Chapter 14 Dividends and Dividend Policy

Key Concepts and Skills

Understand:

- Dividend types and how they are paid
- The issues surrounding dividend policy decisions
- The difference between cash and stock dividends
- Why share repurchases are an alternative to dividends

Chapter Outline

14.1 Cash Dividends and Dividend Payment

14.2 Does Dividend Policy Matter?

14.3 Establishing a Dividend Policy

14.4 Stock Repurchase: An Alternative to Cash Dividends

14.5 Stock Dividends and Stock Splits

Cash Dividends

- Regular cash dividend = cash payments made directly to stockholders, usually each quarter
- Extra cash dividend = indication that the "extra" amount may not be repeated in the future
- Special cash dividend = similar to extra dividend, but definitely won't be repeated
- Liquidating dividend = some or all of the business has been sold

Return to Quick Quiz

Dividend Payment Chronology

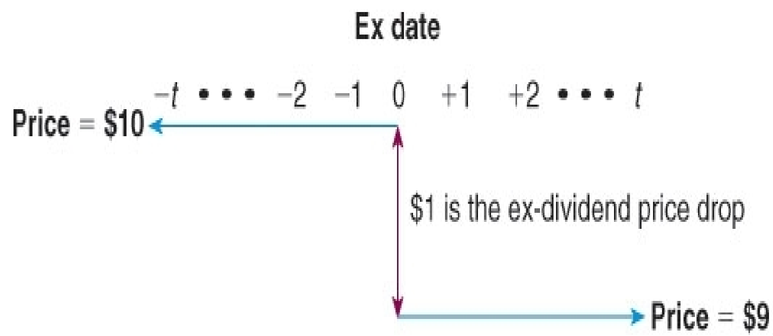
- Declaration Date – Board declares the dividend and it es a liability of the firm
- Ex-dividend Date
- Occurs two business days before date of record
- If you buy stock on or after this date, you will not receive the ing dividend
- Stock price generally drops by approximately the amount of the dividend
- Date of Record – holders of record are determined, and they will receive the dividend payment
- Date of Payment – checks are mailed

Return to Quick Quiz

The Ex-Dividend Day Price Drop
Figure 14.2

FIGURE 14.2

Price behavior around the ex-dividend date for a $1 cash dividend



The stock price will fall by the amount of the dividend on the ex date (Time 0). If the dividend is $1 per share, the price will be equal to $10 − 1 = $9 on the ex date.

Before ex date (Time −1)	Dividend = $0	Price = $10
On ex date (Time 0)	Dividend = $1	Price = $9

Does Dividend Policy Matter?

- Dividends matter
  - The value of the stock is based on the present value of expected future dividends
- Dividend policy may not matter
  - Dividend policy is the decision to pay dividends versus retaining funds to reinvest in the firm
  - In theory, if the firm reinvests capital now, it will grow and can pay higher dividends in the future

Illustration of Irrelevance
Wharton Corporation

- All equity firm with 100 shares outstanding
- Investors require a 10% return.
- Expected cash flow = $10,000 each year
- Plans to dissolve firm in 2 years
- Firm can either:
  A. Pay out dividends of $10,000 per year for each of the next two years ($100 per share), or
  B. Pay $11,000 this year, raising the other $1,000 by issuing stock (or bonds), then pay an amount in year 2 sufficient to provide new shareholders with a 10% return

Illustration of Irrelevance

Wharton Corporation

	PLAN A:			PLAN B:	
	Year 1	Year 2		Year 1	Year 2
Cash Flow	$10,000	$10,000		$10,000	$10,000
New stock	$0	$0		$1,000	$0
CF available to S/H:	$10,000	$10,000		$11,000	
To New S/H:					
Dividends	$0	$0			$1,100
DPS	$0	$0			$110
To Old S/H:					
Dividends	$10,000	$10,000		$11,000	$8,900
DPS	$100	$100		$110	$89
Stock Price	$ 173.55			$ 173.55	
E(R)	10%			10%	

Factors Favoring a Low Payout

- Taxes:
- Individuals in upper e tax brackets might prefer lower dividend payouts, with their immediate tax consequences, in favor of higher capital gains
- Flotation costs:
- Low payouts can decrease the amount of capital that needs to be raised, thereby lowering flotation costs
- Dividend restrictions:
- Debt covenants may limit the percentage of e that can be paid out as dividends

Factors Favoring a High Payout

- Desire for current e:
- Individuals in low tax brackets
- Groups that are prohibited from spending principal (trusts and endowments)
- Uncertainty resolution:
- No guarantee that the higher future dividends will materialize
- Taxes:
- Dividend exclusion for corporations
- Dividends versus capital gains irrelevant to tax-exempt investors