Course Learning Outcomes for Unit VI

Upon completion of this unit, students should be able to:

2. Assess a company's performance based on financial ratio analysis.
   2.1 Analyze the importance of stable dividend policies.
   2.2 Determine reasons behind stock repurchases.

8. Analyze the risk and return of a financial decision.
   8.1 Analyze the impact of stock repurchase plans and returns to a company's financial metrics.

Course/Unit Learning Outcomes	Learning Activity
2.1	Unit Lesson Chapter 14, pp. 561-593 Unit VI Essay
2.2	Unit Lesson Chapter 14, pp. 561-593 Unit VI Essay
8.1	Unit Lesson Chapter 14, pp. 561-593 Unit VI Essay

Required Unit Resources

Chapter 14: Distributions to Shareholders: Dividends and Repurchases, pp. 561-593

Unit Lesson

Cash Distribution

The term *distribution* pertains to the distribution of cash, stocks, or physical products to its investors and shareholders. One type of distribution is called the *mutual fund distribution*. Mutual fund distribution involves the money acquired from net capital gains through the sale of a mutual fund's investments, dividend income, and the interest earned minus the operating costs. For example, if a stock that has been initially bought for $50 has been sold for $150, the capital gains are $100 minus the operating costs.

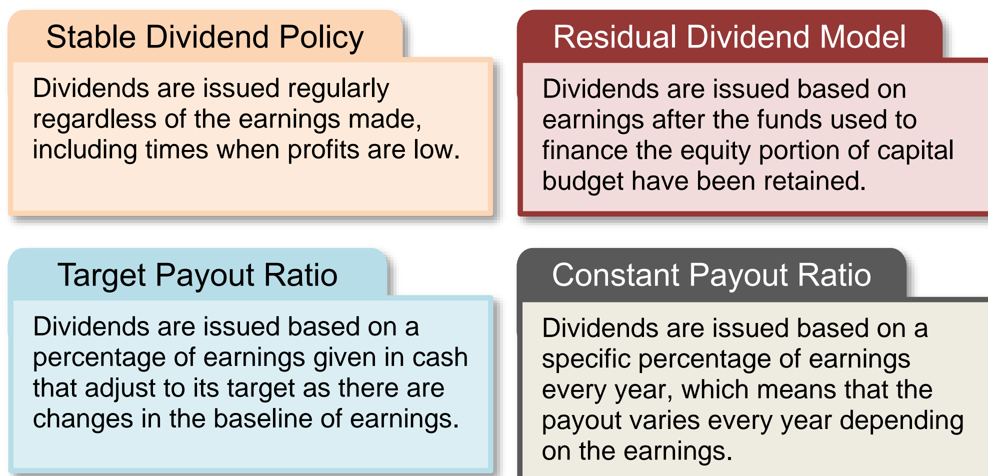
Another type of distribution is called the *cash distribution*, which will be the main focus of this lesson. Cash distribution is the process of paying a company's shareholders with cash. For example, mutual fund companies provide earnings/payouts to shareholders in the form of a distribution, which is an allocation of capital gains (i.e., profits minus operating costs) and income generated during a particular calendar year and paid out to the investors. Distribution can be regarded as the payment of interest, principal, or dividend given on a regular basis by the issuer of a security to the shareholders.

How Does Cash Distribution Work?

When profits are earned by a company, a portion of those profits can be paid to the shareholders or investors through what is called a dividend. If the company provides an option for a dividend reinvestment plan, the pay can be in the form of cash for further shares or through the repurchase of shares. The board of directors of a company is responsible for determining how and when dividends are issued, which are typically monthly or

quarterly. Whatever the decision of the board of directors is regarding the time frame of the dividend payout, dividends should be approved by the shareholders.

The net profits of a company serve as an important factor that determine the dividend. These net profits are divided to the shareholders through dividends (or withheld in the form of retained earnings). Net profits can also be used by a company as a means to repurchase its own shares in the open market. There are different methods that companies choose to pay out dividends to their investors, which are described in the graphic below.



Consider the following example of how cash distributions are implemented through dividends. The board of directors of a corporation has decided that in order to maximize the confidence of the investors, a stable dividend policy will be implemented. With this policy, the dividend will be paid quarterly with a predetermined amount of money based on the share of each shareholder. This dividend will be assigned regardless of the net profits of the company every quarter. The board of directors believes that the profitability of the company is stable enough to pay out fixed dividends for the long-term regardless of the actual quarterly net profits.

Why Do Companies Choose to Issue Dividends?

The decision to offer a dividend (including the method and time frame by which it will be given) is one of the important management tasks for the board of directors of a company (Saraf & Kaur, 2014). There is no agreed-upon rationale for why it would be good for companies to pay out dividends, with some arguing that paying dividends increases confidence in the company, while others claim that dividends are irrelevant (Jabbouri & Attar, 2018).

The main argument supporting the implementation of paying dividends to investors is that investors are less certain about receiving something in the future (i.e., capital gains) compared to receiving something in the moment, such as actual cash (i.e., dividends). Hence, investors are more likely to place more value on current dividends than expected capital gains in the future, even if the two are theoretically equivalent. Investors are not typically concerned with dividend payouts as a source of income as long as the stock price is appreciating. In other words, investors do not care where the return comes from, as long as there is a positive return.

Here is a scenario wherein the practice of giving dividends can affect the financial performance of a corporation. HyperterDrug, a healthcare provider company, announced that their dividend percentage would decrease from 60% to 40%. They did not provide reasons why a dividend payout decrease would be implemented. Word got out about the planned decrease and the percentage of dividend payout to the shareholders. As a result, the stock of the company fell 10.5%. The decrease in dividend payout elicited less confidence from investors, suggesting that the decrease could be a sign that the company is experiencing problems or profitability issues.

What Types of Companies Issue Dividends?

Not all companies issue dividends. For instance, start-up and high-growth companies (e.g., technology and biotechnology) typically do not issue dividends because profits are usually not earned in the first few years, and if they did make a profit, this money is often redirected to support further growth or expansion. Larger and more established companies are usually the types of corporations that offer dividends to their investors, which tend to be on a regular basis in order to maximize the wealth of shareholders. Oil and gas, banks and finance, health care, and utility companies have historically given regular and high dividends to their investors.

Capital Structure

Capital structure pertains to the finances of a company from different sources of funds that are utilized to pay for its operations and growth. The capital structure of a company includes debt and equity. Debt comes from bond issues or long-term notes payable, whereas equity comes from stocks (common and preferred) and retained earnings. Short-term debt, such as the requirements for working capital, is also a part of a company's capital structure.

The capital structure of a company is often composed of a mixture of preferred equity, common equity, short-term debt, and long-term debt. When analyzing the capital structure of a company, the proportion of the short- and long-term debts is considered. When the capital structure of a company is analyzed, the ratio between debt-to-equity (D/E) is calculated, gaining insight into the level of risk a company is to investors. A company that is heavily reliant on debt is typically considered riskier to investors even though this risk is often regarded as a major source of the growth of the company.

Debt Versus Equity

Debt is one of the two ways in which companies raise capital. Debt is often selected for its tax advantages wherein interest payments are considered tax deductible. Unlike equity, debt also allows companies to retain their ownership (as opposed to *equity*, wherein investors are given a share of the company). Another advantage of debt is that in times of low interest rates, access to debt is both abundant and easy, making it highly attractive to companies.

More expensive than debt, equity is another way that companies can raise capital to fund operations or growth. Equity is more expensive—particularly in times when the interest rate is low. One advantage of equity over debt is that if earnings decline, equity does not need to be paid back to the investor. Instead, equity represents future earnings of the company.

As stated before, companies often use a mix of debt and equity when raising capital; however, this mix is often not equal. Consider the following scenario that can demonstrate why a company would choose a majority of one source of funds over the other. Ultraviolet is a basic utility company that plans on expanding its operations. In order to raise the capital needed, the leaders are deciding whether to use debt or equity. The board of directors recognizes that given that the market interest rate is currently high, borrowing money is not the most advantageous source of capital for the company. However, the leaders of the company also recognize that they need to continue to exhibit a significant level of independence in decision-making, which makes debt highly attractive given that banks do not have a say in any of their business decisions. Even though equity requires giving up a portion of their ownership within the company, the most important consideration for these leaders is that they do not want to be pressured into paying back a specific amount of money in a specific date in the future. They do not want to experience the pressure of paying out on a loan. For their current situation, the board of directors decided that the best way to proceed is to have a 65% (equity) to 35% (debt) ratio for their capital structure.

References

Jabbouri, I., & Attar, A. E. (2018, January). The dividend paradox: A literature review. *International Journal of Markets and Business Systems, 3*(3), 197–221.

Saraf, P. & Kaur, R. (2014, March). The study of dividend policy: A review of irrelevance theory. Cyber times *International Journal of Technology and Management*. 7(1). http://www.academia.edu/7004968/IJIRSM-Ranpreet-Kaur-The-Study-of-Dividend-Policy-a-Review-of-Irrelevance-Theory