Study Plan

Chapter 13

Learning Objectives

After studying this chapter you should be able to:

- Discuss the fundamentals of dividends, including payment procedures, types of policies, and other forms of dividends;
- Describe the observed patterns of dividend policies on a worldwide basis;
- Understand the agency cost model of dividends;
- Explain the argument for dividend irrelevance in a world with perfect capital markets;
- Review the real-world influences on dividend policy such as taxes, transactions costs, and uncertainty; and
- Summarize the predictions of the agency cost model, regarding expected dividend payout.

Summary and Conclusions

- One of the most enduring features of corporate finance worldwide is that large publicly traded corporations almost invariably choose to pay regular cash dividends to their shareholders. Furthermore, these payments are generally a constant, absolute amount per period (€0.25 per share), rather than a constant fraction (20 percent) of the firm’s profits. In the United States, dividends are usually paid on a quarterly basis but are paid annually or semiannually in most other countries.
- There are striking regularities in the patterns of dividend payments, as observed across countries and industries. Among developed countries, dividend payout ratios (dividends as a fraction of corporate profits) tend to be highest in British Commonwealth countries, whereas payouts are much smaller in France and Italy. Payouts by U.S. and other continental European companies tend to fall between these two extremes. However, the same industries (utilities, transportation firms) have high dividend payouts in all countries, and certain other industries (high-technology, health sciences) have low dividend payouts in all countries.
- Increasingly corporations frequently choose to repurchase shares on the open market rather than to pay (or in addition to paying) ordinary cash dividends, partly because repurchases are subject to lower effective tax rates for most individual investors. In recent years, repurchases by U.S. corporations have exceeded €100 billion per year, and ordinary (cash) dividend payments have been around €250 billion annually.
- Stock splits and stock dividends are used by companies that want to reduce the per-share price of their stock in the open market. In a 2-for-1 stock split, for example, one new share is distributed for every existing share an investor holds, and the price of the stock falls by roughly half.
- In a world without market imperfections, dividend policy is irrelevant, in the sense that it cannot affect the value of a firm. However, the fact that many firms pay dividends is something of a

puzzle because most real market imperfections (such as taxes) argue against paying cash dividends.

- One theory of dividend policy assumes that dividend payments serve to reduce agency costs between corporate managers and external investors by committing the firm to pay out excess profits. Managers are prevented from consuming the profits as perquisites or wasting them on unwise capital investments (such as unrelated corporate acquisitions). Most of the empirical evidence supports this agency cost model of dividends over the competing signaling model, which predicts that managers use dividend payments to convey information to investors about the firm's expected future earnings.
- In addition to ownership considerations, several other aspects of a firm's operating and regulatory environment seem to influence dividend payouts. Other things being equal, closely held corporations, which operate in a high-growth industry where large ongoing capital investments are needed to compete, have lower dividend payouts than do widely held firms in slow-growing or highly regulated industries.