Dividend Policy: Theory and Practice

Why do corporations pay dividends? 
Does paying dividends $\uparrow$ S/H wealth?

### Mechanics of dividend payment

<table>
<thead>
<tr>
<th>Decl. date</th>
<th>Ex-div.</th>
<th>Record</th>
<th>Pmt.</th>
</tr>
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<tbody>
<tr>
<td>3/18/04</td>
<td>4/15 (Th.)</td>
<td>4/19 (M)</td>
<td>5/7</td>
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- Last day you can buy stock **and** get dividend: 4/14/04
- S.P. ↓ by the $ amount of dividend on the ex-dividend date (theoretically)
Miller-Modigliani (MM)’s Dividend Irrelevance Theorem

Ass.: taxes=transaction costs=0 and Firm’s investment policy is unaffected by dividend policy

Firm_{value} (0 div.) = Firm_{value} (↑ div.) HOW?

- S/Hs receive returns in 2 forms:
  - Dividends & Stock Price appreciation (CGs)
  - ↑ dividends, ↓ the CG and vice-versa
- Overall S/H’s returns are identical
  - Indifferent to dividend policy
Homemade Dividends

S/Hs through their actions can alter the corporate dividend policy to suit their needs. Thus, corporation can’t do anything for the S/Hs that they can’t do for themselves.
If Taxes & Trans. costs ≠ 0, What should be firm’s div. policy?

- \( T_{\text{div.}} > T_{\text{capital gains}} \)
- Investors are not indifferent to level of dividends
  - prefer smaller or no dividends at all
- Firm with a # of +NPV projects
  - not enough $ to fund the projects & to pay dividends
    - paying dividends ⇒ will have to raise funds in the market-- stock/bond issue
    - investors have to pay taxes and firm has to pay issuance costs. lose-lose proposition
Dividend Policy in the Real World-- Continued

-Managers with excess cash
  - Should pay dividends; Otherwise they would be tempted to spend the extra money on negative NPV projects
    - e.g., “bad” acquisitions

- Dividends serve as signal about firm’s future performance

- Clientele Effect
Repurchases

Repurchases can be used as a substitute (for dividends) mechanism for distributing cash.

Taxes make repurchases more attractive.

H.W. 2, 5, 7, 20