
Payout Policy

For the most part, optimal payout policy is the same as optimal capital structure, except that it is like negative equity issuing.

- Chapter 3: In a perfect world, dividends are not manna. They do not destroy value or create value if there is no operational link.
- Chapter 18: In an imperfect world, dividends are not tax efficient.

Background

19-1A

- Declaration day. Cum-dividend vs. ex-dividend day.
- DRIPs — huh?!
- Splits and Stock Dividends. Reverse splits. PIK.
- Repurchases: Auction (pro-rata?) vs. Open-Market Repurchase. Safe harbor against price manipulation charges from the SEC. Almost all programs are open-market.
- Repurchases are announced, but execution is not.

Dividends and Share Repurchases 19-1

Q1: Are investors not participating in a share repurchase left out in the cold?

Q2: Create an equivalent dividend payout

Q3: Does a dividend payment go to the “investment substance” while a repurchase or sale of shares does not?

Q4: In an M&M world, is a dividend or a share repurchase better?

Q5: In a world where dividends are tax-disadvantaged relative to a share repurchase, is a dividend or a share repurchase better?

Perfect Market—Fallacies

19-2

- Dividends eat substance.
- Only tendering shareholders gain from repurchases
- Share repurchases increase EPS

Imperfect market

All the same issues arise with payouts (dividends, repurchases) as arise with payins (debt and equity issues): Corporate taxes, personal taxes, financial distress costs, agency considerations, inside information considerations, etc.

Differences Between Repurchases and Dividends Today

19-3

Currently, the marginal tax advantage of repurchases vs. dividends is at a historical low.

Q6: What are the differences today?

- Tax advantage is very small, perhaps almost gone – you may not have to pay much tax, at all. Some is still present. (See 19-3A.)
- Dividends tend to be more regular. (Called “smoothing”)
- Managers have options written on price, not dividend-adjusted price—so they prefer share repurchases.
- Insiders cannot tender shares.
- Retail investors may strangely like dividends.
- Institutions may sometimes have to hold stocks paying dividends.

Inferring Marginal Tax Rate

Q7: What is the typical investor tax on dividends received?

Around τ times the dividend yield, so maybe 70 basis points.

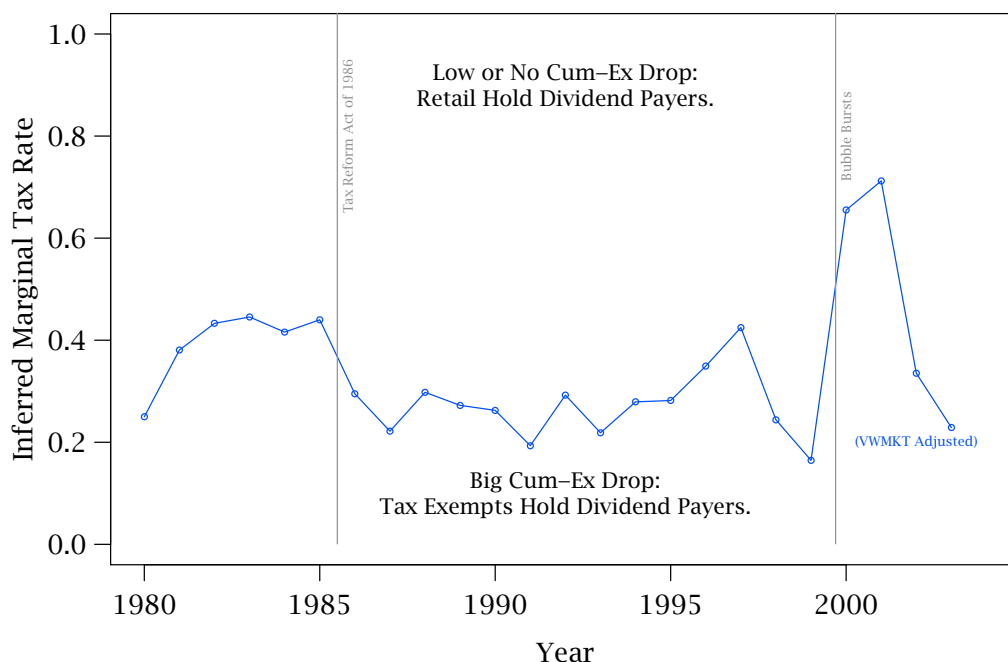
Q8: Who should participate in a share repurchase?

Investors w/o large unrealized capital gains [e.g., purchased it recently at higher price], or who have large capital losses elsewhere.

Q9: Can we determine the effective tax rate from a dividend—that is, whether tax-exempt investors can abundantly arbitrage away tax issues?

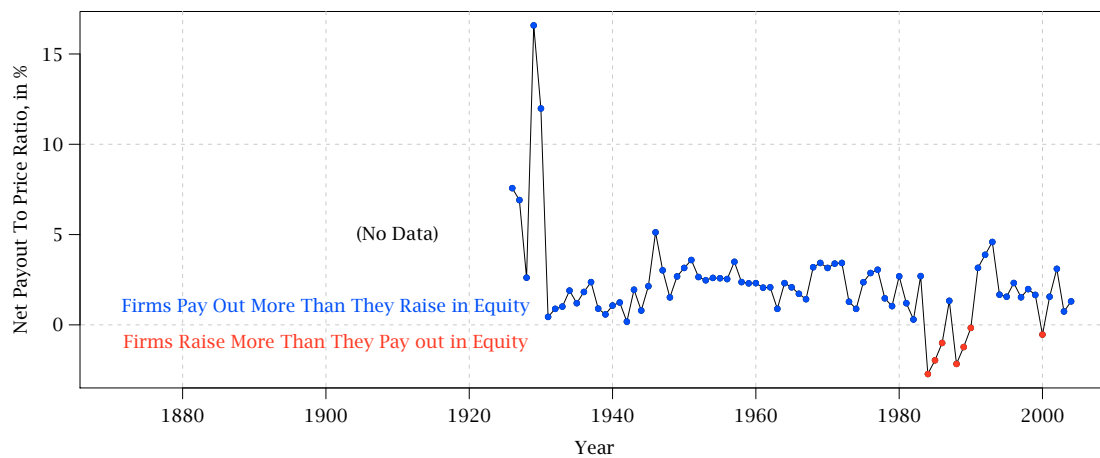
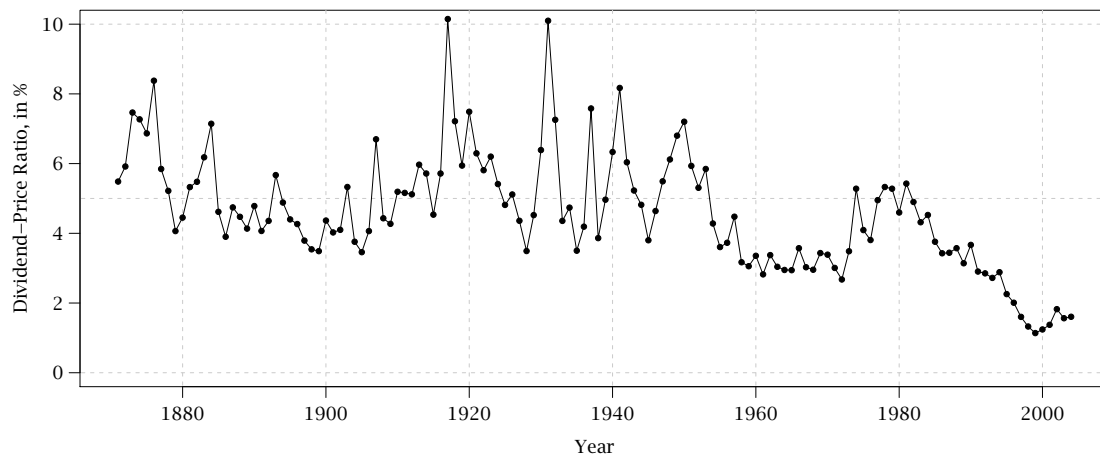
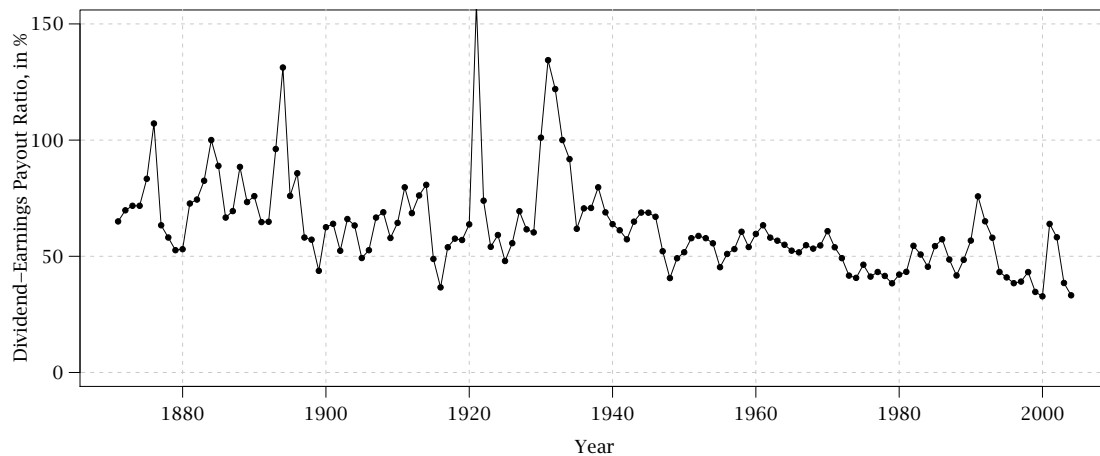
The book gives an example. \$100 \Rightarrow \$85 at a \$20 dividend. ask yourself about what competition among tax-exempt investors will do. (ask about the timing of tax-exempt investing—exactly when tax-exempts want to purchase and when to sell again. talk about bed-and-breakfast deals. The extreme limit is tax-related trading and overnight risk.)

Q10: If the drop from the cum to the ex-day for a \$2 dividend is \$1.70, then what is the marginal tax rate?



Historical Patterns and Market Reactions

19-4A



Other Interesting Evidence

19-4A

- Repurchase Announcement Rate of Return
- Stock Splits Announcements Rate of Return
- Long Run Reaction

Survey Evidence

19-5

- Recognize history importance and smoothing. Recognize flexibility of share repurchases
- Think of own stock as investment opportunity.
- Dividends: Target div/share ratio, some div-earnings, some div-price ratio. Repurchases: target dollar amount.
- Repurchases used for employee plans.
- Dislike obligation of paying to shareholders, especially semi-regularly. Would prefer to use money to pay down debt instead.

(Nonsense claim by managers that dividends impose no discipline.)

Note: Discontinuity. We will cover chapters 21 and 22 next.

Omitted From Subsequent Chapters

Other Chapters:

- How capital structure evolves empirically in the United States.
- Stock Returns are hugely important.
- Seasoned equity offerings in large firms are primarily an M&A phenomenon.
- Various deeper causes for capital structure changes.
- Cash Management.
- Pecking order again; how to measure debt ratios.
- Forces Towards an Optimal Capital Structure.
- Initial Public Offerings. Reasons for Underpricing, Long-run pricing, costs of underwriting etc.
- M&A—soon to be revised.
- Governance—soon to be revised.
- Event Studies describing what happens when firms issue equity or debt or dividends.

Intentionally Omitted

Pro Forms:

- What do you think Textron is worth?
- How do you think Textron will evolve (financially speaking)?
- Should we fire the management team and do something drastic?

What's easier: Theory or Practice?

Final Thoughts

- Remaining homeworks—optional to hand in due to class project
- Epilog—more about finance.

- Next class session: external speaker.