it to return more cash, what form should it take (dividends versus stock buybacks)?

Other Actions that affect Stock Prices

- In the case of dividends and stock buybacks, firms change the value of the assets (by paying out cash) and the number of shares (in the case of buybacks).
-

There are other actions that firms can take to change the value of their stockholder's equity.

- *Divestitures*: They can sell assets to another firm that can utilize them more efficiently, and claim a portion of the value.
- *Spin offs*: In a spin off, a division of a firm is made an independent entity. The parent company has to give up control of the firm.
- *Equity carve outs*: In an ECO, the division is made a semi-independent entity. The parent company retains a controlling interest in the firm.
- *Tracking Stock*: When tracking stock are issued against a division, the parent company retains complete control of the division. It does not have its own board of directors.

Differences in these actions

