

CHANGES TO PAYOUT POLICY

Course: Impact of COVID-19 to
financial markets

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- ▶ A firm generates cash flow:
- ▶ It then invests some of it
- ▶ The question is how much of the cash flow is paid out to investors and what form will the payment take?
- ▶ Basically: What is the effect of a change in payout policy, *given* the firm's capital budgeting and borrowing decision?

WHAT IS PAYOUT POLICY



- ▶ Ordinary Dividend
- ▶ Extraordinary Dividend
- ▶ Repurchase of shares
- ▶ Repurchase of other securities

ALTERNATIVES AVAILABLE



LOS ANGELES--(BUSINESS WIRE)--Sept. 11, 2008—

Center Financial Corporation (NASDAQ: CLFC), the holding company of Center Bank, today announced that its Board of Directors declared a quarterly cash dividend of **\$0.05** per share. The cash dividend will be paid on or about **October 8, 2008** to shareholders of record at the close of market on **September 24, 2008**.

- ▶ There are four critical dates here, although only three are contained in the announcement:
 - ▶ Announcement Date: September 11, 2008
 - ▶ Record Date: September 24, 2008
 - ▶ Payment Date: October 8, 2008
 - ▶ Ex-Dividend Date: September 22, 2008
 - ▶ The Ex-Dividend date is defined by the Exchange or Nasdaq and is 2 business days before the record date.
 - ▶ We say that before the ex-date, the stock is trading “cum-dividend”

WHAT THIS MEANS?

The ex-dividend date is the date on which ownership of the dividend is determined.

If you held the stock on the close of business on September 21, you owned the dividend. So if you sold the stock on the ex-date, Sept. 22 you still would be paid the dividend on October 8.

If you first bought the stock on Sept. 22 you would not receive the dividend even though you continued to own it through the payment date of October 8

SIGNIFICANCE OF EX-DIVIDEND DATE

CLFC

- ▶ Announcement Date
- ▶ Ex-Dividend Date
- ▶ Record Date
- ▶ Payment Date

EXPECTED STOCK PRICE
MOVEMENT



- ▶ Signaling
- ▶ Agency Problems
- ▶ Taxes
- ▶ Capital Structure Adjustments
- ▶ Excess Cash Flow
- ▶ Provide Liquidity

FACTORS AFFECTING PAYOUT POLICY



- ▶ We have seen a dramatic increase in the incidence of Share Repurchases
- ▶ What kind of share repurchases are there?
 - ▶ Fixed Price tender offer
 - ▶ Dutch Auction
 - ▶ Open Market Purchases
 - ▶ Direct negotiation with large stockholder

REPURCHASE OF SHARES AS AN ALTERNATIVE TO DIVIDEND PAYMENTS



- ▶ Offer: to sell 10 million shares
- ▶ Stockholders' are invited to offer the shares at various prices
- ▶ Hypothetical Auction results
 - ▶ 1 million shares offered at \$35
 - ▶ 6 million shares offered at \$34.90
 - ▶ 3 million shares offered at \$34.80
 - ▶ 4 million shares offered at \$34.70
 - ▶ And so on:

DUTCH AUCTION EXAMPLE



- ▶ Open Market is the overwhelming dominant means of purchasing shares (91%), and they are increasing in proportion
- ▶ Repurchases are increasing over time relative to Dividends
- ▶ Repurchases as a proportion of Earnings have increased

RECENT OBSERVATIONS



- ▶ The ratio of repurchases to earnings increase from the 1970's to 2002 from about 7% to 34% of earnings
- ▶ Dividend Payouts have increased also but more modestly from 41% to 48% over the same period.
- ▶ Repurchase as a percent of total payouts have increased from about 12% to about 71%.

PAYOUT POLICY



- ▶ 1982: Clarification of rules regarding stock price manipulation (10b-18)
 - ▶ Rule 10b-18 provides a “safe harbor” for stock repurchases. The problem is that Corporations are “insiders” and as such are limited in their dealings in stock transactions of their own firm. However, Stock buybacks will not in general be questioned if they satisfy the conditions of 10b-18; to wit:

WHY?



- ▶ Cannot trade at opening, and cannot trade within 30 minutes of the close
- ▶ Cannot pay a price greater than the last recorded sale price or the highest bid quotation
- ▶ Only one broker or dealer may be used
- ▶ Corp. must publicly announce the intent to buy back
- ▶ After announcement there can not be significant non-public information revealed
- ▶ During any one day can not buy back more stock than 25% of the average daily trading volume over the last four weeks
 - ▶ Block trades privately negotiated are excluded

10B-18 RULE

- ▶ But what does payouts signal?
 - ▶ Suppose a firm that was announcing fairly regular, flat earnings historically of say \$1.20 per quarter. Suddenly it announces earnings of \$1.38 a 15% increase. As an investor what would you like to know about that announcement?

DIVIDEND SIGNALING



- ▶ But what does payouts signal?
 - ▶ Suppose a firm that was announcing fairly regular, flat earnings historically of say \$1.20 per quarter. Suddenly it announces earnings of \$1.38 a 15% increase. As an investor what would you like to know about that announcement?
 - ▶ The Dividend is forward looking and is generally tied to the long run earnings prospect of the Firm.

DIVIDEND SIGNALING



- ▶ Initiation of Dividends leads to a 4% average increase in stock price
- ▶ Decline or omission of dividends on average leads to a 9.5% decline in stock price
- ▶ Increase (decrease) in dividends were followed by increases (decreases) in the next 4 quarters of earnings.

HEALEY AND PALEPU



- ▶ Firms have long-run target dividend payouts
- ▶ Managers focus on dividend changes rather than levels
- ▶ Dividend changes follow shifts in long-run sustainable earnings
 - ▶ Managers tend to “smooth” earnings
 - ▶ Transitory changes in earnings does not effect dividend payments
- ▶ Managers are reluctant to cut dividends

LINTNER



- ▶ $Div_{(t)}^* = T \times EPS_{(t)}$ where T is Dividend Target Ratio (Target Dividend/Long Run EPS)

Smoothing

- ▶ Dividend Changes = $a(Div_{(t)}^* - Div_{(t-1)})$

$$Div_{(t)} - Div_{(t-1)} = \{aT \times EPS_{(t)}\} - \{a \times Div_{(t-1)}\}$$

“a” is called the “partial adjustment coefficient” and T is the Target Payout Ratio.

How do we determine this?

THE LINTNER MODEL

- ▶ Notice that we are saying Dividend changes are a function of two things, Managers' perception of long term EPS and previous quarter's dividend
- ▶ Managers' perceptions can't be measured but current earnings can. So we use current earnings as a proxy (substitute) for Management's Perception of Long-Term Earnings
- ▶ This works as long as Manager's have unbiased estimates of earnings over time.

HOW CAN WE DETERMINE



- ▶ So how do we measure this:
- ▶ We want to relate a dependent variable:
Dividends to some independent variables:
 - ▶ Current EPS
 - ▶ The previous quarter's Dividend

LINTNER



- ▶ What determines the incidents of repurchases:
 - ▶ Firms repurchase stock when they accumulate a large amount of unwanted cash
 - ▶ Firms repurchase stock when they want to increase the leverage ratio of the firm.
 - ▶ Replace Equity with Debt
 - ▶ Firms do not think of repurchases as a substitute for dividends

REPURCHASES AND SIGNALING



- ▶ Empirical Evidence regarding Operating Performance after a Repurchase
 - ▶ Depends on type of repurchase
 - ▶ **Fixed Price Repurchase** followed by improved operating results
 - ▶ **Open Market Repurchases** weak increase or actual decline in operating performance
- ▶ WHY?

REPURCHASES AND SIGNALS



- ▶ Empirical Evidenced on Financial Performance
 - ▶ Market Reaction Short Run
 - ▶ Fixed Price Tender = 11% to 15%
 - ▶ Open Market Purchase = 2% to 4%
 - ▶ Market Reaction Long Run (4 years)
 - ▶ Low Market/Book = + 45%
 - ▶ High Market/Book = +4.3%
- ▶ WHY?

SIGNALS



- ▶ What does a Repurchase signal?
 - ▶ What does a fixed price tender signal
 - ▶ What does open market purchase signal
- ▶ What does a dividend signal?
 - ▶ What does a Special Dividend Signal

EXPLANATION?



The Theory

You want to get excess cash out of the hands of management since given the temptation, Management will squander it

Empirical:

Positive reaction positively related to excess cash

Positive reaction negatively related to ROI

AGENCY COST FREE CASH FLOW THEORY



- ▶ Share repurchases are associated with shrinking investment opportunities
- ▶ Asset base shrinks after repurchase
- ▶ Repurchases accompanied by subsequent reduction in Capital Expenditures

CAPITAL MARKET REALLOCATION



- ▶ Tax Motives-unlikely

DIVIDEND SUBSTITUTION

- ▶ Typical repurchase plans are relatively modest and designed to offset other equity increasing activity:
 - ▶ ESOP
 - ▶ Executive Stock Option Plans
 - ▶ DRIP's

CAPITAL STRUCTURE ADJUSTMENTS



- ▶ Mixed empirical results
 - ▶ bid-ask spreads tend to widen around repurchases, reducing liquidity
 - ▶ Ready buyer in down market increases liquidity
 - ▶ Reduced volatility accompanies repurchase plans

STOCK LIQUIDITY



- ▶ It used to be that this would have a devastating effect on the stock price
- ▶ Now, it has at best a temporary impact
- ▶ FPL
 - ▶ Immediate reduction of 14% recovered by end of month
 - ▶ Today: Current Dividend is \$1.78 a yield of 3.36% and a Payout of 59% (compared to 90%)

DIVIDEND REDUCTIONS ACCOMPANIED BY A REPURCHASE AGREEMENT



- ▶ We want to know if a firm is better off with a high payout policy or a low payout policy
- ▶ Note: Definition of Payout Policy: The firm's established policy of paying a large proportion of earnings out in dividends or not.

GENERAL POLICY



- ▶ What investors do regarding dividend policy
- ▶ What Firms do
- ▶ How all this effects stock price.

WE WANT TO KNOW:



WHAT INVESTORS DO

CLIENTELES

CORPORATE HOLDERS OF SECURITIES IN OTHER FIRMS

INDIVIDUAL TAX BRACKETS AND CLIENTELES

OTHER FACTORS AFFECTING CLIENTELES

WHICH CLIENTELE SHOULD A FIRM WANT TO "ATTRACT"



WHAT FIRMS DO

It is clear that firms in general have a long run view of dividend payouts and are careful about the dividend payout policy.

Dividends are used as a means of conveying important information to investors.

Firms are very conservative in adjusting dividends to their concept of long-run earnings.

Firms are very reluctant to reduce dividends.

- ▶ From Lintner's model we can see that dividends reveal information about the firm. This information content is very strong and can be explained by sound theory.

THE INFORMATION CONTENT OF DIVIDENDS



Does a policy of paying a high (or low) dividend have a detectable impact on stockholders' wealth.

The Basic test:

Regression Results

Do a Cross sectional Regression of Return against

both Beta and Dividend Yield.

DIVIDEND POLICY VERSUS

These tests were done during a regime when taxes on Dividends

ANNOUNCEMENT EFFECT
were high relative to Capital Gains

The assertion is that there will be a significant coefficient on the dividend yield variable.

That is: Run the regression:

$$R_i = \alpha + \gamma_1(R_m - R_f) + \gamma_2(\text{Div Yield}_i)$$

The question is, is the coefficient on the dividend yield significantly different than 0.

Hypotheses:

Tax Effect: $\gamma_2 > 0$

Irrelevance: $\gamma_2 = 0$

Preference: $\gamma_2 < 0$

Hypotheses:

Tax Effect

Irrelevance:

Brennan: A Tax Effect

Miller and Scholes: Irrelevance



Final Conclusion:
Prices Versus Dividends

TAX PENALTY

Brennan

Litzenberger-Ramaswamy

Short-Run Definition

IRRELEVANCE

Black & Scholes

Miller & Scholes

Long-Run Def.



Non-Tax Effects:

Jensen's free Cash Flow Argument

Pecking order and Cash Reserves

Information Content

Can you reverse dividend information

impact?

Not by stating purpose

Simultaneous announcement of stock dividends or stock repurchase mitigates the negative impact

SUMMARY

WHAT SHOULD CORPORATIONS DO

1. INFORMATION CONTENT OF DIVIDENDS
2. SERVICE THEIR CLIENTELES
3. HIGH OR LOW DIVIDEND PAYOUT?

WHAT SHOULD INVESTORS DO

1. USE DIVIDEND ANNOUNCEMENTS AS A SIGNAL OF MANAGERS' VIEW OF THE FUTURE
2. TAILOR THEIR PORTFOLIOS TO THEIR INDIVIDUAL NEEDS BUT RECOGNIZE THE COSTS OF DOING SO.

WHAT IMPACT DOES DIVIDEND POLICY HAVE ON THE VALUE OF THE FIRM?

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