



Video  
Lecture

# Payout Policy

Advanced Financial Management

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# Payout options

Policy	Types	Details
<b>Dividends</b>	<b>Cash Dividend:</b> Firm pays cash to shareholders on a pro-rata basis, e.g. shareholders receive \$0.50 in cash for each share held.	<ul style="list-style-type: none"> <li>▪ Regular cash dividend (quarterly, semi-annual)</li> <li>▪ Special cash dividend (one-off)</li> </ul>
	<b>Stock Dividend:</b> Firm pays additional stock to shareholders on a pro-rata basis, e.g. 10% stock dividend means shareholders receive 10 shares for every 100 held.	<ul style="list-style-type: none"> <li>▪ No actual transfer of cash to shareholders</li> <li>▪ Essentially a stock split with a much smaller split factor</li> </ul>
<b>Share repurchase</b> Firm uses cash to purchase its own stock from shareholders.	<b>Open market repurchase (most common)</b>	<ul style="list-style-type: none"> <li>▪ Firm purchases shares in the open (i.e. secondary) market anonymously.</li> <li>▪ Usually lasts up to 3 years</li> </ul>
	<b>Tender offer</b>	<ul style="list-style-type: none"> <li>▪ Firm pre-specifies the number of shares and the price which it will offer</li> <li>▪ The offer price is normally at a premium to the current price (typically 10-20%).</li> </ul>

# Modigliani & Miller Payout policy Irrelevance

Modigliani and Miller (1958) showed that under the following assumptions (“perfect capital markets”):

1. Investment is held constant
2. No transactions costs
3. Efficient capital markets
4. Managers maximise shareholders' wealth
5. No taxes (or, no differential tax)

The payout policy does not affect the value of the firm and the wealth of shareholders.

# MM Payout Irrelevance

	Initial Price	Dividend Paid		
		Year 0	Year 1	Year 2
Policy 1	€52	€2	€5	...
Policy 2	€52	€0	€5.2	...
Policy 3	€52	€4.73	€4.73	...

## Post Balance Balance Sheet

$$A = \frac{50}{0.1} = €500M$$

$$E = \text{Equity} = €500M$$

## Ex-dividend Price:

$$\text{Policy 1: } P = \frac{€500M}{10M} = €50$$

$$\text{Policy 2: } P = \frac{€500M}{9.615M} = €52$$

$$\text{Policy 3: } P = \frac{€500M}{10.577M} = €47.3$$

- All three policies have the same initial price. This means that the present value of all three policies is the same for the shareholder.
- Shareholders should be indifferent between the 3 policies.
- The wealth of shareholders is the same in all 3 policies. Wealth from 1 share is the dividend received plus the value of the share:  
 Policy 1: €2 + €50 = €52  
 Policy 2: €0 + €52 = €52  
 Policy 3: €4.73 + €47.3 = €52

# Modigliani Miller

Consider a firm unexpectedly, announces a dividend of \$5 per share. The firm before the announcement was trading at \$50.

- a) What is the price after the announcement
- b) What is the price after the exdividend date
- c) What is the return of the firm stock from the day before the announcement to the day after the exdividend date.

# Determinants of Dividends – Asymmetric information

## Managers' beliefs and behaviours

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- Managers' beliefs about information in payout decisions
  - Over 80% of managers say that dividend and repurchase decisions convey information to investors.
  - 88% believe there are negative consequences to reducing dividends. There is no similar belief around repurchase decisions.
- Dividend smoothing
  - Management believes that investors prefer stable dividends with sustained growth
  - Thus, firms raise their dividends only when they perceive a long-term sustainable increase in the expected level of earnings.

## Theories

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- Dividend signalling hypothesis:
  - When a **firm increases its dividend** it sends a positive signal to investors that management expects to be able to afford the higher dividend for the foreseeable future.
  - When a **firm decreases its dividend** it may signal that management has given up hope that earnings will rebound in the near term.
- Mixed Signals? Perhaps.
  - When a firm increases its dividend, it might instead signal a lack of investment opportunities.

# Determinants of Dividends – Other

## **Tax Preferences**

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- The preference for a payout policy depends on the difference between the dividend tax rate and the capital gains tax rate.
- E.g., much lower taxes on capital gains leads to a strong preference for buybacks over dividends.

## **Precautionary motives**

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- Other financing frictions could lead to precautionary or transactional cash holding motives
- Keep cash if external financing is very costly or investment opportunities are fleeting (e.g., R&D, acquisition opportunities).

# Key takeaways

- 01** Understand what payout policy is.
- 02** Understand payout policy irrelevance under the assumptions of Modigliani and Miller model.
- 03** Recognize reasons why payout policy may affect value of the firm