

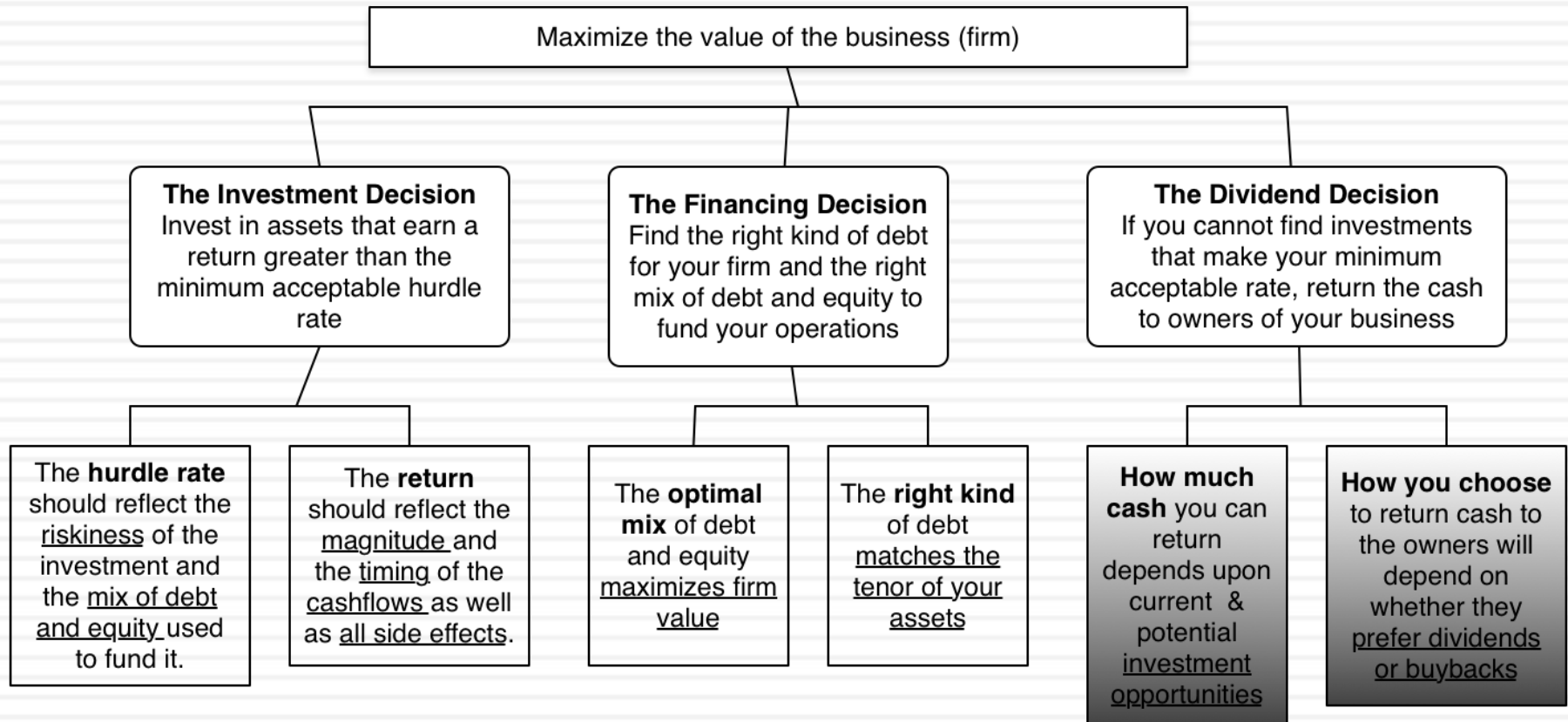


## RETURNING CASH TO THE OWNERS: DIVIDEND POLICY

“Companies don’t have cash. They hold cash for their stockholders.”

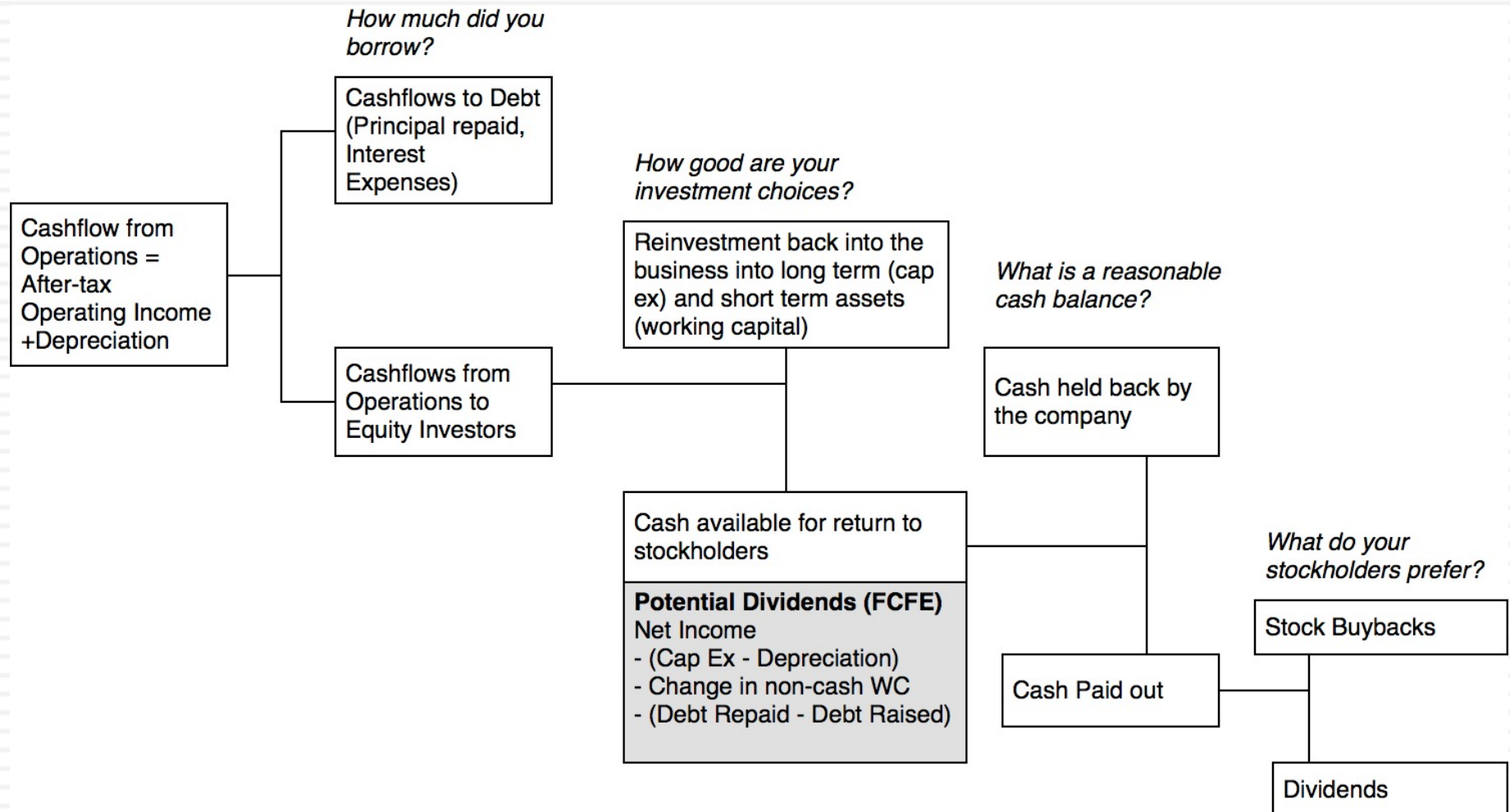
# First Principles

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# Steps to the Dividend Decision... if equity is treated as a residual claim

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# The Roots of Dividend Dysfunction

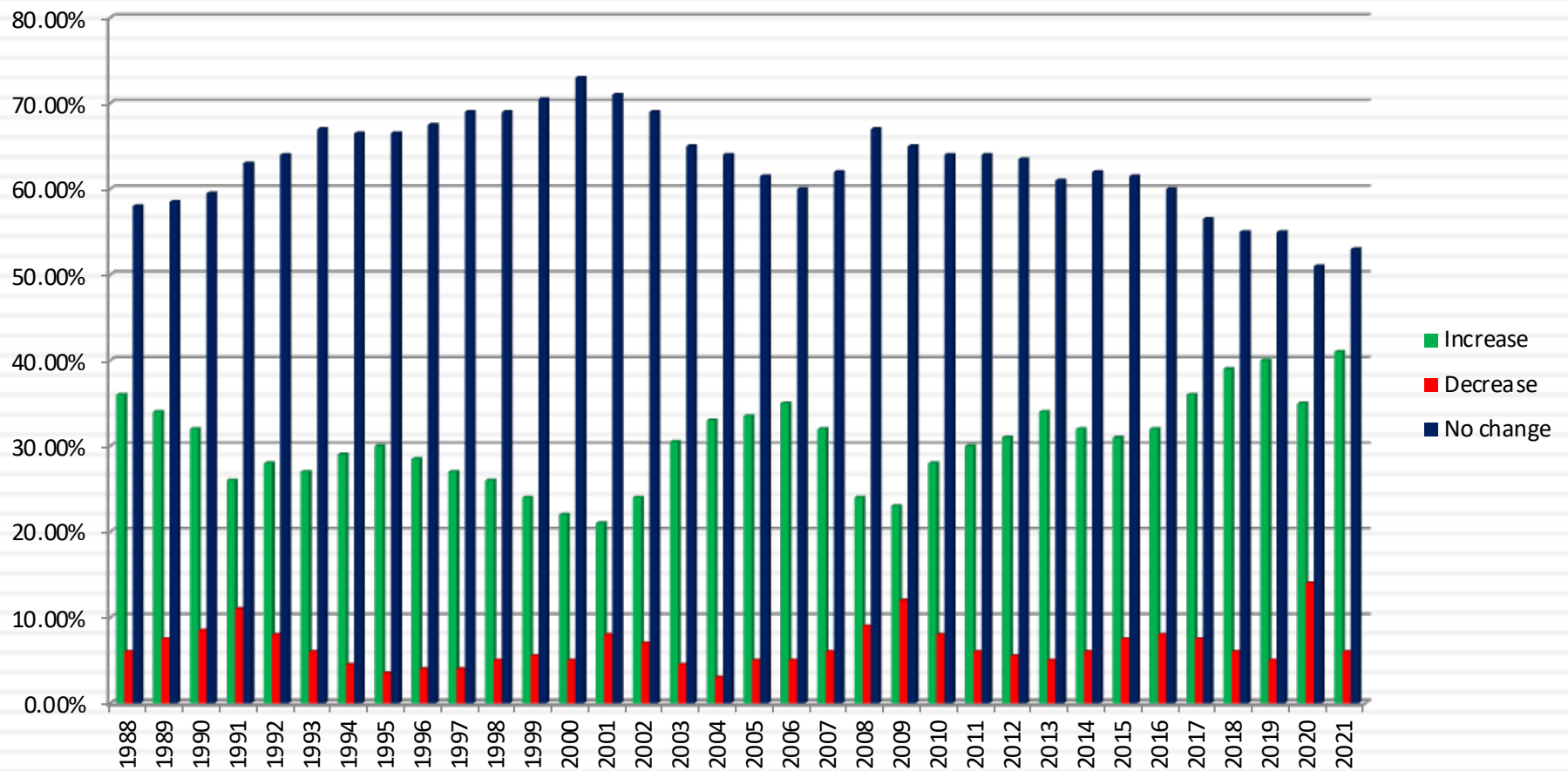
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- In practice, dividend policy is dysfunctional and does not follow the logical process of starting with your investment opportunities and working your way down to residual cash.
- The two dominant factors driving dividend policy around the world are:
  - Inertia: Companies seem to hate to let of their past, when it comes to dividend policy.
  - Me-too-ism: Companies want to behave like their peer group.

# I. Dividends are sticky

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*Dividend Changes at US companies*



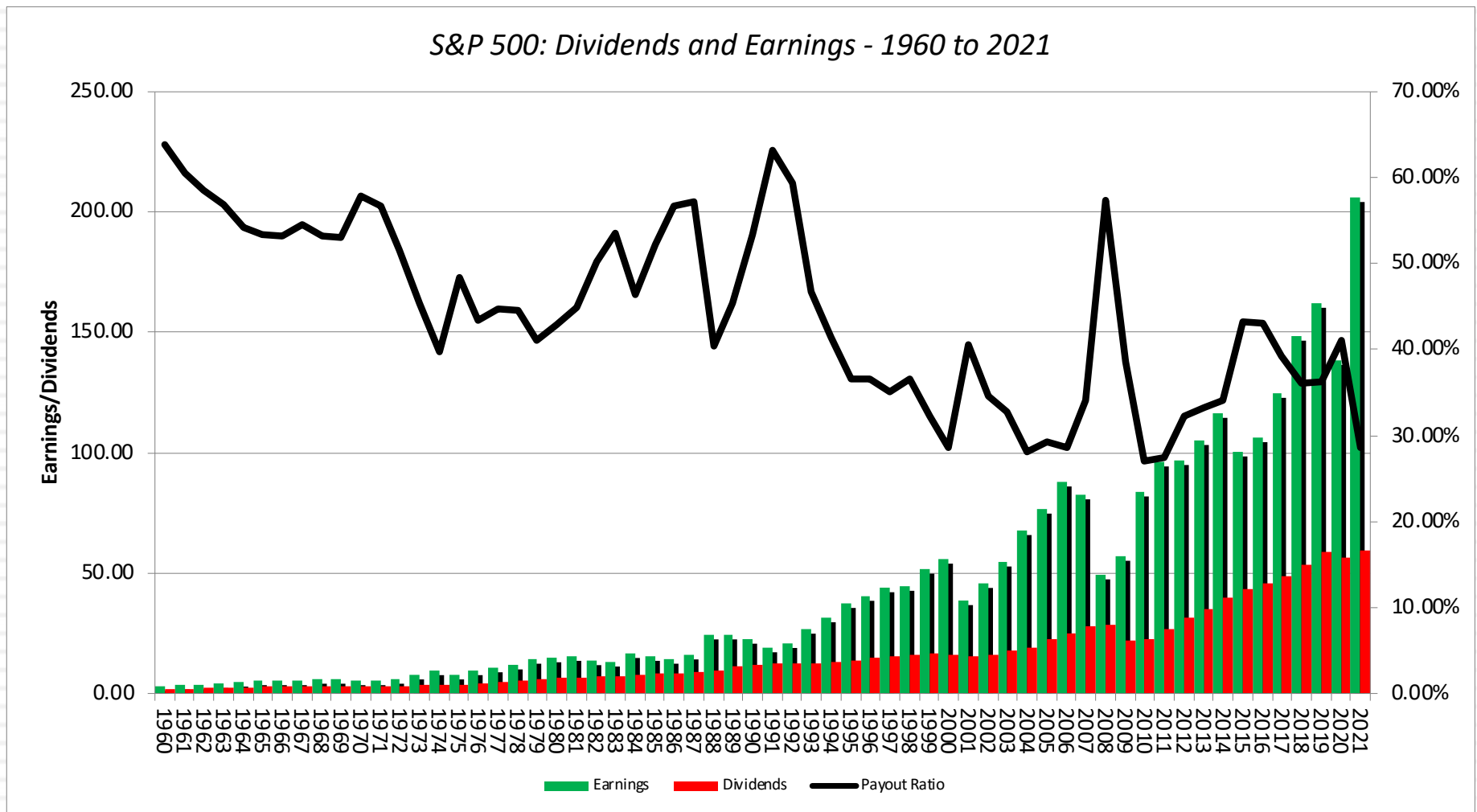
In 2020, a crisis year for many companies...here is what they did..

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- Of the S&P 500 companies, 287 companies increased their dividends and 11 companies initiated dividends.
- Of the S&P 500 companies, 27 decreased dividends and 42 suspended dividends.
  - While the 42 dividend suspensions were the most in the last 20 years, the number of companies that increased dividends (298) vastly exceeded the number that cut or suspended dividends (69).
  - In perhaps the most revealing statistic of all, 133 of the 500 largest market cap companies did not pay dividends leading into 2020 or in 2020.

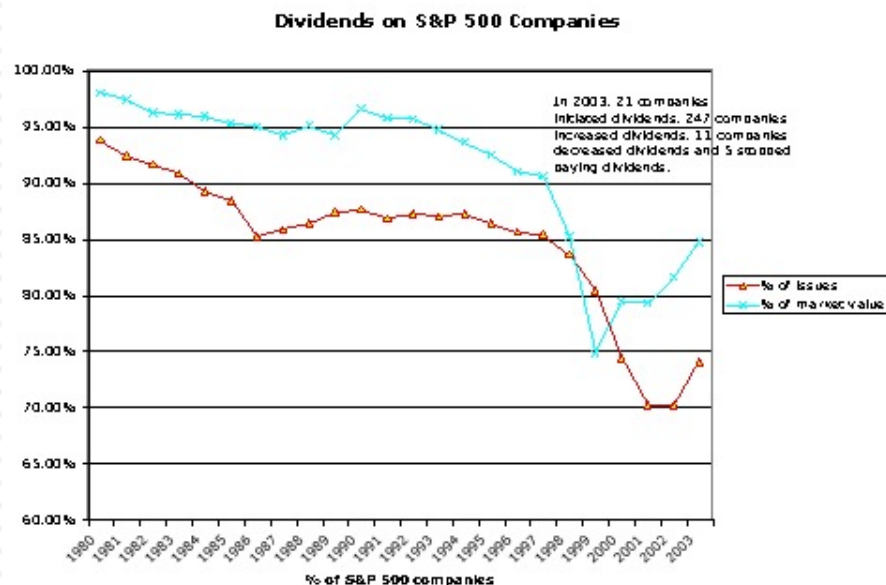
## II. Dividends tend to follow earnings

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# III. Are affected by tax laws...

## In 2003



## In the last quarter of 2012

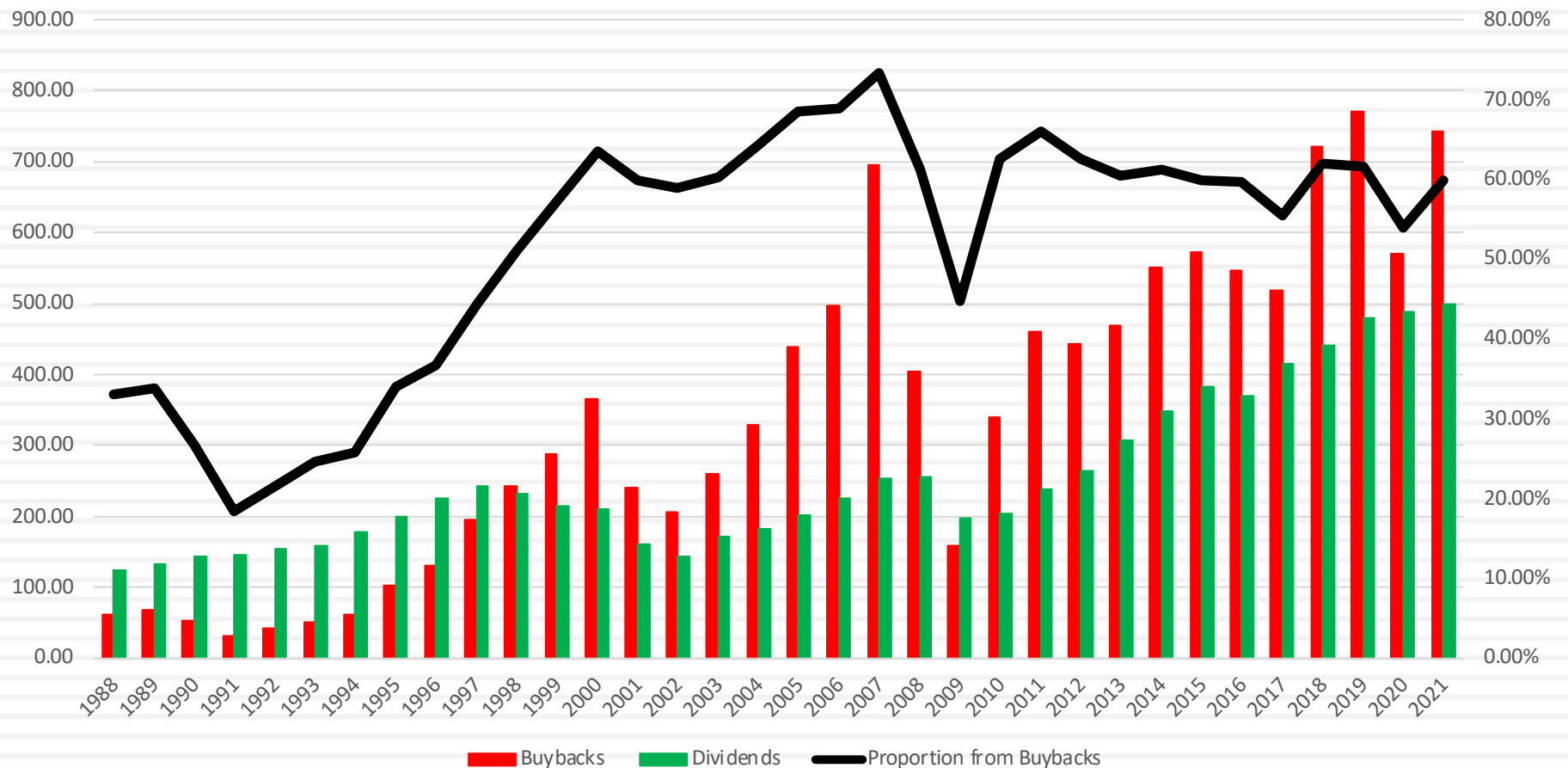
- As the possibility of tax rates reverting back to pre-2003 levels rose, 233 companies paid out \$31 billion in dividends.
- Of these companies, 101 had insider holdings in excess of 20% of the outstanding stock.



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

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*Dividends and Buybacks on S&P 500: 1988- 2021*



# And its going global.. In 2021

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Sub Region	Number of firms	Market Cap (\$ mil)	Net Income (\$ mil)	Dividends (\$ mil)	Buybacks (\$ mil)	Dividend Payout	% of cash from Buybacks	Cash Payout Ratio
Africa and Middle East	2,356	4698102	260259	138928	\$ 12,274.95	53.38%	8.12%	58.10%
Australia & NZ	1,878	1930982	77123	45034	\$ 6,578.66	58.39%	12.75%	66.92%
Canada	2,937	3129490	162432	65382	\$ 34,780.69	40.25%	34.72%	61.66%
China	7,043	19024215	1001151	471821	\$ 50,414.13	47.13%	9.65%	52.16%
Eastern Europe & Russia	528	649262	99799	33562	\$ 6,154.50	33.63%	15.50%	39.80%
EU & Environs	6,000	17098249	868662	332208	\$ 132,019.21	38.24%	28.44%	53.44%
India	3,982	3572361	120717	35772	\$ 8,540.15	29.63%	19.27%	36.71%
Japan	3,947	6510572	448920	127328	\$ 58,087.77	28.36%	31.33%	41.30%
Latin America & Caribbean	1,043	1724743	122751	61399	\$ 17,400.56	50.02%	22.08%	64.19%
Small Asia	9,408	7205112	426861	160991	\$ 10,953.15	37.72%	6.37%	40.28%
UK	1,255	3599149	193457	86628	\$ 18,860.98	44.78%	17.88%	54.53%
United States	7,229	52446672	1789714	591709	\$ 842,299.68	33.06%	58.74%	80.12%
Global	47,607	121588908	5571847	2150763	\$ 1,198,364.43	38.60%	35.78%	60.11%

*\$ values are all in millions of US \$*

# Measures of Dividend Policy

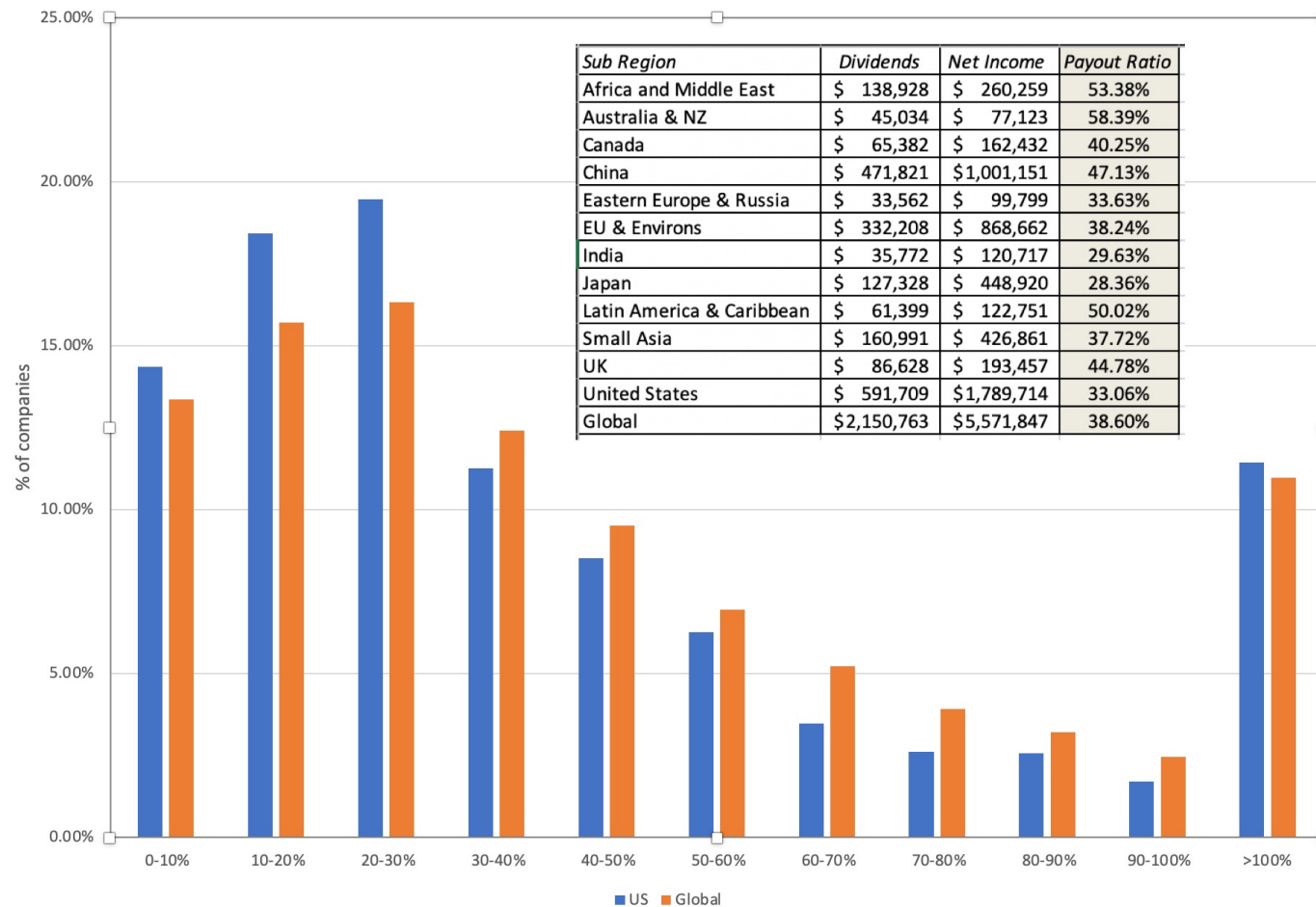
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- Dividend Payout = Dividends/ Net Income
  - Measures the percentage of earnings that the company pays in dividends
  - If the net income is negative, the payout ratio cannot be computed.
- Dividend Yield = Dividends per share/ Stock price
  - Measures the return that an investor can make from dividends alone
  - Becomes part of the expected return on the investment.

# Dividend Payout Ratio: January 2022

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Dividend Payout Ratios for Dividend Paying firms: January 2022



# Dividend Yields: January 2022

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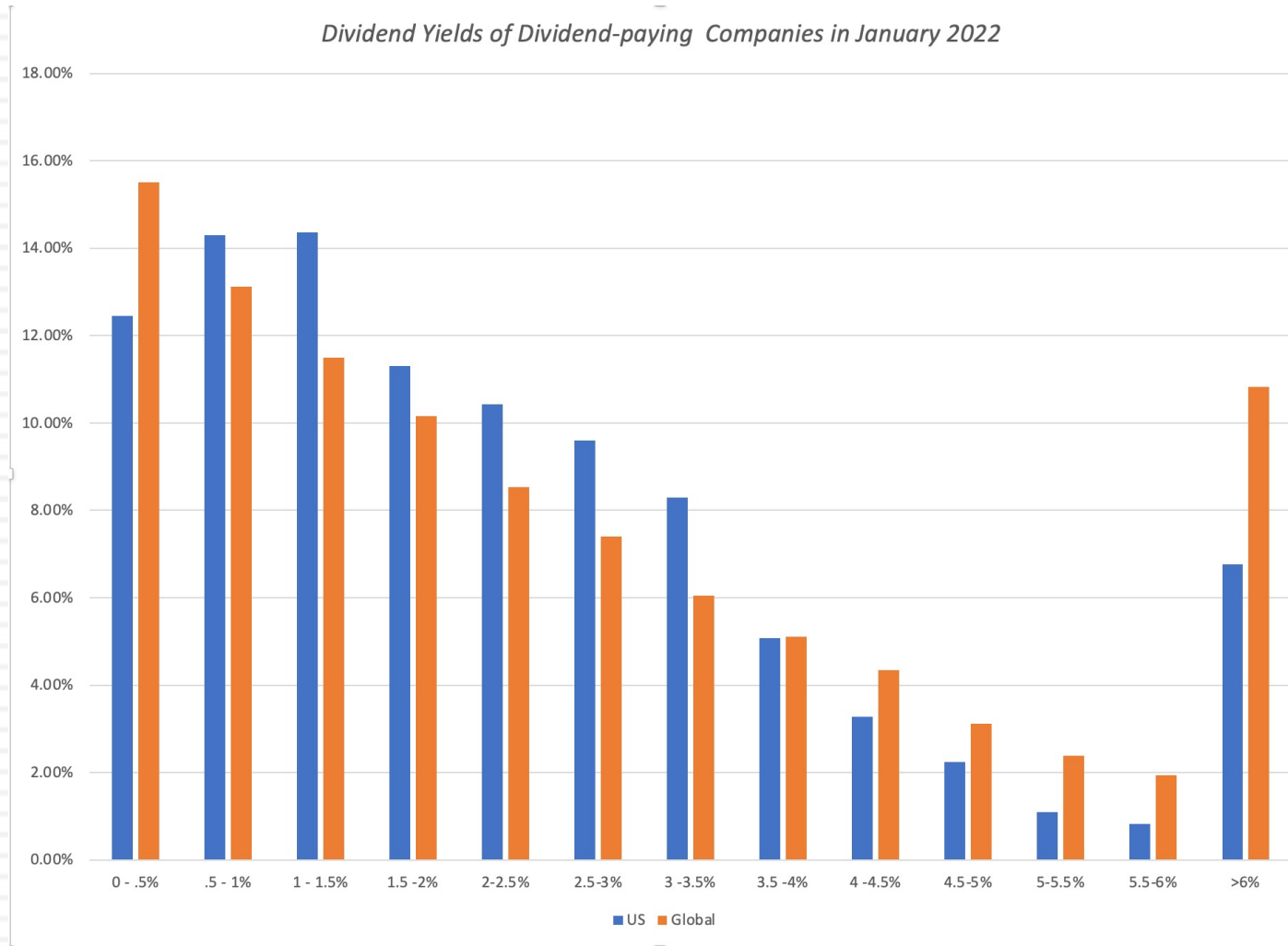
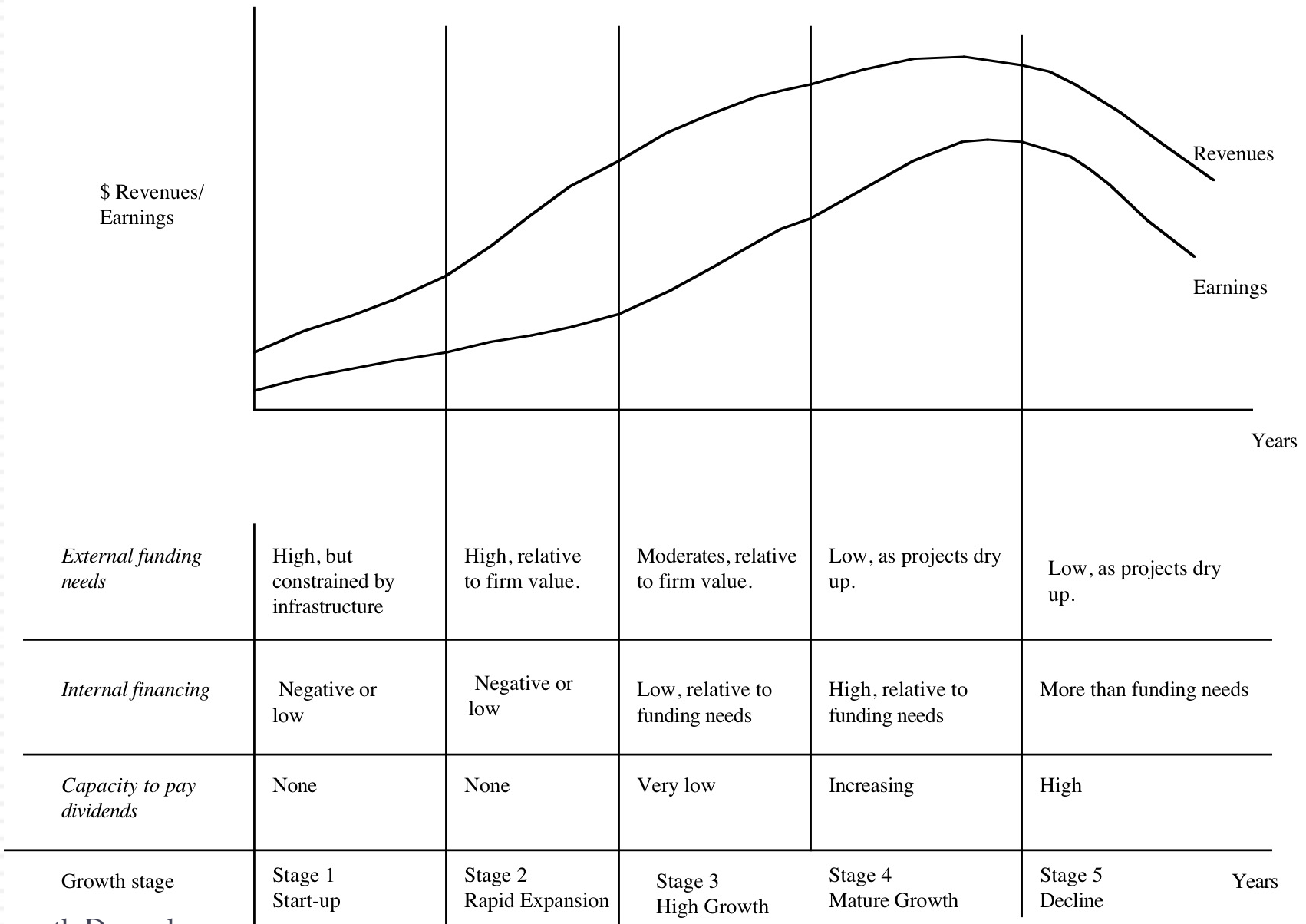


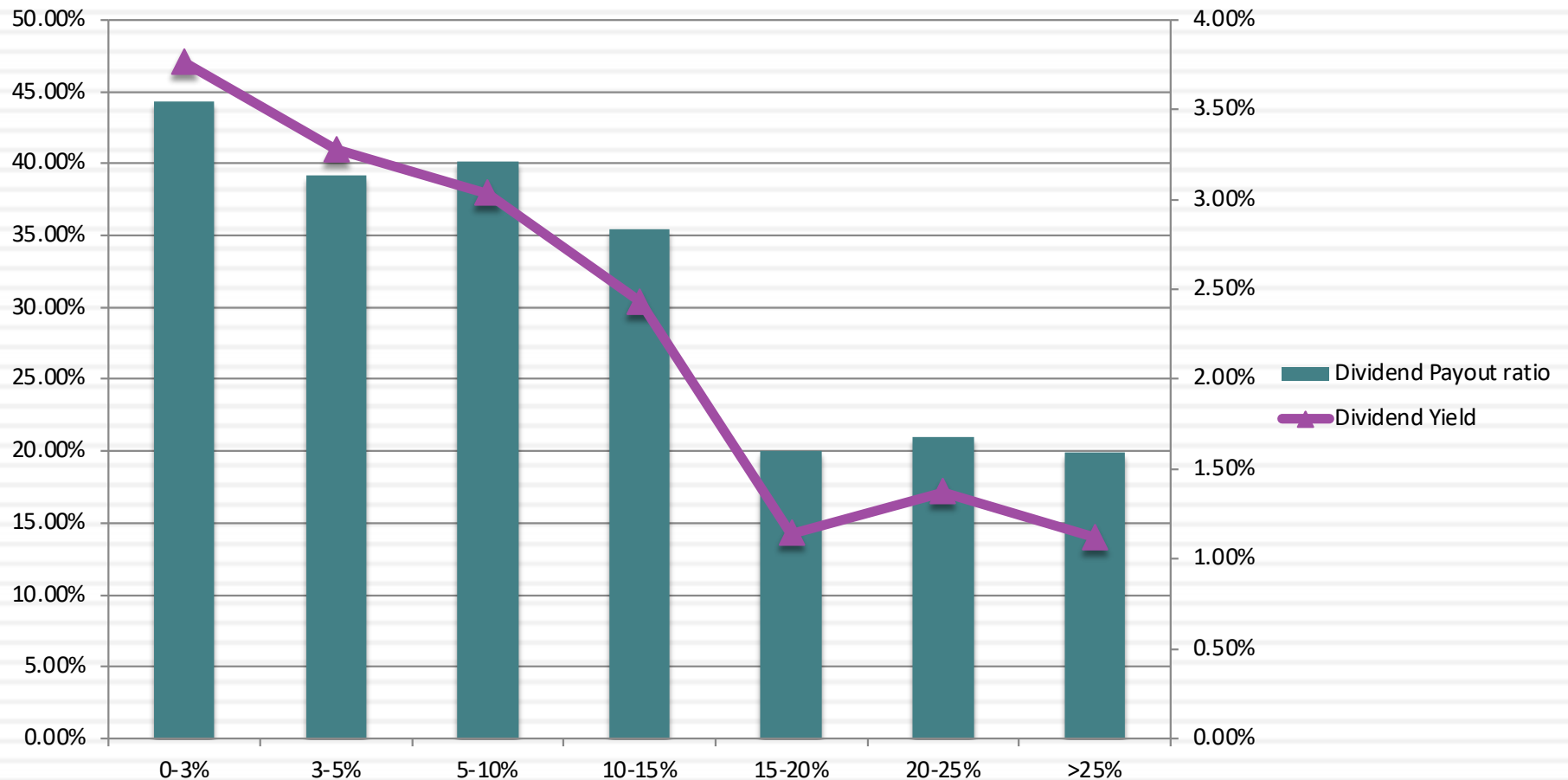
Figure 10.7: Life Cycle Analysis of Dividend Policy



# Dividend Yields and Payout Ratios: Growth Classes

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*Dividend Yields and Payout Ratios: By Growth Class*



# Dividend Policy: Disney, Vale, Tata Motors, Baidu and Deutsche Bank

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	Disney	Vale	Tata Motors	Baidu	Deutsche Bank
Dividend Yield - Last 12 months	1.09%	6.56%	1.31%	0.00%	1.96%
Dividend Payout ratio - Last 12 months	21.58%	113.45%	16.09%	0.00%	362.63%
Dividend Yield - 2008-2012	1.17%	4.01%	1.82%	0.00%	3.14%
Dividend Payout - 2008-2012	17.11%	37.69%	15.53%	0.00%	37.39%



# Three Schools Of Thought On Dividends

1. If there are no tax disadvantages associated with dividends & companies can issue stock, at no issuance cost, to raise equity, whenever needed

**Dividends do not matter, and dividend policy does not affect value.**

2. If dividends create a tax disadvantage for investors (relative to capital gains)

**Dividends are bad, and increasing dividends will reduce value**

3. If dividends create a tax advantage for investors (relative to capital gains) and/or stockholders like dividends

**Dividends are good, and increasing dividends will increase value**

# The balanced viewpoint

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

# The Dividends don't matter school

## The Miller Modigliani Hypothesis

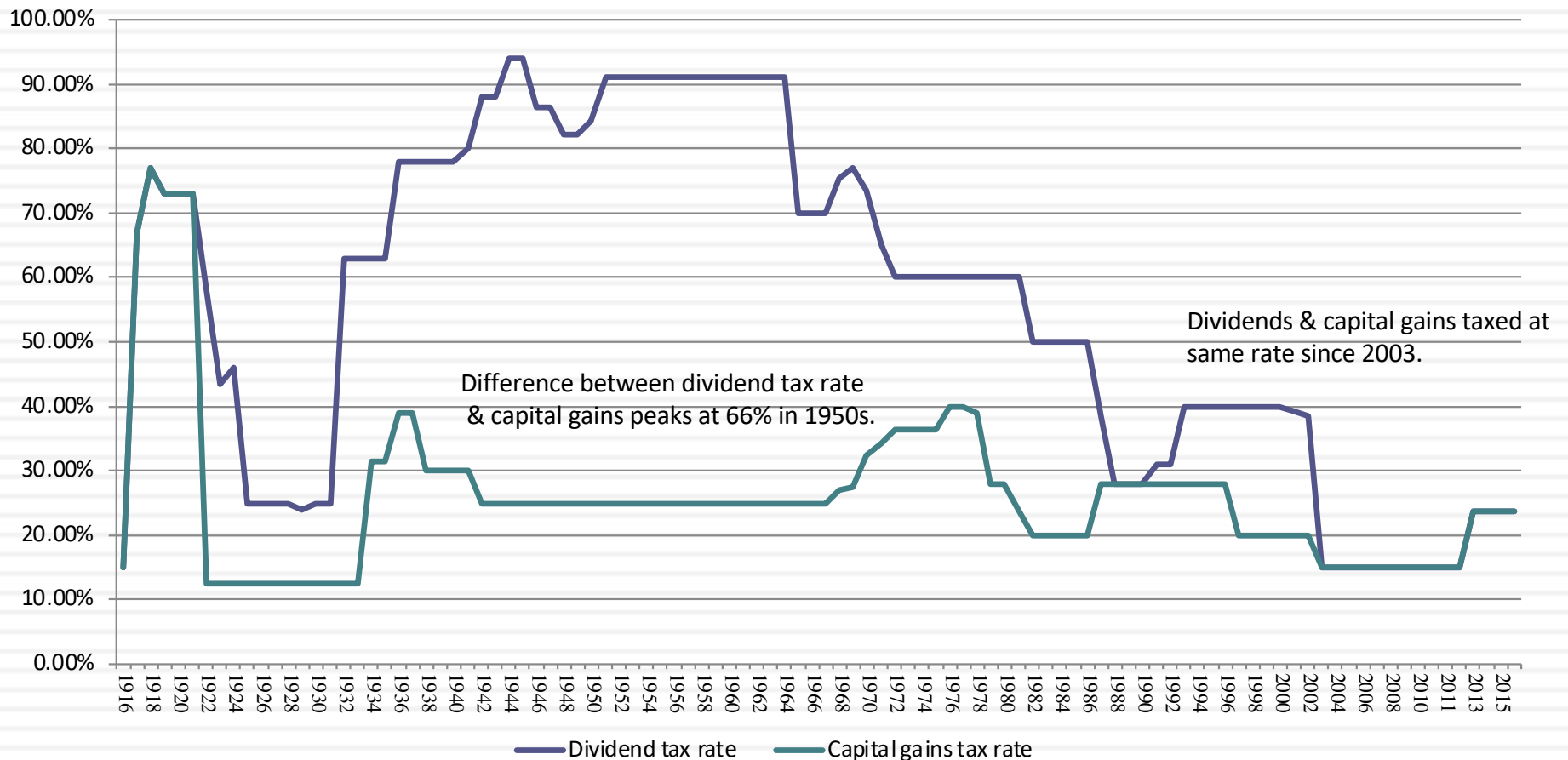
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- The Miller-Modigliani Hypothesis: Dividends do not affect value
- Basis:
  - ▣ If a firm's investment policies (and hence cash flows) don't change, the value of the firm cannot change as it changes dividends.
  - ▣ If a firm pays more in dividends, it will have to issue new equity to fund the same projects. By doing so, it will reduce expected price appreciation on the stock but it will be offset by a higher dividend yield.
  - ▣ 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 to investors 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.

## II. The Dividends are “bad” school: And the evidence to back them up...

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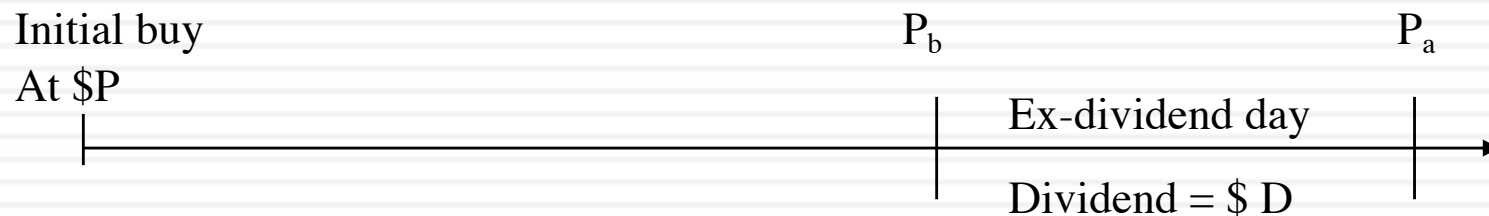
Figure 10.10: Tax rates on Dividends and Capital Gains- US



# What do investors in your stock think about dividends? Clues on the ex-dividend day!

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- Assume that you are the owner of a stock that is approaching an ex-dividend day and you know that dollar dividend with certainty. In addition, assume that you have owned the stock for several years.



$P$  = Price at which you bought the stock a “while” back

$P_b$  = 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

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- The cash flows from selling before ex-dividend day are:  
 $P_b - (P_b - P) t_{cg}$
- The cash flows from selling after 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 -  
 $P_b - (P_b - P) t_{cg} = P_a - (P_a - P) t_{cg} + D(1-t_o)$
- Some basic algebra leads us to the following:

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

# Intuitive Implications

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- The relationship between the price change on the ex-dividend day and the dollar dividend will be determined by the difference between the tax rate on dividends and the tax rate on capital gains for the typical investor in the stock.

<i>Tax Rates</i>	<i>Ex-dividend day behavior</i>
If dividends and capital gains are taxed equally	Price change = Dividend
If dividends are taxed at a higher rate than capital gains	Price change < Dividend
If dividends are taxed at a lower rate than capital gains	Price change > Dividend

# The empirical evidence...

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1966-1969

- Ordinary tax rate = 70%
- Capital gains rate = 28%
- Price change as % of Dividend = 78%

1981-1985

- Ordinary tax rate = 50%
- Capital gains rate = 20%
- Price change as % of Dividend = 85%

1986-1990

- Ordinary tax rate = 28%
- Capital gains rate = 28%
- Price change as % of Dividend = 90%



# Dividend Arbitrage

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- 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?
  - a. Invest in the stock for the long term
  - b. Sell short the day before the ex-dividend day, buy on the ex-dividend day
  - c. Buy just before the ex-dividend day, and sell after.
  - d. \_\_\_\_\_

# Example of dividend capture strategy with tax factors

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- 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

# Two bad reasons for paying dividends

## 1. The bird in the hand fallacy

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- Argument: Dividends now are more certain than capital gains later. Hence dividends are more valuable than capital gains. Stocks that pay dividends will therefore be more highly valued than stocks that do not.
- Counter: The appropriate comparison should be between dividends today and price appreciation today. The stock price drops on the ex-dividend day.

## 2. We have excess cash this year...

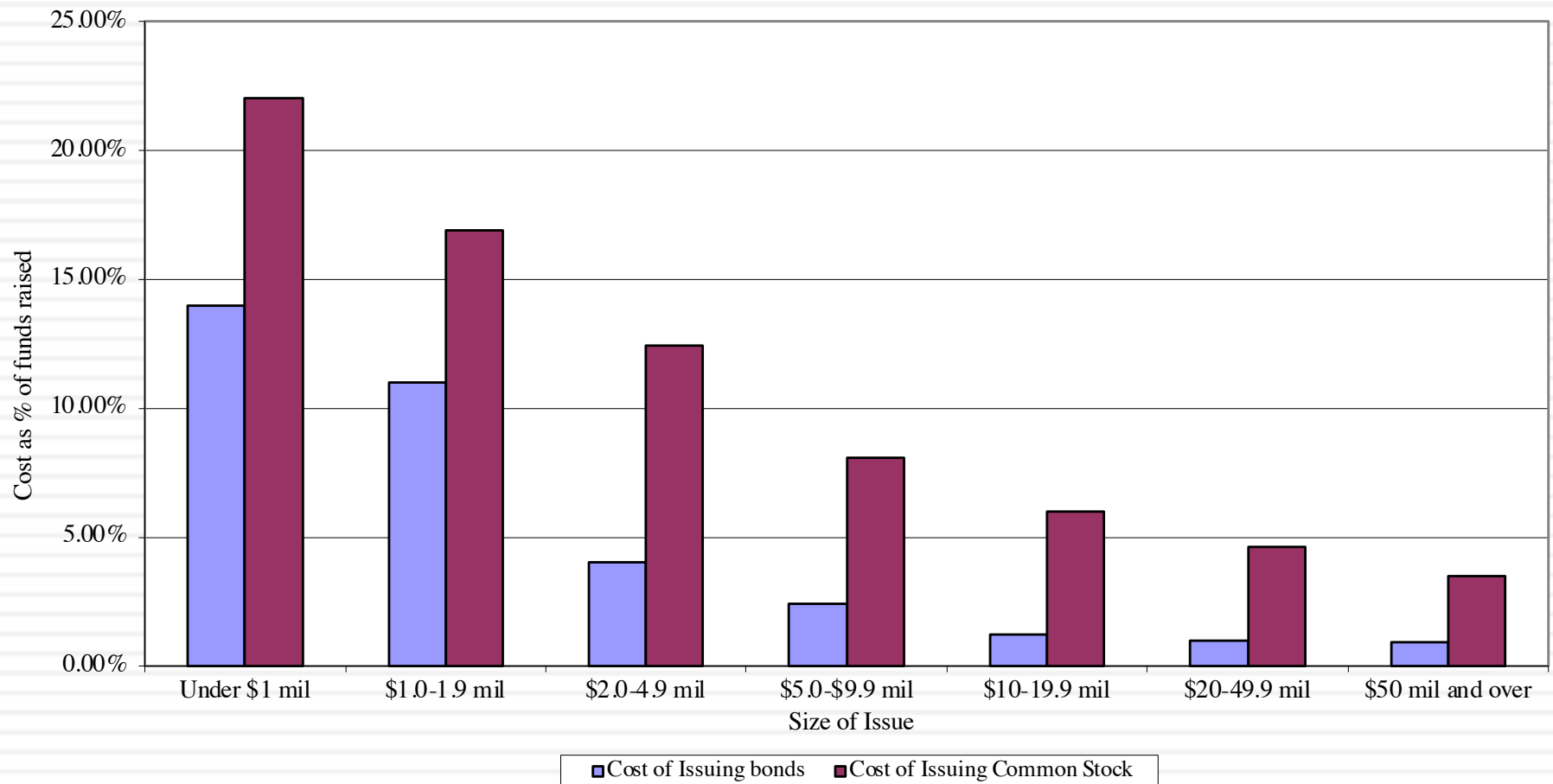
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- Argument: The firm has excess cash on its hands this year, no investment projects this year and wants to give the money back to stockholders.
- Counter: So why not just repurchase stock? If this is a one-time phenomenon, the firm has to consider future financing needs. The cost of raising new financing in future years, especially by issuing new equity, can be staggering.

# The Cost of Raising Capital

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*Figure 10.12: Issuance Costs for Stocks and Bonds*



# Three “good” reasons for paying dividends...

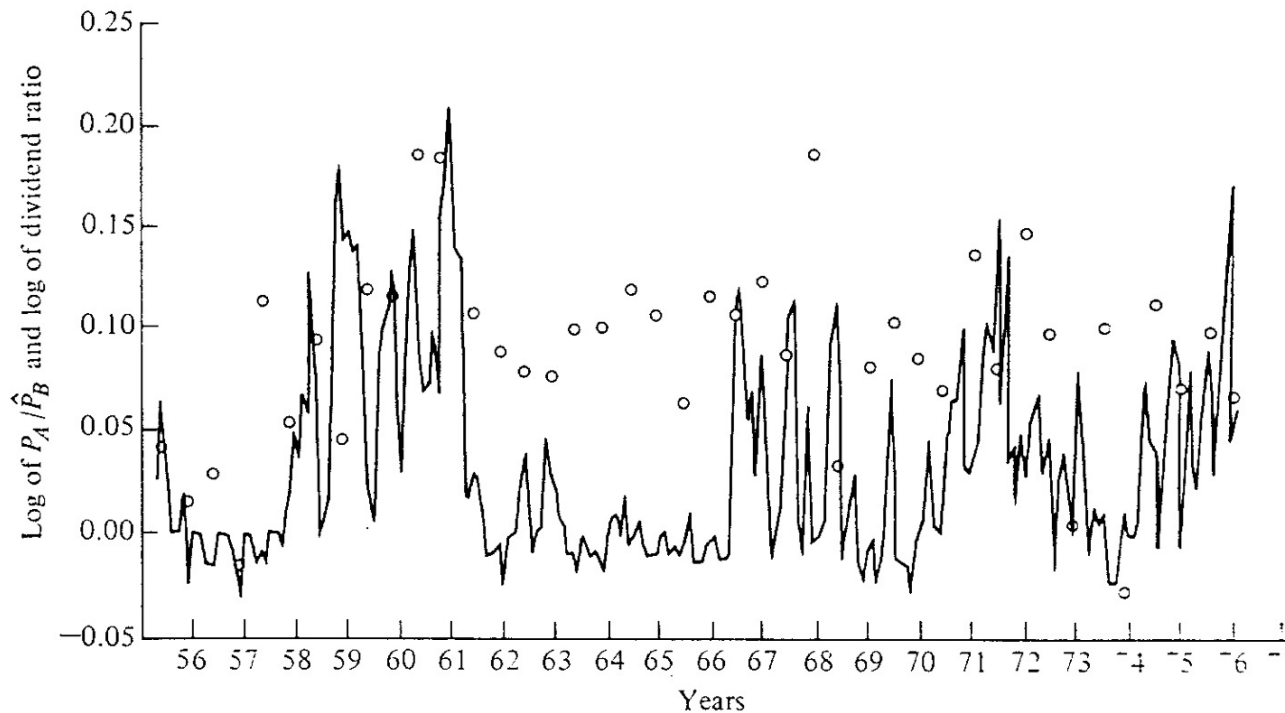
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- Clientele Effect: The investors in your company like dividends.
- The Signalling Story: Dividends can be signals to the market that you believe that you have good cash flow prospects in the future.
- The Wealth Appropriation Story: Dividends are one way of transferring wealth from lenders to equity investors (this is good for equity investors but bad for lenders)

# 1. The Clientele Effect

## The “strange case” of Citizen’s Utility

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Class A  
shares pay  
cash  
dividend

Class B  
shares offer  
the same  
amount as a  
stock  
dividend &  
can be  
converted to  
class A  
shares

# Evidence from Canadian firms

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Company	Premium for cash dividend shares
Consolidated Bathurst	+ 19.30%
Donfasco	+ 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 across companies	+ 7.54%



# A clientele based explanation

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- 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.