Stock Dividends & Repurchases

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Income Statement

(Assume Cash Basis)

Revenues less Expenses = Income

- Revenues - Cost of Goods Sold = Gross Income
- Gross Income - S. G. & A. = Operating Income (EBIT)
- Operating Income - Interest - Taxes = Net Income (Bottom Line)

Income Statement

- Net Income is what is available to return to the owners of the company (Stockholders)

- Question is how to give back to the shareholders:

  1) pay cash dividends;

  or

  2) repurchase stock from the stockholders.

Federal Income Tax System

- 27% is the highest marginal corporate tax rate.
- 70% of dividends received by one corporation from another is tax-free (if they own < 20%).
- Double taxation of dividends paid.
- 2-year loss carry-back and 20-year loss carry-forward is permitted.
- Improper accumulation to avoid payment of dividends.

Corporate Tax Rates*

• Canada	26.5%
• China	25.0%
• Denmark	22.0%
• France	28.0%
• Germany	30.0%
• Ireland	12.5%
• Italy	24.0%
• Japan	30.6%
• Korea	25.0%
• U. K.	19.0%
• U. S.	27.0%

* Source – KPMG's Corporate Tax Rates 2020

Corporate Tax Rates*

• Africa Average	28.3%
• Asia Average	21.0%
• Europe Average	19.1%
• Global Average	23.8%
• Latin America Average	27.4%
• North America Average	26.8%
• South America Average	27.4%

* Source – KPMG's Corporate Tax Rates 2020

Zero Corporate Tax Rates*

• Bahamas	0.0%
• Bahrain	0.0%
• Bermuda	0.0%
• Cayman Islands	0.0%
• Isle of Man	0.0%
• Turks & Caicos Islands	0.0%

* Source – KPMG's Corporate Tax Rates 2020

Dividends & Repurchases

- How much cash should be passed on to the shareholders?
- Should it be passed on in the form of dividends or by repurchasing stock?
- Should it maintain a stable, consistent policy, or let payments vary with conditions?

Dividends & Repurchases

I. Dividend Irrelevance Theory (Modigliani & Miller -1961)

Assume perfect capital markets, which includes no taxes and no transaction costs.

Investors can create their own dividend policy.

As a result, dividend policy does not affect the required rate of return on equity.

Dividends & Repurchases

II. Bird-in-the-Hand Theory

Investors view dividends as being less risky than capital gains. Therefore, companies that pay out a higher percentage of net income as dividends are viewed as being less risky.

Dividends & Repurchases

M&M disagreed with the claim that the required return on equity would decrease with higher dividend payout and called this the ‘bird-in-the-hand’ fallacy.

M&M argued that most investors would reinvest their dividends in the same or similar firms, and the riskiness of the cash flows to investors over time is determined by the riskiness of operating cash flows and not dividend policy.

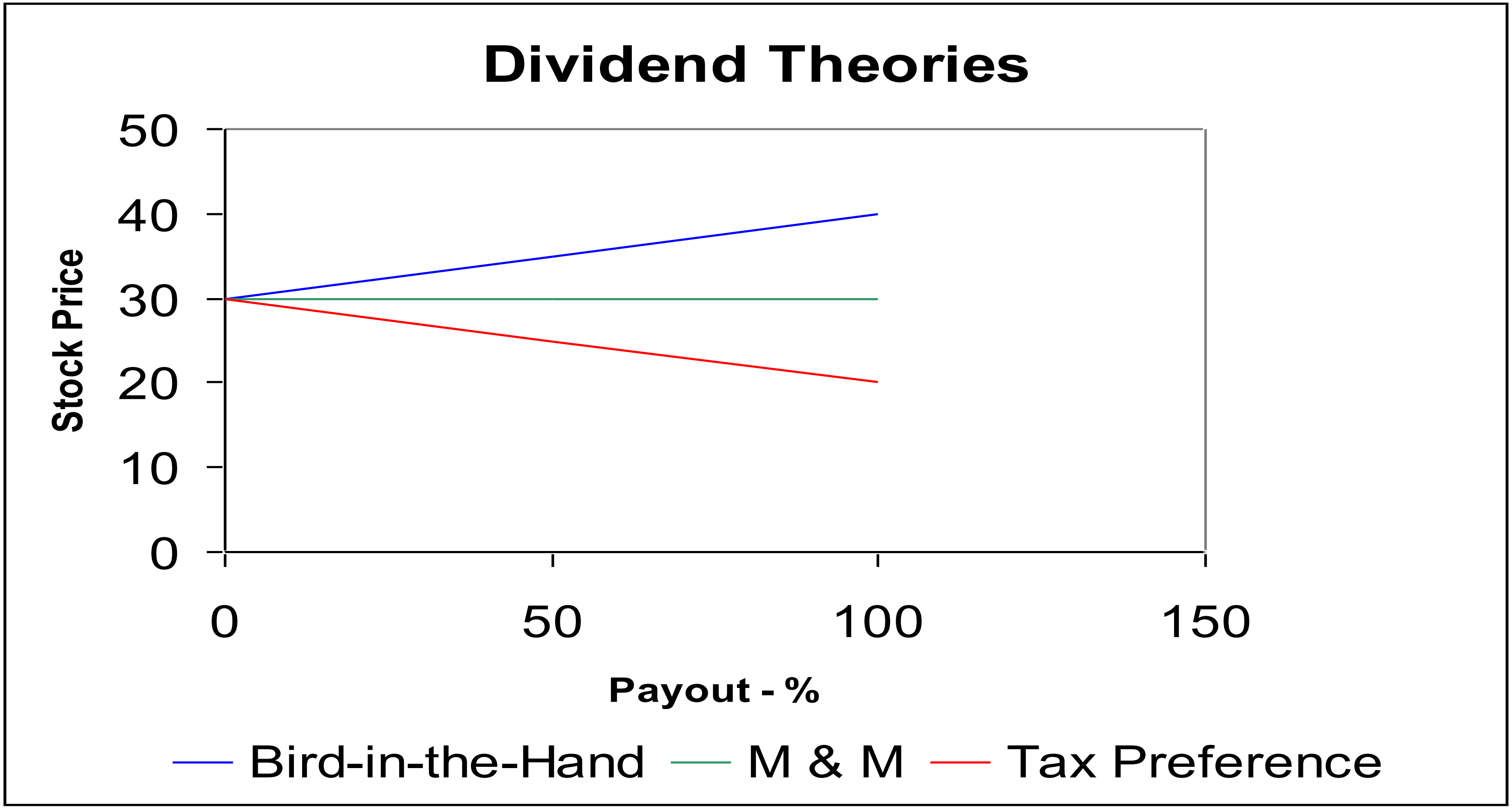
Dividends & Repurchases

III. Tax Preference Theory

Earnings reinvested generate capital gains that are not taxed until stock is sold so there is a time benefit as well.

Capital gains tax is avoided altogether if stock is part of an estate.

Dividends & Repurchases



Dividends & Repurchases

- Signaling Hypothesis
  - Dividends paid conveys information about the firm.
  - Dividend increases or decreases may result in price increases or decreases, depending on what was anticipated.
  - Firms are reluctant to cut dividends, so dividend increases beyond those anticipated signal the firm forecasts good future earnings.

Dividends & Buybacks

- Clientele Effect
  - Investors gravitate to firms that follow a dividend policy that they prefer.
  - A policy change will cause some stockholders to sell, incurring transaction costs.
  - As a result, frequent changes in dividend policy is unwise.

Dividends & Repurchases

- Residual Dividend Policy
  - Determine the capital budget.
  - Identify the debt and equity required, using the target capital structure, to meet the capital needs.
  - If income remains after funding the capital budget, pay it out as dividends.
  - In reality, the residual policy takes the form of a year-end extra.

Dividends & Repurchases

- Payment Procedures
  - Dividends are usually paid quarterly.
  - Amount is constant within a year.
  - There may be a year-end ‘extra’ dividend’.
  - Legally enforceable claim only when the Board of Directors declares a dividend.

Dividends & Repurchases

- **Declaration Date**

  Board declares a dividend.

- **Record Date**

  Owners of stock on this day are entitled to receive the dividend. The ex-dividend date is two business days prior to this date.

Dividends & Repurchases

- **Ex-Dividend Date**

  The first day to buy the stock and not receive the dividend . This occurs two business days prior to the holder-of-record date.

- **Payment Date**

  The date on which the dividend check is mailed.

Dividends & Repurchases

Factors Influencing Dividend Policy

- Constraints on Dividend Payments
  - Bond Indentures
  - Preferred Stock Restrictions
  - Impairment of Capital Rule – Dividends cannot exceed Retained Earnings
  - Availability of Cash
  - Penalty Tax on Improperly Accumulated Earnings

Dividends & Repurchases

– Investment Opportunities
  - Number of Positive NPV Projects Expected
  - Possibility of Accelerating or Delaying Projects

– Alternative Sources of Capital
  - Cost of Selling New Stock – High flotation costs may lead to lower payout ratios
  - Ability to Substitute Debt for Equity – Use debt when it doesn’t raise costs significantly
  - Control – Maintain higher retained earnings in lieu of needing to sell additional stock

Dividends & Repurchases

- Stock Dividends and Stock Splits
  - Increase number of shares outstanding
  - Firm doesn’t sell more shares or receive cash
  - Cuts equity pie into more pieces without changing the size of the pie

Dividends & Repurchases

- Share Repurchases
  - Companies can buy back their own stock, which reduces outstanding shares and increases earnings per share (EPS) but does not change stock price.
  - Shares bought become treasury stock.

Dividends & Repurchases

Consider a company whose stock price is \$57.00 per share and has 260 million shares outstanding (n_0). The CFO estimates the company has \$1.2 billion in excess cash (EXC). How many shares can the company repurchase, and what will happen to the stock price?

Market Capitalization = \$57.00×260 = \$14,820 million

This value includes the value of the excess cash so the value of the equity from operations is:

$$E_{Ops} = \$14,820 - \$1,200 = \$13,620$$

Dividends & Repurchases

The excess cash (EXC) will be able to buy shares at the new price of P_{New}, leaving n_1 shares outstanding.

$$EXC = P_{New} \times (n_0 - n_1)$$

But

$$P_{New} = E_{Ops} / n_1$$

So

$$n_1 = (E_{Ops} \times n_0) / (E_{Ops} + EXC)$$

Therefore,

$$n_1 = (13{,}620 \times 260) / (13{,}620 + 1{,}200) = 238.95$$

Dividends & Repurchases

The number of shares that can be bought is

$$(n_0 - n_1) = 260.00 - 238.95 = 21.05 \text{ million}$$

But

$$P_{New} = E_{Ops} / n_1$$

So

$$P_{New} = 13{,}620 / 238.95$$

$$P_{New} = \$57.00$$

Therefore, the repurchase has not changed the price.

Dividends & Repurchases

- Reasons for Stock Repurchases
  - Convey positive inside information to the market
  - Change the capital structure of the firm
  - Minimize taxes
  - Change ownership structure of the firm
  - Transfer of wealth from debtholders to stockholders
  - Avoid a takeover by leveraging up the company

Dividends & Repurchases

- Methods of Stock Repurchases
  - Fixed-price Tender Offers
    - Fixed price 20 to 25% above market price
    - Expiration date three to four weeks
    - Shares sought about 15% of shares outstanding
    - Firm usually has the right to purchase more if offer is oversubscribed

Dividends & Repurchases

– Open-market Share Repurchases

- Open market purchases over an extended period of time
- Normally occur after a period of falling prices

Dividends & Repurchases

– Dutch-Auction Repurchases

- Firm specifies a range of prices (usually 2-17% above current market price) and total number of shares sought
- Shareholder submits bid as to the lowest price and number of shares willing to sell
- Firm rank orders offers from low to high on price, and pays the lowest price that will buy the sought-after number of shares
- Average premium is lower than fixed-price tender offers

Dividends & Repurchases

– Transferable Put-Rights Distributions

  - Shareholders get the right to sell shares back to the firm at a specified price before an expiration date
  - A secondary market for trading develops for the rights

Dividends & Repurchases

– Targeted Stock Repurchases

- Normally targets a single, large block shareholder, with the terms negotiated
- Average premium is about 13%
- Can be used in a corporate control contest and is usually accompanied by a ‘standstill’ agreement
- The target can also be small share holdings in an effort to save costs of servicing small accounts, and typical premiums of about 10%

Dividends & Repurchases

- Management Beliefs About Dividend Policy
  - A firm’s dividend payout ratio affects its stock price.
  - Dividend payments act as a signal to the market.
  - Dividend announcements provide information.
  - Investors believe dividends are safer than retained earnings.
  - Investors are not indifferent between dividends and price appreciation.
  - Stockholders are attracted to firms with dividend policies that they like.

Dividends & Repurchases

- Determinants of Dividend Policy
  - *Investment Opportunities*
    - More opportunities →→ Lower dividends
  - *Stability in Earnings*
    - More stable earnings →→ Higher dividends
  - *Alternative Sources of Capital*
    - More alternative sources →→ Higher dividends

Dividends & Repurchases

- *Constraints*
  - More constraints imposed by creditors → → Lower dividends
- *Signaling Incentives*
  - More options to supply information to the market → → Lower need to pay dividends as a signal
- *Stockholder Characteristics*
  - Older, poorer stockholders → → Higher dividends