Last Lecture Agenda

- Chapter 16: Dividend Policy
- Top 10 List Re-visited
- 3 Key things to remember from Fin 254

Dividend Policy

Chapter 16

Topics of Discussion

- Payment of Dividends
- Stock Dividends
- Stock Splits
- Share Repurchases
- Dividend Policy Theories
- Other Dividend Policy Issues
- Dividend Policy in Practice
Payment of Dividends

- The dividend payment procedure follows the following calendar:
  - Declaration Date
  - Ex-Dividend Date (3-4 business days prior to record date): the date the right to the current dividend no longer accompanies the stock. The stock price usually opens at the previous day’s close less the declared dividend
  - Holder of Record Date: must own the stock on this date to receive the declared dividend
  - Payment Date

Dividend Payments

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<th>Date</th>
<th>Declaration date</th>
<th>With (cum)-dividend date</th>
<th>Ex-dividend date</th>
<th>Record date</th>
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Stock Dividend - Distribution of additional shares to a firm’s stockholders.

Stock Splits - Issue of additional shares to firm’s stockholders.

Stock Repurchase - Firm buys back stock from its shareholders.
**Stock Dividend**

**Example** – Divide & Conquer has 4 million shares currently outstanding at a price of $20 per share. The company declares a 25% stock dividend. How many shares will be outstanding after the dividend is paid?

**Answer**

\[ 4 \text{ mil} \times 0.25 = 1 \text{ mil} + 4 \text{ mil} = 5 \text{ mil shares} \]

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**Example** - cont - After the stock dividend what is the new price per share and what is the new value of the firm?

**Answer**

- The value of the firm was 4 mil x $20 per share, or $80 mil. After the dividend the value will remain the same.
- Price per share = $80 mil / 5 mil sh = $16 per sh.

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**Summary of Stock Dividends, Splits, & Repurchases**

- Unless accompanied by an increase in cash dividends, stock dividends and stock splits have no impact on firm value. They just “divide the pie into smaller pieces.”
- Stock repurchases are just another way of returning cash to stockholders like cash dividends and also shouldn’t impact overall firm value.
Introduction to Dividend Policy

- Optimal dividend policy is the balance between dividends and retained earnings for future growth that maximizes shareholder wealth (stock price).
- We will look at theory and practice regarding dividend policy.

\[ p_0 = \frac{D_i + v_0 (1 + g)}{r - g} \]

Dividend Policy Theories

- Dividend Irrelevance Theory
- Bird-in-the-Hand Theory
- Tax Preference Theory

Dividend Irrelevance Theory

- Miller and Modigliani (MM) argue that dividend policy has no effect on the firm’s stock price or WACC.
- They say investors can create their own dividends and capital gains by selling some of their stock and reinvesting dividends in the firm’s stock, respectively.
- Ignored taxes and brokerage costs.
Bird-in-the-Hand Theory

- Gordon and Lintner argue that the dividend yield is the less risky component of total expected return: \( r = \frac{\text{Div}}{P_0} + g \).
- Therefore, when the firm increases its dividend yield, its required return decreases and its stock price increases.

Tax Preference Theory

- Because of differential tax rates and deferment of payment, investors prefer capital gains to dividends.
- Investors can choose when to sell stock and realize capital gains.
- Dividends are taxed when paid.
- An increase in the dividend yield leads to a higher required rate of return and lower stock price.
- Due to recent tax changes for individual investors, this theory is less relevant because both dividends and long-term capital gains are taxed at the same maximum rate of 15%.

Other Dividend Policy Issues

- Information Content (Signaling) Hypothesis
  - When the company increases its dividend, it is fairly certain of improved future earnings.
- Clientele Effect
  - Some investors prefer income, others prefer capital gains.
    - For example, Bill Gates prefers capital gains.
    - Microsoft Corp. prefers dividend income (can exclude 70%, max. tax rate of 10.5%) over capital gains income (tax rate of 35%).
  - Knowing which type of investor that its stock attracts can influence a firm’s dividend policy.
Dividend Policy in Practice

- Residual Dividend Policy
- Constant, or Steadily Increasing, Dividends (most common policy in practice)
- Constant Payout Ratio
- Low Regular Dividends plus Extras

Dividend Policy: What This Means

- In practice, investors do not like to see their dividends fall.
- So, in general, companies strive to maintain their current dividend, increasing it only when they are certain of a "permanent" increase in future earnings.
- Reality lends credence to Signaling Theory