Class 15

UG3F14
Corporate Finance

Class 15 Topics and Content

- Long-Term Financial Policies: Dividend Policy – Other Considerations

- Stock Splits, and the Strategy in Stock Buyback
- Factors Affecting Dividend Decisions
- Optimum Payout Policy for a Business: How is the Dividend Policy Determined?

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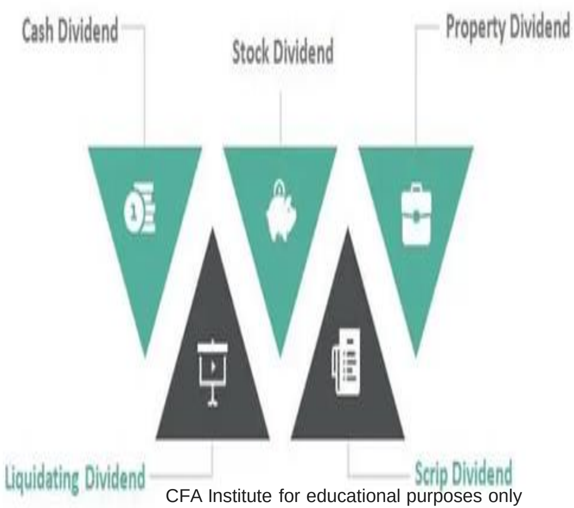
- Long-Term Financial Policies: Dividend Policy – Other Considerations

➢ Stock Splits



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Stock Splits is similar to a stock dividend, except that a split is expressed as a ratio instead of a percentage

- ✓ When a split is declared, each share is split up to create additional shares
- ✓ For example, 3:1 stock split, each old share is split into three new shares

*Apple's stock has split **five times** since the company went public. The stock split on a 4-for-1 basis on August 28, 2020, a 7-for-1 basis on June 9, 2014, and split on a 2-for-1 basis on February 28, 2005, June 21, 2000, and June 16, 1987 source: www.nasdaq.com*

Stock Reverse Split

- ✓ To decrease the number of shares
- ✓ For example: 1:10 reverse stock split each investor exchanges 10 old shares for 1 new share to reduce the number of its shares outstanding, and the prices is adjusted proportionally

Priceline.com (NASDAQ:BKNG) is the biggest winner. It went through a 1-for-6 reverse split in 2003 when the online travel portal was flopping around after the dot-com bubble burst source: www.nasdaq.com

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- ✓ When a firm declares a stock split, it increases the number of shares outstanding and decreases the price - each is entitled to a smaller percentage of the firm's cash flow

For example, if the managers of a firm whose stock is selling at $90 declare a 3:1 stock split, the price of a share of stock should fall to $30

- ✓ A stock split strongly resembles a stock dividend
- ✓ An alternative form of cash payout is a stock repurchase - use cash to buy back shares of its stock - the shares are held by the corporation and accounted for as treasury stock

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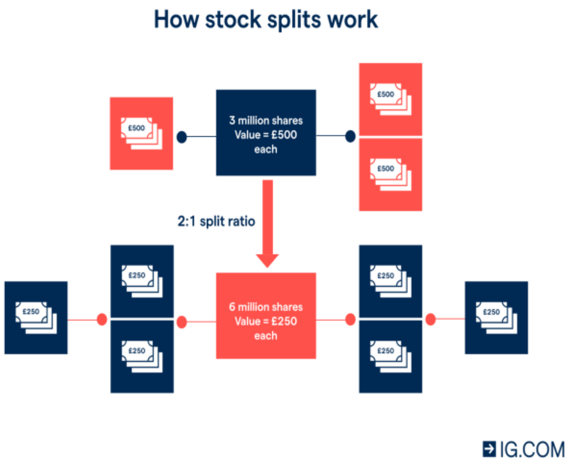
Pros and Cons of Stock Splits

Pros
- Improves liquidity
- Often increases share price

Cons
- Could increase volatility
- Not all stock splits increase share price



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✓ Repurchase of Stock

Apple was the largest individual stock repurchase in the first quarter of 2021 followed by Alphabet ($11.4 billion); Microsoft ($6.9 billion.); and Berkshire Hathaway ($6.6 billion)

- Instead of paying dividends, a firm may use cash to repurchase shares of its own stock
- Share repurchases have taken on increased importance in recent years
- Share repurchases is accomplished in the form of one of the three actions:
    1. Purchase their own stock in the open market purchases
    2. Tender offer - the firm announces to all of its stockholders that it is willing to buy a fixed number of shares at a specific price
    3. Repurchase shares from specific individual stockholders - targeted repurchase.

Apple has spent $319.2 billion on share buybacks over the past five years, a period in which its stock price has almost quintupled in value

source: forbes.com

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- Long-Term Financial Policies: Dividend Policy – Other Considerations

- Factors affecting dividend decisions

  - ✓ Dividend decision relates to how much of the company's net profit is to be distributed to the shareholders and how much of it should be retained in the business for meeting the investment requirements while keeping in view the overall objective of maximizing shareholders' wealth.
  - ✓ Factors affecting dividend decision :
    - Amount of Earnings: Dividends are paid out of current and past earnings
    - Stability in Earnings: A company having higher and stable earnings can declare higher dividends than a company with lower and unstable earnings.
    - Stability of Dividends: Generally, companies try to stabilize dividends per share. A steady dividend is given each year like Coca Cola Company
    - Growth Opportunities: Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment. Dividends declared in growth companies is, therefore, smaller than that in the non-growth companies. .

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✓ Dividend Vs Repurchase

Assuming the company has a certain amount of cash they wish to return to shareholders, the two ways they can do it are through dividends and share repurchases

- Share repurchases is the best option when the share price is undervalued, and not-so-great when the share price is overvalued

Share Repurchases
-Better tax treatment than dividends for investors
-Share repurchases are more flexible than regular dividends for the company

Regular Dividends
-Important for those seeking current income
-Dividends are more flexible than share repurchases for the shareholder
-Provides a psychological edge and discipline to both shareholders and company management

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Advantages:

1. Cash dividends help in establishing the prices of equity
2. It attracts investors particularly those who wants returns in the form of dividends
3. Increase or higher cash dividend increases equity share price
4. It can help reduce agency cost that might arise from management and shareholders' conflict due to “excess cash

Disadvantages:

1. It can decrease internal sources of financing and management might rely on costly external financing
2. Shareholders will pay tax for dividends received
3. Once declared, dividends cannot be reduced without affecting the equity share price

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- Long-Term Financial Policies: Dividend Policy – Other Considerations

- Factors affecting dividend decisions
  - ✓ Factors affecting dividend decision :
    - Cash Flow Position: Availability of enough cash is necessary for payment or declaration of dividends.
    - Shareholders' Preference: The companies should consider the preferences of all shareholder's
    - Taxation Policy: If the tax on dividends is higher, it is better to pay less by way of dividends.
    - Stock Market Reaction: An increase in dividends has a positive impact on stock market
    - Access to Capital Market: Large and reputed companies generally have easy access to the capital market and, therefore, may depend less on retained earnings to finance their growth-tend to pay higher dividends than the smaller companies.
    - Legal Constraints that place restrictions on payouts as dividend
    - Contractual Constraints for example when granting loans to a company, the lender may impose restrictions on the payment of dividends in future

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- Optimum Pay Out Policy for a Business: How is the Dividend Policy Determined

Corporations take a large number of various factors into account when deciding about the character of their dividend policy

a) Country legal rules
b) Business liquidity position
c) The CF priorities - need to pay off debt
d) Restrictions in debt contract
e) Rate of expansion of assets
f) Profit rate
g) Stability of earnings
h) Access to capital markets
i) Control, and
j) Tax position of shareholders - the clientele effect on dividend policy

Financial analyst combine these factors into dividend theories about the way in which dividend policy affects less the company's value

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➢ Optimum Pay Out Policy for a Business: How is the Dividend Policy Determined

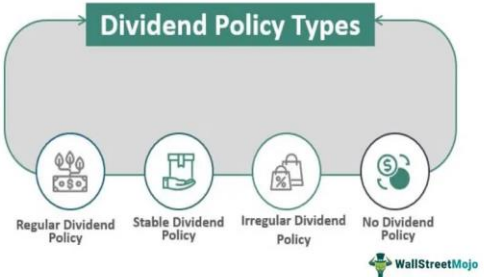
Leading dividend policies:

(a) Regular dividend policy

- The company pays out dividends to its shareholders periodically
- Excess profits are withheld by the company as retained earnings
- Shareholders will still be paid a dividend if the business has losses
- Used by companies with a steady cash flow and earnings
- Companies are considered low-risk investments: Coca Cola Co

(b) Stable dividend policy

- Fixed % of profits paid out as dividends
- Investing is risky for investors
- Uncertain to Shareholders



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Leading dividend policies:

(c) Irregular dividend policy

- The business is under no obligation to pay its shareholders
- Used by companies that do not enjoy a steady cash flow or lack liquidity
- Risky for investors as there is a possibility of not receiving any dividends during the financial year

(d) No dividend policy

- The business keeps the earnings for reinvestment or operations
- Shareholders values more price appreciation than dividend yield

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- In a highly competitive environment, financial objective of a firm should be set within the framework of corporate objective of sustainable competitive edge. As such Wealth maximization objective has come to be widely recognized criterion with which the performance of a business enterprise is evaluated
- Dividend Payout is measured by the Dividend Yield: Stock's annual dividend payments to shareholders expressed as a percentage of the stock's current price
- Dividend policy is irrelevant as it has no effect on the equity share price and the even on the cost of capital - Modigliani and Miller
- The dividend payment policy of the company is the reflection of the financial performance of the company. Thus the company should choose the dividend policy that it will be following correctly as it is critical to the company's financial growth and success