Dividend Policy: Theory and Practice

Why do corporations pay dividends?
Does paying dividends ⇑ S/H wealth?

Mechanics of dividend payment

Decl. date	Ex-div.	Record	Pmt.
3/18/04	4/15 (Th.)	4/19 (M)	5/7

- 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 $\neq 0$, *What should be firm's div. policy?*

- $T_{div.} > T_{capital\ gains}$
- 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 $\Rightarrow$ 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