Payout policy

Corporate Finance

Payout policy basics

- Free cash-flows to equity are either retained or distributed

- "Obviously," firms with a lot of growth opportunities should retain as long as:
  1. It is legal for them to do so (not a REIT, e.g.)
  2. Their shareholders don't have a strict preference for dividends (*clientele effect, bird in the hand…*)
  3. It doesn't send the wrong message (asymmetric information)

How do corporations distribute?

- Firms distribute cash-flows mostly by paying dividends and buying back shares
- For non-taxed shareholders, these are equivalent
- For taxed investors, buy-backs are generally better…
- … and not surprisingly have become much more common
- In fact, why pay dividends at all?

Dividend dates

- *Declaration/announcement date*: board announces a distribution
- *Record date*: date an investor must be recorded as a shareholder to receive the dividend
- *Ex-dividend date*: set by exchange, usually two days before record date. If purchase is made on or after ex-dividend date, investor is not entitled to payment
- *Payment date*: date when investor accounts are credited (or checks mailed)

Dividend types

- *Cash dividends*: dividend paid in cash drawn from retained earnings(taxed as income)
- *Stock dividend:* dividend paid in common stock (generally not taxed)
- *Property dividend:* non-monetary dividends (taxed as income, generally)
- *Liquidation dividend:* dividend paid in cash from sources other than retained earnings (not taxed as income, but big restrictions)

Qualified dividends

- Most dividends paid by US corporations are *qualified* which means, chiefly, that they are taxed at the capital gains tax rate rather than the typically higher ordinary income tax rate

- Exceptions:
  1. Must meet holding requirements
  2. Most distributions by REITs and other pass-through vehicles are not considered qualified

MM (1961)'s irrelevance result

- In perfect markets (no taxes or other frictions), dividend policy is irrelevant
- If dividend payment comes from selling existing assets, it is taking from one of the shareholder's pockets to put in the other
- If dividend payment is paid by issuing new liabilities, it is a transfer from new stake-holders to incumbent shareholders
- As with MM 1958, this does not say that dividend policy does not matter
- Instead, it tells us why it matters (taxes, frictions…)

Stock repurchase vs dividends

- In perfect markets (no taxes or other frictions), dividends and stock repurchases are equivalent
- Taxes make stock repurchases better but, while firms do take advantage of this preferential treatment, they do so within limits and without ever saying that tax savings are the motives
- Otherwise, the IRS would likely recognize share repurchases for what they are (untaxed dividends) and start taxing them

Share repurchase, real talk

- The standard story (here drawn from bankrate.com) is 97.3% bogus:

"Buybacks can elevate investors' returns significantly, especially when pursued consistently over time. Some shareholders love them as a strategy and those top executives who use them well.

Share buybacks can create value for investors in a few ways:

1. *Repurchases return cash to shareholders who want to exit the investment.*
2. *With a buyback, the company can increase earnings per share, all else equal. The same earnings pie cut into fewer slices is worth a greater share of the earnings.*
3. *By reducing share count, buybacks increase the stock's potential upside for shareholders who want to remain owners. If the company is worth $1 billion, but is split fewer ways, each share is worth more.*
4. *They're a more tax-efficient way to return the earnings of the business to shareholders, relative to dividends, which are taxable to those who receive them.*

These reasons become all the more compelling if a company buys back stock over time, if it has the excess cash to do so. By reducing share count by even 2 or 3 percent each year, a company can increase a shareholder's return by a comparable amount each year. And the company may actually take advantage of its own form of dollar-cost averaging."

Fully diluted market capitalization

- A proper measurement of enterprise value requires taking into account all equity claims
- Options to buy shares embedded in compensation packages and hybrids should be reflected in E
- How do corporations/analysts measure and report E?
- Treasury method:
  1. Treat all (and only) in-the-money options as if already exercised
  2. Assume current price reflects all those implicit claims fully already
  3. Assume the Corporation uses exercise proceeds to buy back shares