A Tour of Payout Policies—— (and of some earnings ratios)

(Welch, Chapter 20)

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Events of Interest

Distributions:

- Dividends
  - 65% of publicly-traded firms do not pay dividends!
  - Dividends are a "large firm" phenomenon.
- Repurchases

Non-Distributions:

- *stock splits*
- *stock dividends*

"Placebo" without cash effects.

Dividend Mechanics

- Declaration Date.
- Cum-Dividend Date / Ex-Dividend Date.
- (Payment Date)

Repurchase Mechanics

- Auction-based repurchases:
  - Pro-rata on volunteers.
  - Usually large, often one-time.
  - Usually exclude insiders.
- Open-market repurchases:
  - Via **Rule 10b-5** safe-harbor exemption (to avoid stock manipulation charges).
  - Careful: details must be taken care of.

Perfect Capital Market

1. No differences in opinion.
2. No taxes.
3. No transaction costs.
4. No big sellers/buyers—infinitely many clones that can buy or sell.

Let's understand the first-order effects

...and some common fallacies.

Firm Scale and Leverage

What do distributions do to firm scale?
What do distributions do to firm leverage?

Announcements of Distributions

In a PCM, when a firm announces

- *future* dividend payments, and/or
- *future* repurchases,

what happens to firm value?

Should distributions be good news for investors?
Are distributions good news for investors?

Investment "Substance"

Does selling shares nibble away the "investment substance," whereas dividend payments do not?

Non-Tendering Investors?

Do only tendering investors benefit from share repurchases?

- could but is rarely used to discriminate in favor of cash-rich investors.

EPS Effects

Do share repurchases increase earnings-per-share?

Imperfect Capital Markets (ICM)

1. Differences in opinion.
2. Taxes.
3. Transaction costs.
4. Large sellers/buyers
5. Risk and Risk-Aversion
6. and so on.

Can real-world issues matter now?

ICM Dividend Theory I

Dividend Theory = Capital Structure Theory

The same forces apply. For example,

- Direct PV effects
  - If paying out reduces positive NPV projects, value should go down.
  - If paying out reduces negative NPV projects, value should go up.

ICM Dividend Theory II

- Repurchases are more tax efficient than dividends.
- If you pay dividends and replace capital with debt, you get tax advantages, but you can suffer more financial distress.
- If investors learn from dividends that your projects performed unexpectedly well and are likely to do so in the future, then dividends are a signal of your confidence and project quality.
- If you pay out dividends, managers will have less money to waste.

Tax Efficiency

What is better from a tax non-payment perspective?

- Dividends,
- Share Repurchases, or
- Reinvestment?
- DRIPs: Dividend Reinvestment Plan

(Taxes are small when payout rates are small.)

Graph: History of U.S. Tax Rates

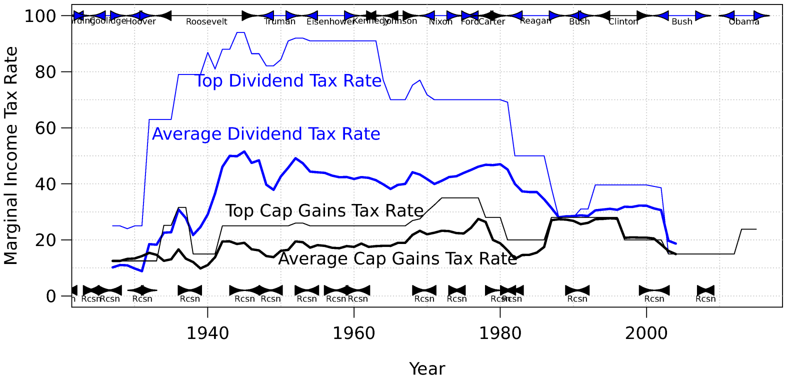

Figure 1: History of U.S. Tax Rates

Graph Footnotes

Tax rates varied widely.
The punishment of "job creators" did not seem to have hampered economy much in the 1960s.

- Curious, but do *not* draw inferences from likely spurious correlation.

Distributions

Should firms pay out funds?

What happens when they do?

Graph: Dividend Announcement Response — Good or Bad News?

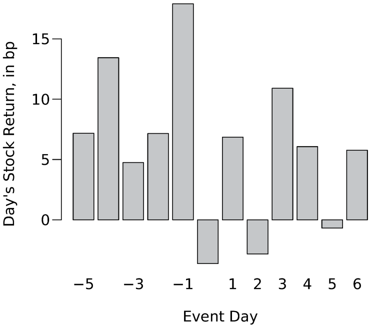

Figure 2: Dividend Announcement Reponse

More Empirical Evidence

- The announcement value increase continues (is stronger) in the long-run. (huh!?)
- The *relative* return effect is large:
  - the *per dollar paid* response can be larger than dividend payment itself,
  - denominated effects are called "dilution."

- We have little data for repurchases, because firms do not disclose event dates.

Graph: Value Benefit Variability

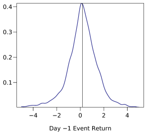

Figure 3: Variability

Graph Footnotes

Great variability in response across firms.

- Lots of noise.
- Some gain, some lose.
- Not fully understood why.

Dividend Smoothing?

Dividends tend to be sticky.

Firms do not like to cut them.

Roughly,

- 30% keep them
- 3% initiate them.
- 2% stop them.
- rest do not pay any.

Implicit Commitment = Signal?

If dividends come with an implicit commitment to continue them,
then they may serve a signaling purpose,
that execs are confident about future earnings.

- Even the most regular repurchasing programs are less sticky than dividends.

Best Pay-Out Choice

How should you distribute earnings:

- dividends, *or*
- share repurchase?

Other Div-Repo Differences

Executives (and insiders) can receive dividends, but they cannot sell into share repurchases.

Floridians have preferences for dividends.

Institutions have preferences, too.

- Many fund charters even require them.
- Why? Beats me.

Graph: Dividend-Earnings Ratio

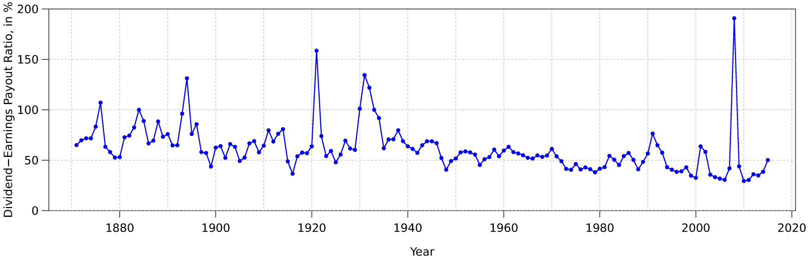

Figure 4: debt/equity

Graph: Dividend-Price Ratio

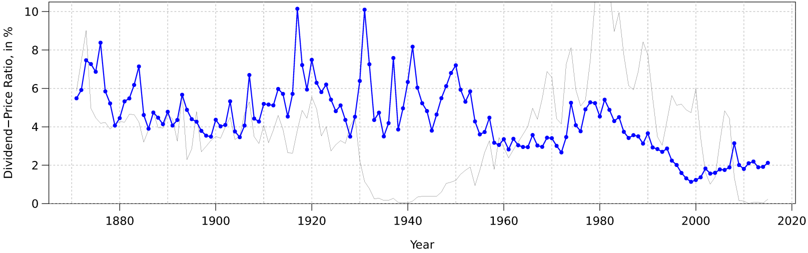

Figure 5: dividend/price

Graph Footnotes

The dotted line is the dividend-price ratio.

The thin black line is the interest rate.

Note:

- When dividends are only 1-2%/year, then tax advantages of capital gains over dividends are only of modest concerns for most retail investors.
- Hardly worth the bother.
- (Not true for institutions.)

Graph: Cash-Flow Yield

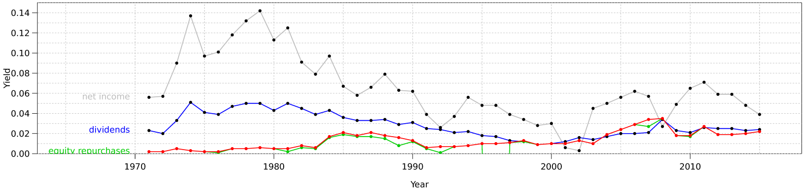

Figure 6: cash flow yield

Graph: Net Earnings Payout

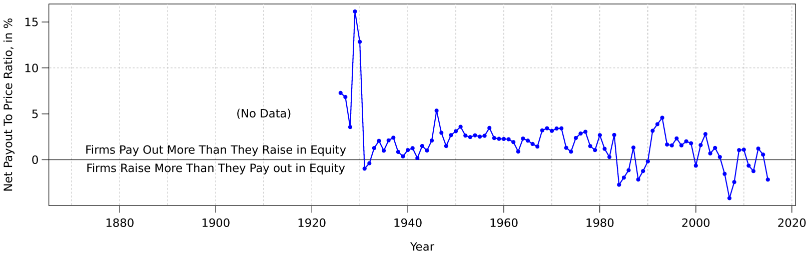

Figure 7: Net Issuance

Disappearing Dividends?

Fama-French (JFE 2001):

- Fraction of firms paying went from 67% in 1978 to 21% by 1999.

But this was primarily variation in the number of companies listed.

- The number of firms paying dividends has largely remained the same.
- Thus, after 1999, fraction has gone back up to around 25-30%.

Dividend Catering?

Baker-Wurgler (JF 2004):

- Firms start paying dividends when the P-E multiple on dividend-paying firms is higher than the P-E multiple on non-dividend paying firms.
- Requires holding constant many firm differences.

Stock Splits

In a PCM, how should stock splits matter?

In the real world, do stock splits matter?

CFO Survey I: Sense

1. Execs feel trapped by history
2. Claim they care more about dividends than about positive NPV projects, to the point of foregoing positive NPV projects to continue paying dividends.
3. Want to attract institutions with dividends.
4. Believe that dividends increase EPS (?!).
5. Some target D/S, some D/E, some D/P.

CFO Survey II: Huh?

6. dividends impose no discipline on them, (haha!)
7. would love to use dividend money not to take more pos-NPV projects, but to reduce debt, (haha!)
8. like the "flexibility" of repurchases,
9. repurchase because they believe they can time their purchases (inside info?), and
10. repurchase shares for ESOP distributions.

Omitted: Effective Tax Rate

Which investor is indifferent between holding and selling the instant before the stock goes cum-to-ex?

You can extract the marginal dividend tax rate:

- if avg drop is 1-to-1, it is 0%.
- if avg drop is 0-to-1, it is 100%.

Current Situation in the USA

Dividends after 2016 were $\leq 2\%$ in nominal terms (relative to share value),

- Tax considerations are less burning.
- Covid crises dropped both.
- What are anticipated future dividend tax rates?