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

(Welch, Chapter 20)

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Distributions

- Dividends
  - 65% of publicly-traded firms do not pay dividends!
  - Dividends are a “large firm” phenomenon.
- Repurchases
  - not fully disclosed, so more mysterious.

Non-Cash Distributions

- *stock splits*
- *stock dividends*

Consider as "placebo" without cash effects?

Dividend Mechanics

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

Repurchase Mechanics

- Auction-based repurchases:
  - Pro-rata on voluntary participants..
  - Usually large, often one-time.
  - Usually exclude eligibility for 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.

First-Order Aspects and Nonsense

- 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 should happen to firm value?

- Should cash distributions be good for investors?
- In the real ICM, *are* distributions news for investors?

Investment "Substance"

- From *a* retail investor's perspective, if she is selling her shares, does she nibble *away* more on the "investment substance" than when she collects dividend payments?

Non-Tendering Investors?

- Do only tendering investors benefit from share repurchases?
- In PCM theory, share repurchases could be used to discriminate in favor of cash-rich investors. However, this is extremely rarely the case.

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, just inverse.
- For example, direct PV effects should work as follows
  - If paying out dividends reduces positive NPV projects, announcement value should go down.
  - If paying out dividends reduces negative NPV projects, announcement value should go up.
  - ...well, *maybe*, because all sorts of other things can go heywire in ICM, too.

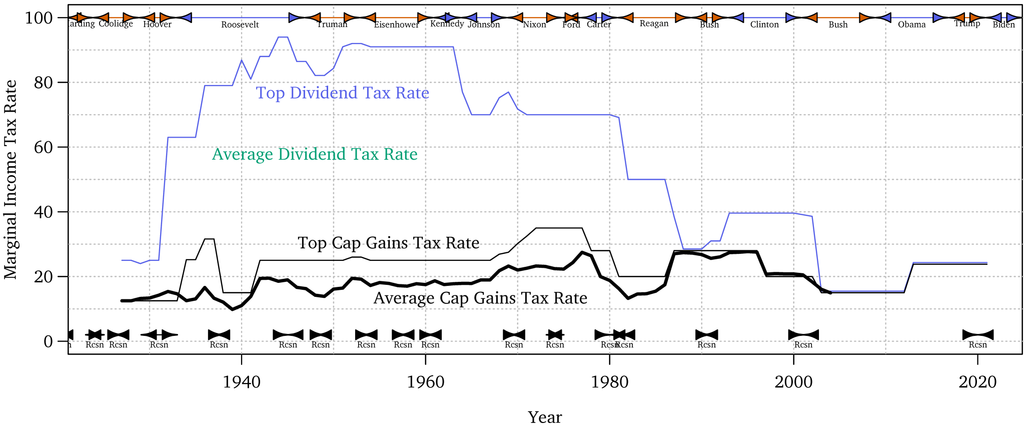
ICM Dividend Theory II

- Repurchases are more tax efficient than dividends.
- If you pay dividends from issed 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 = Free Cash Flow Waste Theory.

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



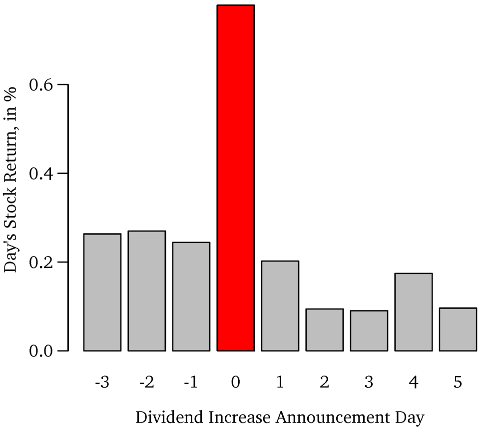
Graph Footnotes

- Tax rates varied widely.
- The punishment of “job creators” did not seem to have hampered economy much in the 1960s.
  - At best *a* curiousity — but do *not* draw inferences from (likely spurious) correlation.
  - Politicians love economics when it favors what they want to do.

Distributions

- Should firms pay out funds?
- What happens when they do?

Time-Series: Avg Dividend Announcement Response — Good or Bad News?



Day's Stock Return, in %
0.0
0.2
0.4
0.6
-3
-2
-1
0
1
2
3
4
5
Dividend Increase Announcement Day

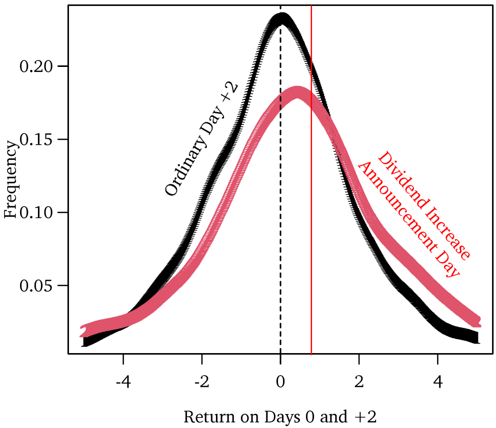
- Average stock market response to announcement of more dividends is *much* higher than the average stock market response on other (more ordinary) days.

Empirical Evidence

- A dividend announcement is good news (on avg)
- The announcement value increase continued (was even 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.

Histogram: Anncmt Benefit Variability

- Do all or most increasing firms experience positive announcement rates of return?


Frequency
0.20
0.15
0.10
0.05
-4
-2
0
2
4
Return on Days 0 and +2
Ordinary Day +2
Dividend Increase
Announcement Day

- Large cross-sectional variability.
  - Some go down
  - A few more go up
  - You cannot conclude that increasing dividends always increases value!

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.
  - PS: Even the most regular repurchasing programs are less sticky than dividends.
- Firms do not like to cut them.
- If dividends come with an implicit commitment to continue them,
  - then they may serve a signaling purpose,
  - that execs are confident about future earnings.

Annual Changes, 2010-2020

	Fraction
Unchanged Zero	52%
Initiated	3%
Reduced	9%
Stopped	2%
Continued	30%
Same	7%
Little Up	7%
Great Up	15%

Implicit Commitment = Signal?

Best Pay-Out Choice

- How should you distribute earnings:

1. Dividends, *or*
2. Share repurchase?

Other Div-Repo Differences

- Executives (and insiders) can receive dividends, but they cannot sell into share repurchases.
- Do Floridians have preferences for dividends?
- Institutions have preferences, too.
  - Many fund charters even require them.
  - Why? Beats me.

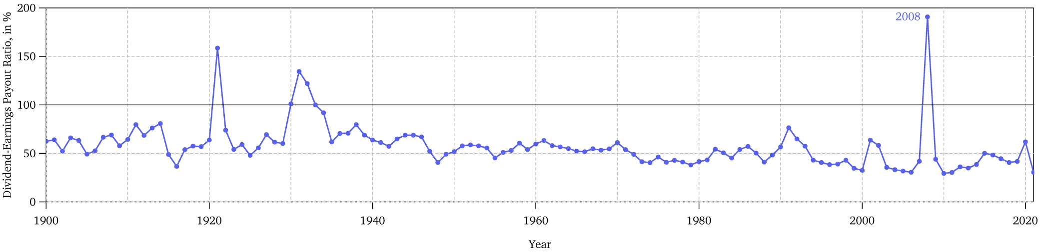
Some *Earnings* Background

- Before 2000, talking heads were babbling a lot about the myopia of the stock market.
- Less so today, but some still claim some of this
  - More talking heads nowadays claim stock markets cares too little about today.
  - C'est La Vie.
- Lots of good background statistics are in the book.

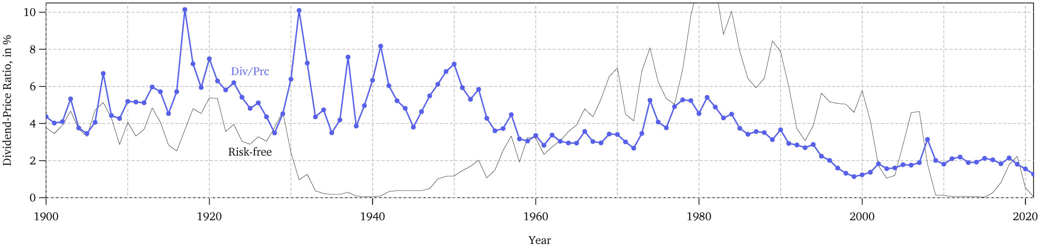
Some Earnings Background on Public

Decade	NFirms	Pos Earn	Yield|+
1970s	5,000	85%	11.4%
1980s	6,000	70%	9.6%
1990s	7,000	64%	4.5%
2000s	5,000	59%	4.5%
2010s	4,000	59%	5.4%
2020s	4,500	56%	3.3%

Graph: Dividend-Earnings Ratio



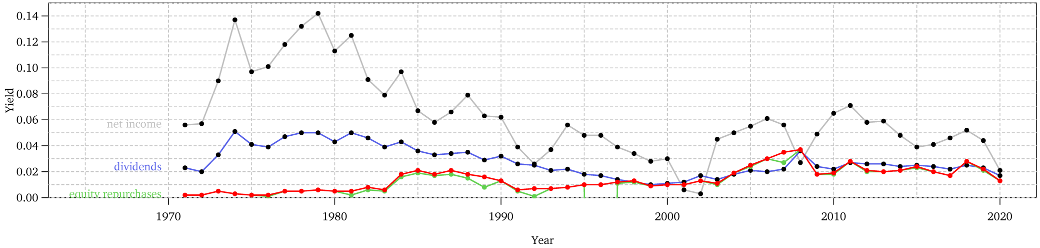
Graph: Dividend-Price Ratio



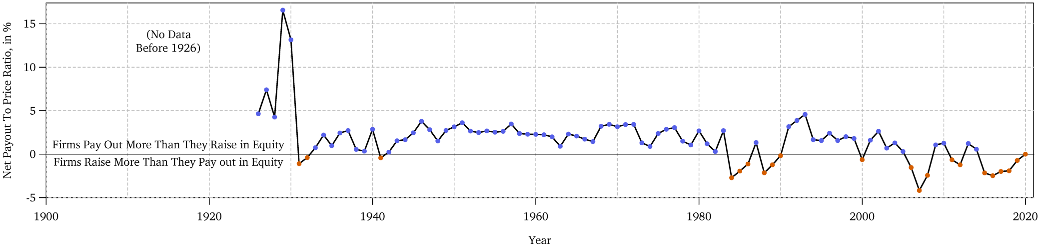
Graph Footnotes

- 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



Graph: Net Earnings Payout



Dividend-Paying Fraction of Companies

- Number of dividend payers has staid about the same.
- Ergo, fraction of all public companies paying dividends troughed in 1999 (at 20%)
    - nowadays back to 25-30%

Dividend Catering?

- Firms pay dividends when market likes dividend payers
  - When the P-E multiple on dividend-paying firms is higher than the P-E multiple on non-dividend paying firms.
  - Maybe coincidental, maybe not.

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.

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%.

Situation in the USA

- Dividends until 2020 were $\leq 2\%$ in nominal terms (relative to share value),
  - Ergo, tax considerations were less burning.
  - Covid crises reduced earnings and interest rates further.
- What will be the anticipated future dividend tax rates?
  - and inflation rising as of 2022?