Lecture 10: Distribution to shareholders

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- **Level** of free cash-flow, depends on company's investment opportunities and operating plans.
- **Level** of debt and interest payments, depends on the capital structure policy.
- **Level** of short term assets depends on the working capital policy (why?).

What should we do with the remaining FCF?

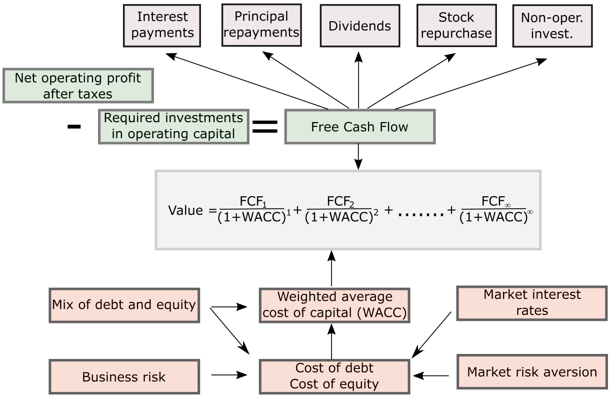
Firm's value depends on its ability to generate free cash flow. Can we influence the value of firm through distribution policy?

Distribution policy is a set of rules that determine the:

- **level** of distribution - How much money to distribute among shareholders?
- **form** of distribution - Should we pay dividends or re-purchase stocks?
- **stability** of distribution - Should we change our previous distribution policy?

This is a complex decision as different stakeholders prefer different levels and forms of distribution, and our action can influence firm's value as perceived by investors.

Where do we stand?



5 good ways to use FCF

Recall that we have five good ways how to use FCF.

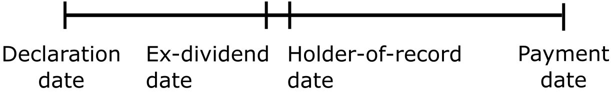
- Pay interest.
- Pay principal on debt.
- Pay dividends.
- Re-purchase stocks.
- Invest into non-operating activities, i.e. short-term investments.

Which decisions (among the five above) are determined by the:

1. **capital structure** of the company and which by the
2. **working capital management** strategy?

Dividend payments

Company makes an announcement (obligation) (**Declaration** date) to pay dividends of a given size (annually or quarterly) at a given date (**Payment** date), while specifying who is going to be recognized as an owner (**Holder-of-record**) by acknowledging share transfers up-until some date (**Ex-dividend** date, usually 2 business days prior to HoR date).



https://www.nasdaq.com/market-activity/stocks/msft/dividend-history

Stock re-purchase

Stock **re-purchase** is a process when company buys **own** outstanding shares.

Why would a company do that?

- Changes in capital structure.
- It might buy stocks that it wants to give employees.
- Excess cash.

When re-purchase tends to occur: i) share price decline, ii) lower interest rates, iii) interest expenses are tax deductible, iv) prevent takeover,...

What is the current trend in the world - distributing money through dividends or stock re-purchases?

Is distribution policy influencing firm's value? Is there an optimal (value maximizing) distribution policy?

Investor's preference for:

- Dividends.
- Capital gains.

Distribution ratio - percentage of net income distributed to shareholders as **cash dividends** or **stock re-purchase**. Payout ratio - percentage of net income distributed to shareholder as **cash dividends**. Dividend yield - annual dividends divided by the share price.

Three theories of investor's preference:

- **Dividend irrelevance theory** of Miller and Modigliani (1961) (see also H. DeAngelo and L. DeAngelo, 2006). Their idea is that under certain assumptions (no taxes and transaction costs), shareholders can construct their own dividend policy (at 'no costs') and therefore dividend policy does not matter.

	Scenario 1	Scenario 2
Conditions		
# stocks at the beginning	100	100
Price at the begining	1	1
Price at the end	1.11	1
Action taken		
Dividend per stock	0	0.11
Sell stocks	10	0
Wealth		
Cash earned	11	11
# stocks remained	90	100
Value of stock	100	100

- **Dividend preference theory** of Gordon (1963) and Lintner (1962). Their idea is that returns from dividends are more certain than returns from capital gains and therefore paying dividends reduces the risk of holding the shares. Given risk aversion of investors, paying dividends reduces required capital gain (rate of return) on the stock and therefore dividend policy influences capital structure.

Similar conclusions are found with the '**agency cost**' problem. How dividends influence manager's behavior? The higher the debt, the higher are interest expenses and therefore: i) less cash to 'play' with, ii) more overseeing from debtors. Just like in the dividend preference theory, owners might prefer dividends as opposed to capital gains.

- **Tax effect theory**. If taxes on dividends and capital gains are equal, capital gains tend to be preferred because of time value of money. You never pay taxes from capital gains sooner than taxes from dividends. Why? Usually you received dividends net of taxes. Capital gains are paid only in the next calendar (accounting) year! In certain countries (e.g. Slovakia) you are not required to pay capital gain tax if you own the stock for more than 1 year!

Which theory is supported by empirical data?

Different investors prefer different distribution policies - **clientele effect**. Why? Someone might prefer current cash income and someone who is in no need of cash might prefer to reinvest or save.

- If your stock does not pay dividends and you would prefer current cash income you would need to sell stocks, which is not for free.
- If you would prefer to save or reinvest you would need to re-invest after-tax dividends if your stock pays dividends, which is also not free.

Therefore **investors tend to seek firms that meet their preference**. This has implications for distribution policy.

Whatever your distribution policy, **stability** of the policy matters!

Which theory is supported by empirical data?

Different stockholders and potential investors have different views on the current and future financial condition (cash flows and risks). However, it is safe to assume that, managers are better informed.

Research suggests that an **'asymmetric' effect** exists. If dividends are cut (decreased), value tends to decline (stock prices decline). If dividends are increased, value tends **not to decline**. This has distribution policy implications.

You should not be **overly optimistic** with the amount of dividends as cut backs in the future are 'expensive'.

How much should we distribute?

Assume:

- We know the optimal capital budget for the next year.
- We know the target capital structure.

$$Net\ Income - Target\ Equity\ Ratio \times Optimal\ Capital\ Budget$$

Firms should use the residual distribution model to advice them on the long-run target distribution ratios.

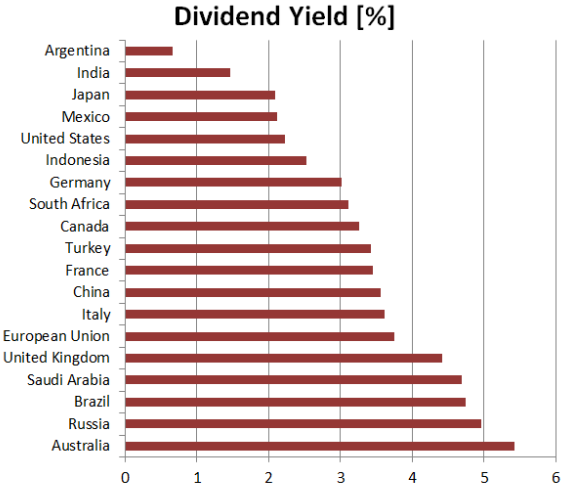
Example

Assume a company has net income of 100, and target equity ratio of 0.70. Now given three scenarios, what are the target distribution levels?"

- Lack of investment opportunities lead to a planned 70 in capital budget.
- Moderate investment opportunities lead to a planned 110 in capital budget.
- Excellent investment opportunities lead to a planned 200 in capital budget.

- Re-purchase announcements are viewed positively and increase the market value of firm. Cash dividends might increase the market value even more.
- 'Clientele' can decide whether to sell their stock or to keep it - dividends **must be accepted**.
- Re-purchase is not perceived as a long-term commitment as opposed to a dividend payment.
- Re-purchase can be used to change capital structure (drastically and fast).
- Re-purchase might be viewed as very expensive (why?).
- Re-purchase has tax advantage over dividends (deferred capital gain tax).
- Dividend policy should be **stable** (**signaling theory**).

Dividend yields around the world



Constraints on dividend policy

Although distribution policy theory might be useful, there are several practical constraints.

- Debtors might limit the firm to pay dividends.
- Obligations from preferred stocks need to be met first.
- Maximum amount of dividend payments might exists.

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Summary

- Distribution policy: dividend payments vs. stock re-purchase
- Theories of distribution policies
- What are the pros and cons of dividends and stock re-purchase

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