# Dividends and Dividend Policy

**Learning Outcomes**

After completing this module, students will be able to:

1. Describe the types of dividends and how they are distributed.
2. Explain how different classes of investors tax dividends and capital gains.
3. Discuss how stock splits, reverse stock splits, and stock dividends are used to manage a firm’s share price.
4. Discuss why stock repurchases are an effective alternative to regular cash dividends and how they are implemented in practice.
5. Demonstrate the factors that influence dividend decisions and why dividend policy is relevant to investors.
6. Compare the different theories that explain corporate dividend policies.
7. Develop an appropriate dividend policy that incorporates current industry practice.

**Introduction**

A company can distribute surplus cash to its shareholders by paying them a cash dividend, repurchasing their common shares, or a combination of both. The amount paid out is usually the portion of a business’s earnings that is not needed to finance its future growth, but it can also include a return of share capital if the company is liquidating all or a portion of its operations. Common share dividends are quoted as a dollar amount per share, but preferred share dividends are sometimes denoted as a percentage of the share’s par or stated value.

Many academics feel that it is irrelevant whether a company pays a dividend or not. They claim that if the dividend is too low, shareholders can generate additional cash by selling some of their shares in the company. If the dividend is too high, they can use the funds to buy more shares. It does matter, though, whether a shareholder receives a cash dividend or earns a capital gain selling shares, as these two sources of income are taxed differently. Transaction costs incurred by shareholders buying and selling shares and the issuance costs paid by companies raising new equity vary with the size of the dividend. The size of the dividend also influences management’s financial flexibility and the agency costs incurred by the company’s shareholders. Finally, the size of a dividend and whether it is increasing or decreasing provide important information to the financial markets about a firm’s financial performance. Whether a company pays a dividend or not is relevant.

Senior managers must be familiar with the mechanics of distributing a company’s surplus cash and be able to design a dividend policy that best meets its financing needs and stock market expectations.

#### 1.1 | Taxation of Dividends and Capital Gains

Dividends and the capital gains earned when a share is repurchased are taxed differently depending on the type of investor. This may affect the decision of whether to pay a cash dividend or repurchase common shares.

#### Individual Investors Saving Outside a Tax-Shelter Account

For individual investors saving outside of a tax-sheltered account, such as a company pension plan, Registered Retirement Savings Plan (RRSP), or Tax-Free Savings Account (TFSA), capital gains are taxed at a slightly lower rate than dividends in Canada and also offer a tax deferral. A tax deferral means capital gains are only taxed when the shares are sold, which can be an extended period for a long-term investor who is saving for retirement in 20 to 30 years. This may influence a company to distribute earnings through a stock repurchase instead of a dividend.

The following exhibit compares the effective tax rates for dividends and capital gains:

**Exhibit 1: Taxation of Dividends and Capital Gains in Canada**

|  |
| --- |
| **Dividends (CAD)** |
| Dividend income | 100.00 |
| Gross-up (38% of dividend income) | 38.00 |
| Taxable (grossed-up) dividend | 138.00 |
| Federal tax (29% of taxable dividend) | 40.02 |
| Provincial tax (12.29% of taxable dividend) | 16.96 |
| Federal dividend tax credit (15.02% of grossed-up dividend)  | 20.73 |
| Provincial dividend tax credit (10% of grossed-up dividend) | 13.80 |
| Taxes payable | 22.45 |
| Effective tax rate | 22.45% |

|  |
| --- |
| **Capital Gains (CAD)** |
| Capital gains  | 100.00 |
| Taxable capital gains (50%) | 50.00 |
| Federal tax (29%) | 14.50 |
| Provincial tax (12.29%) | 6.14 |
| Taxes payable | 20.64 |
| Effective tax rate | 20.64% |

The effective rates vary by province. The Provincial and Federal Dividend Tax Credits help to eliminate the double taxation of dividend income. Double taxation means that corporate income is first taxed at the corporate income tax rate when it is earned and again at the personal tax rate when the dividends are distributed to shareholders.

#### Individual Investors Saving Inside a Tax-Shelter Account

For investments inside tax-sheltered accounts that are funded with before-tax dollars, like most pension plans and RRSPs, dividends and capital gains are not taxed as long as the funds remain inside the account. The dividends and capital gains are taxed as normal income when funds are taken out of the account in the future.

For investments inside tax-sheltered accounts that are funded with after-tax dollars, such as some pension plans and TSFAs, dividends and capital gains are not taxed as long as the funds remain inside the account. The dividends and capital gains are also not taxed when they are taken from the account, as taxes were paid before the funds were invested.

Whether retained earnings are distributed as dividends or capital gains is irrelevant to both these types of investors.

#### Corporations

Corporations do not pay taxes on intercorporate dividends but do pay tax on all capital gains. This favours the payment of dividends instead of capital gains if the shareholders are other corporations.

#### Non-Profit Organizations

Non-profit organizations like charities and their endowments are not subject to tax. Whether retained earnings are distributed as dividends or capital gains is irrelevant to non-profits.

#### Trusts

Trust fund beneficiaries can be taxed like investors inside a tax-sheltered account or outside a tax-sheltered account, so the preference for dividends or capital gains varies.

#### 1.2 | Types of Dividends

**Cash Dividends**

Regular cash dividends are usually paid quarterly in North America, but additional, extra or special dividends may be paid at any time. Extra dividends depend on the availability of cash in that period. These dividends may begin to be viewed as regular dividends by investors if they are paid too often. Special dividends are much less common and are generally not confused by investors with regular dividends.

Combining small regular dividends with extra dividends is common in cyclical industries that have variable cash flows. Large extra dividends are paid out during cyclical highs when companies generate more cash than needed for growth, and are then curtailed during cyclical lows when cash is required internally. Special dividends may be used to distribute surplus cash after one-time events such as the sale of a business unit.

Dividends are commonly paid on a semi-annual basis in Europe and Japan and annually in the rest of Asia. A longer time between dividend payments allows companies to save on administration costs and earn more interest on their idle cash balances. These savings are particularly significant for companies with a large number of shares.

Stripped common shares are created by investment dealers who sell a share’s dividend and capital gain streams separately to appeal to different investors. Some investors want regular cash payments to support their spending needs, while others want their investment to grow at a faster rate by deferring taxation on any capital gains. Investment dealers are financial institutions that help companies sell new stocks and bonds by pricing the issues and finding interested buyers such as pension plans, trust companies, life insurance companies, or mutual funds.

#### Important Dividend Dates

There are several important dates relating to the distribution of dividends:

**Date of declaration.** The date when a company’s board of directors agrees to pay a dividend to its shareholders, and it becomes a liability of the business.

**Ex-dividend date.** The date set by the stock exchange determines which shareholders are entitled to the dividend. Shares trade cum-dividend (i.e. entitled to the dividend) before this date and ex-dividend (i.e. not entitled to the dividend) afterward.

**Date of record.** All shareholders listed in the corporation’s records on this date receive the dividend. The company sets this date, and it usually occurs one or two days after the ex-dividend date to provide sufficient time for them to process all sales transactions.

**Date of payment.** The date when the dividend is paid to shareholders.

Share prices generally fall by the average after-tax value of the dividend when they go ex-dividend, since potential buyers are no longer entitled to that payment. For example, if a share with an upcoming dividend of CAD 1 were trading at CAD 30 cum-dividend just before the ex-dividend date, it would trade at approximately CAD 29 ex-dividend. This is consistent with the dividend discount model, which states the value of a share is equal to the present value of the future dividends a shareholder will receive.

#### Dividend Reinvestment Plans and Stock Purchase Plans

Some companies offer dividend reinvestment plans (DRIPs) so shareholders can reinvest the dividends they do not want by buying additional shares in the company. Many DRIPs also offer a stock purchase plan (SPP) or optional cash purchase (OCP) feature that allows shareholders to buy additional shares without reference to the size of their dividend, although a limit may be placed on the number of shares that can be purchased this way. Shares issued under a DRIP are usually new equity, but if the company does not need the additional capital, it sometimes buys existing shares in the open market to meet shareholder demand.

DRIPs offer several advantages:

* Companies do not incur issuance costs when raising new capital because the shares are sold directly to investors. Equity issuance costs average 7% to 8% of the funds raised in Canada, but these expenses are much higher for smaller issues by startup or growth companies.
* Shareholders may be able to purchase additional stock at a discount since they are buying directly from the company, which can pass along some of their savings. Shareholders also save on trading costs by not having to purchase the shares through a stockbroker. DRIPs are especially attractive to small investors as they do not have to buy shares through the exchanges in the standard board lot size of 100 shares to receive the lowest commission, and they may also be allowed to buy fractional shares.
* Management can build a more diverse and loyal investor clientele that is less likely to sell their shares during a market downturn, resulting in a more stable share price.
* Investors are forced to cost-average their share purchases over time. Cost average means shareholders buy shares regularly throughout the regular up-and-down movements of the stock market. Thus, they do not risk buying all their shares during a market peak when shares are likely overvalued.

One disadvantage of a DRIP is that the dividends reinvested are still taxable even though shareholders receive no cash. This makes these plans more suitable for investors who are using tax-sheltered accounts like an RRSP.

**Liquidating Dividends**

Liquidating dividends occur when a business is wholly or partially liquidated, and its share capital is returned to investors. Since the dividend is paid out of the initial investment in the company and not retained earnings, it is not subject to tax.

**Stock Splits**

Stock splits lower a company’s share price by exchanging current shares for multiple new shares, commonly in a 2-for-1, 3-for-2, or 3-for-1 ratio. The number of outstanding shares increases, but the value of a firm’s equity remains the same, so the share price falls. Each shareholder owns more shares and has more votes, but continues to have the same fractional ownership and voting position in the company after the split, and the value of their investment does not change.

Companies use stock splits to keep their share price in a preferred trading range that is more appealing to retail and institutional investors, leading to greater market liquidity and a higher share price. For example, shares trade on the TSX in standard board lot sizes of 100, which can become quite expensive for retail investors if the share price becomes too high. Management surveys and practice support the concept of a preferred trading range. Shares have continued to trade in the same average price range under CAD 100 over decades despite considerable growth in the consumer price index and the value of the corporation’s equity, which should have increased average share prices.

Theoretically, the decision to split a stock should be irrelevant since the value of a shareholder’s investment and their ownership percentage do not change. Industry research does not support this view and has contributed several important findings:

* Manager surveys indicate that they strongly feel there is a preferred share price range.
* Managers do use stock splits to reduce their company’s share price to the preferred price range after periods of high earnings and dividend growth. Splits are structured to reduce the share price to approximately the same level that it was after the last stock split.
* Shareholders generally earn substantial positive abnormal returns after a stock split due to greater market liquidity (i.e. trading volume) caused by an increased number of shares and a lower share price. This positive return is reduced by increased transaction costs after the split caused by a larger bid-ask spread relative to the new share price. The higher relative spread, though, does encourage brokerage firms to recruit more new investors, thus increasing market liquidity and creating a more diversified shareholder base. The bid-ask spread is the difference between what a market maker pays for a share (i.e., bid price) and what they will then sell it for (i.e., ask price). The size of the spread varies and moves inversely with liquidity and is a major transaction cost for investors.
* Shareholders generally earn substantial positive abnormal returns after a stock split due to the favourable signal it gives about a company’s future performance. Shareholders believe management would not split a stock unless they expected the company’s strong performance to continue. If the share price is reduced below the last stock split price, the markets interpret this information more positively, thinking future performance will be even stronger. The announcement of a stock split also attracts new investors who had not considered the stock in the past and causes equity analysts to raise their earnings forecasts for the company. Both these factors contribute to a higher share price.

**Reverse Stock Splits**

A reverse stock split, also called a consolidation, is the same as a stock split except it reduces the number of shares, such as in a 1-for-10 ratio. Since the value of the firm’s equity remains the same, having fewer shares leads to a higher share price. Reverse stock splits are used to:

* Return a share price to its preferred trading range to improve market liquidity.
* Eliminate the negative stigma associated with a low-priced share, such as with “penny” stocks that are generally valued at under a few dollars.
* Comply with security regulations that prevent institutional investors from purchasing shares that are valued below a specified price because they are perceived as having greater risk.
* Comply with minimum price rules established by some stock exchanges or indexes to prevent shares from being delisted or removed from an index.
* Lower administrative costs by reducing the number of shares.
* Eliminate minority shareholders who own less than a specified number of shares after a split.

Similar to stock splits, industry research indicates that reverse stock splits are relevant. Generally, investors experience significant negative abnormal returns after a reverse split. Management is signaling that a decline in share price is permanent and that it wants to return the share price to the preferred trading range to improve its liquidity or comply with market requirements. Industry research shows firms that declare multiple reverse stock splits usually fail or are eventually delisted.

**Stock Dividends**

Stock dividends have the same effect as stock splits. Instead of paying the dividend in cash, dividends are paid with new shares in the company. Again, the number of outstanding shares goes up, but the firm’s equity remains the same, so the value of each share falls.

Stock dividends and stock splits do not change liquidity ratios (e.g., current ratio) or financial leverage ratios (e.g., debt ratio) as assets and liabilities are unaffected since no cash is distributed. Stock dividends require that equity be moved from retained earnings to share capital, but the company’s total equity remains the same. The amount transferred equals the number of shares issued times their market value. Stock splits require no journal entries, but the higher number of shares is noted in the financial statements.

The rationale for utilizing stock dividends is similar to that of stock splits, but industry research findings are different. Shareholders earn positive abnormal returns after a stock dividend due to the favourable signal they give about a company’s future performance. Still, research shows these abnormal returns are considerably lower than with stock splits. Market liquidity is also improved through higher trading volume and by returning the share price to its preferred range, but there is generally no significant abnormal shareholder return. This can be explained by the fact that stock dividends result in considerably fewer new shares on average when compared to stock splits. Finally, it is sometimes maintained that a stock dividend is used by companies to conserve cash to fund lucrative growth opportunities or deal with temporary cash shortages. The stock dividend supposedly sends a signal to investors that even though the regular dividend is being cut now, this action is only temporary. This does not appear to be common practice based on industry research.

Stock dividends are not common in Canada because they are taxed as regular dividends by the Canada Revenue Agency (CRA). When equity is transferred from retained earnings to share capital, any subsequent distributions from share capital are considered a liquidating dividend and are not taxable. CRA charges tax at the time of the initial transfer to compensate.

#### 1.3 | Stock Repurchases

Stock repurchases or buybacks are an alternative to paying cash dividends. Companies distribute surplus cash to shareholders by re-acquiring their shares. Only shareholders who choose to sell will receive part of this cash distribution, and their fractional ownership in the company will fall. These shares are either cancelled or held as treasury shares, which can be resold more quickly. Regardless, they no longer have a vote or pay a dividend, and are excluded from the calculation of earnings per share.

Historically, paying dividends was the dominant method of distributing cash to shareholders, but that has changed dramatically. The value of stock repurchases now exceeds dividends, and the proportion of companies using stock repurchases surpasses those paying dividends. This trend started in the U.S. in the early 1980s when U.S. regulators no longer considered stock repurchases to be a form of insider trading, even though the company’s management possessed material, non-public information about the firm. Stock repurchases are becoming more important in other developed economies in Europe and Asia.

There are many reasons for the popularity of stock repurchases:

* Provide companies with greater financial flexibility since management is no longer committed to paying large, regular dividends. They can instead focus their spending on research and development, capital expenditures, and other important corporate expenses.
* Can be easily postponed, reduced, or eliminated as they are not viewed as permanent by shareholders like a regular dividend. If a company reduces its dividend, market pessimism will likely increase, and its share price will decline. It is safer for a firm to fulfill its investment needs first and then distribute whatever remains using a stock repurchase.
* Used to support a company’s share price when it is issuing new equity or reacting to negative market news, such as a key executive’s resignation or a decline in earnings.
* Signal to investors that a company’s shares are undervalued, as management is thought to have superior information about the company’s future performance and would rationally only buy shares if they are undervalued. This causes the share price to increase as investors buy shares, hoping to earn a profit. The S&P 500 Buyback Index measures the performance of the 100 S&P 500 stocks with the highest [buyback ratios](https://www.investopedia.com/terms/b/buyback-ratio.asp) over the past 12 months. Exchange-traded funds (ETFs) are available that track this and other similar indexes, and these funds typically generate positive excess returns compared to their benchmarks.
* Used by companies to time the equity markets by repurchasing shares when prices are undervalued and reselling them when overvalued. As mentioned, managers are trading while in possession of insider information, which is most valuable when shareholders are less informed retail investors and not sophisticated institutional investors or insiders such as managers. The discrepancy between public and private information is greatest in this case.
* Increase executive compensation by inflating a company’s earnings per share and share price by reducing the number of shares outstanding. Well-designed pay plans should adjust their performance targets, like earnings per share, for the effect of stock repurchases, so managers are not unfairly rewarded.
* Offset the dilution of earnings per share caused by share-based compensation plans by repurchasing shares and limiting the net increase in stock.
* Quickly adjust a company’s capital structure to the optimal borrowing level or over-leverage the firm as a take-over defence.
* Distribute surplus, low-yielding cash balances to shareholders to limit agency costs.
* Reduce taxes as capital gains earned in a share repurchase are taxed at a lower rate than dividends in many countries.
* Improve shareholder cash and tax planning. They can sell shares as part of a stock repurchase if cash is needed or remain invested and continue to defer capital gains taxes.

#### Mechanics of Stock Repurchases

The use of stock repurchases is limited in many countries to protect both shareholders and creditors. The Canada Business Corporation Act (CBCA) does not allow a company to pay a dividend or repurchase stock if it renders it unable to pay its liabilities or makes it insolvent (i.e. assets are less than liabilities). A corporation’s bylaws can stipulate that shareholders need to approve all share buyback plans. Bank loan conditions usually limit the size of stock repurchases to keep more cash in a business so it can better service its debts. Finally, stock exchanges generally prescribe the repurchase procedure that companies must follow to ensure all investors are treated fairly.

Stock repurchases in Canada can be done in one of four ways:

**Open-market share repurchase.** Under a Normal Course Issuer Bid (NCIB) through the Toronto Stock Exchange (TSX), a company can repurchase up to 5% of its shares over 12 months at the market price, with no more than 2% purchased in a given 30-day period. Since the buyback is small, the exchange does not feel that the transparency of a public tender offer is required.

**Fixed-price tender offer.** With the TSX’s permission, the company can repurchase over 5% of its shares in a short period. The number of shares and the repurchase price are specified, and the price is usually set at a substantial premium of approximately 20% over the market price before the public repurchase announcement. The stock exchange requires this formal tender offer to ensure all investors can participate in the offer. If more than the desired number of shares are tendered, repurchases are made on a prorated basis. If fewer are tendered, the offer can be cancelled, only the shares offered can be purchased, or the expiration date can be extended.

**Dutch-auction bid**. With the TSX’s permission, the company indicates the number of shares it wishes to repurchase and provides a set price range. Investors offer to sell blocks of shares at varying prices in the range. The company then determines the one bid price at or below which it will be able to repurchase the number of shares it wants. This competitive bidding process encourages shareholders to sell shares at lower prices, thus providing the company with the best repurchase price possible. If too few shares are offered up, then the company can either cancel the auction or buy the shares offered at the maximum offer price in its price range.

**Targeted (selective) stock repurchases**. This method buys the stock of specific shareholders to 1) reduce the administration costs of servicing small investor groups, 2) provide a legal remedy when a shareholder group has been found to have been treated unfairly by the company, or 3) buy out large blocks of shares from particular investors at a premium to block a corporate takeover or silence their criticism of the firm. TSX limits the use of this method because it doesn’t offer the same price to all investors, but it may be allowed in exceptional cases.

Open-market share repurchase plans are substitutes for paying regular dividends and account for over 95% of stock buybacks globally. They allow companies to repurchase relatively small numbers of shares to distribute surplus cash to shareholders and pursue other financial goals such as supporting the share price or timing the equity markets. Fixed-price tender offers and Dutch auction bids are used to buy much larger blocks of shares as part of a corporate takeover defence or other forms of business restructuring.

Open-market share repurchase plans are generally announced with great fanfare as either a dollar amount or a percentage of the company’s outstanding shares to send a positive signal to the stock market. The effect on the company’s share price varies with the size of the repurchase announced and the likelihood that it will be completed. Repurchase plans are very flexible, allowing managers to buy back shares at the most opportune time over several years when their liquidity is strongest, or the share price is the most undervalued. These plans are not binding, so management can cancel them at any time or only buy back a portion of the shares.

Companies buy approximately 80% of the share buybacks that they initially announced. This completion rate is positively correlated with the firm’s reputation, particularly its track record of completing previous stock repurchases. Also, the more undervalued its share, the more likely a company is to complete the plan because of the higher profit potential. Finally, companies with more uncertain cash flows generally have lower completion rates. Many firms also decide to buy back considerably more shares than they initially announced. These factors support the theory that open-market share repurchase plans provide management with greater financial flexibility than paying regular dividends.

If a company has a poor track record of completing share buybacks, it can enhance its reputation by using accelerated share repurchases (ASRs). First, the company contracts with an investment bank to have them repurchase the announced number of shares in the future. The company pays the investment bank upfront for these shares at an agreed-upon price. Second, the investment bank borrows the shares from its clients or security lenders and then transfers them to the company, which immediately reduces the number of shares outstanding. Third, in the coming days or months, the investment bank purchases the company’s shares in the open market and hopefully earns a profit before returning them to their clients or security lenders. Security lending allows investors to earn fee income on securities in their portfolios that they lend. The transaction is very safe for investors as it is secured by collateral pledged by the investment banker, who also compensates the security lender for any missed dividends or rights distributions.

The primary advantage of ASRs is that the buyback plan is executed immediately, which enhances the company’s reputation. Fast completion may also be necessary if the company is trying to manipulate its earnings before awarding executive compensation or hiding recently issued stock options before reporting to shareholders. The investment bank also absorbs any price risk related to the share repurchase by agreeing to a set price with the company at the beginning of the process. Finally, investment banks can buy back shares in the stock market at any time. At the same time, companies are unable to trade during earnings blackout periods, increasing the potential to time the equity markets. A blackout period is a time before a corporate earnings announcement when the company and its [directors](https://www.nasdaq.com/investing/glossary/b/board-of-directors) and specific employees are unable to trade in the company’s shares because they possess insider information.

#### 1.4 | Is Dividend Policy Relevant?

In perfectly efficient capital markets, investors have full information and act rationally. The markets are free of friction, such as transaction costs, issuance costs, or taxes that may influence the trading of assets. In these types of markets, dividend policy is irrelevant because dividends can be obtained by selling shares (i.e. homemade dividends) or avoided by buying additional shares with the dividends received.

Markets are not perfectly efficient, though, and several factors support paying either a higher or lower dividend, thus making a company’s dividend policy relevant. These factors include:

**Transaction costs**. Brokerage costs are incurred by investors when buying and selling shares. This supports paying **higher dividends** as investors avoid the cost of selling shares to raise needed cash.

**Issuance costs**. Issuance or flotation costs are high on the sale of new debt and equity, especially for startup companies or companies experiencing financial difficulties. This supports paying **lower dividends** as more cash is retained, reducing the need to issue new debt or equity.

**Irrational investor behaviour**. Some investors discipline themselves to preserve their investment capital by spending only the cash return (“live off the dividends, invest the capital”). This supports paying **higher dividends** as investors have a higher cash return each year.

**Taxes**. Capital gains may be taxed at a lower rate than dividends and offer a tax deferral. Business income is also usually taxed at a lower rate than personal income. This supports **lower dividends** as retaining funds allows businesses to take advantage of lower tax rates on capital gains and business income and defer income taxes.

**Agency costs**. Some managers view paying dividends as a sign of failure and instead retain their earnings and waste them on new projects having negative net present values, overpaying for corporate takeovers, or investing in low-yielding marketable securities that do not earn the cost of capital. This supports paying **higher dividends** asagency costs are reduced by getting excess funds out of a business, where shareholders can earn higher returns, and funds are not wasted by management.

**Asymmetric information**. Managers have better information about the operation of their companies, and the markets react when they act based on this knowledge. This supports paying **higher dividends** as it indicates to investors that a company’s prospects are improving when it can afford to pay higher dividends.

**Bird-in-hand argument.** It is better to receive a smaller dividend now than a potentially larger dividend in the future if earnings are reinvested successfully. This supports paying **higher dividends** as current dividends are more certain in the minds of shareholders.

**Financial flexibility.** Having more cash allows companies to better respond to unforeseen operating problems or capitalize on unexpected investment opportunities. This supports paying **lower dividends** to increase cash reserves.

#### Dividend Policy over the Business Life Cycle

The importance of some of the factors that influence dividend policy varies over a business’s life cycle.

**Exhibit 2: Varying Influence of Factors**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Source of Market Friction** | **Start-Up** | **IPO** | **Rapid Growth** | **Maturity** | **Decline** |
| **Taxes to equity holders** | High | High for the majority owners | Declining with the addition of new equity owners | Declining with growing institutional ownership | Declining with institutional and corporate ownership |
| **Agency costs** | Low | Low | Growing | High | Very high |
| **Asymmetric information** | Extremely High | Very high | Moderating | Falling | Modest |
| **Flotation costs** | High | High | Moderating | Low | Low |
| **Transactions costs** | High | High | Moderating | Falling | Low |
| **Implied dividend policy** | No dividends | No dividends | Low-dividend payout policy | Growing dividend payout policy | Generous dividend payout policy |

Adapted from: Lease, R. C., John, K., Kalay, A., Loewenstein, U., and Sarig, O. H. (2000). *Dividend policy: Its impact on firm value*. Boston, MA: Harvard Business School Press.

**Taxation to equity holders.** Market friction relating to this factor is high in the start-up and IPO phases, as any dividends received by founders, controlling shareholders, angels, and venture capitalists usually are taxable. During the rapid growth and maturity phases, non-taxable institutional and corporate investors make up a larger proportion of the ownership group. This factor has **decreasing** importance over the business life cycle.

**Agency costs.** Market friction relating to this factor is low in the start-up and IPO phases, as managers of new businesses are typically the founders or controlling shareholders who will act in their own best interest. During the rapid growth and maturity phases, professional managers are hired to lead the company and the founders may assume a more passive role, lose control, or sell out entirely. Once this occurs, agency costs relating to the separation of management and ownership can become relatively high. This factor has **increasing** importance over the business life cycle.

**Asymmetric information.** Market friction relating to this factor is high for businesses in the start-up and IPO phases, as they are typically privately held, so their shares are not traded publicly. Since outside equity analysts do not follow private companies closely, little investment information is available other than what is provided by management, making this information very valuable. In the rapid growth and maturity phases, once the company goes public and share trading volume increases, more information becomes available as more equity analysts follow the stock. This factor has **decreasing** importance over the business life cycle.

**Flotation costs.** Market friction relating to this factor is high in the start-up and IPO phases, as new entrepreneurs have considerable difficulty raising new equity. They have limited capital of their own, and angels and venture capitalists demand a high percentage of businesses in exchange for their investment. Raising equity publicly is not an option until an initial public offering (IPO) is completed, which is expensive. Flotation costs for subsequent share issuances are high to moderate until the business matures. This factor has **decreasing** importance over the business life cycle.

**Transaction costs.** Market friction relating to this factor is high for investors in the start-up and IPO phases, as trading costs for shares in private or small public companies are high due to a lack of market liquidity. As businesses grow and then mature, market liquidity improves as the number of investors interested in buying these shares increases. This factor has **decreasing** importance over the business life cycle.

**Other Factors Influencing Dividend Decisions**

Besides market imperfections, several practical considerations also influence the dividend decision.

**Liquidity position.** As discussed, the Canada Business Corporations Act does not allow a company to pay dividends or repurchase stock if it is unable to pay its liabilities or becomes insolvent. Even a highly profitable company can be “cash poor” if its financial resources are being used to fund additional working capital, fixed asset purchases, or debt reduction. Businesses with liquidity problems must restrict their dividends.

**Restrictive lending conditions.** Loan agreements usually limit a company’s dividends or prevent them from being paid at all until its debts are repaid. These agreements also contain liquidity requirements, like maintaining a minimum current ratio, that affect how a business can spend its cash. Preferred share agreements also stipulate that companies cannot pay common share dividends if their preferred share dividends are in arrears.

**Control issues.** Issuing shares may result in the current owners losing control. This is especially important for many small and medium-sized enterprises where the founder and their family often still own the majority of shares. Dividends may have to be lowered to curb the number of shares issued.

**Limited access to external financing.** Small and medium-sized enterprises have limited access to capital markets because of their smaller size and minimal credit history. Their earnings have to be retained instead of being paid out as dividends.

**Growth rate.** High-growth companies may need to restrict dividends to finance their rapid expansion. Conversely, mature companies usually have considerably more funds than they need.

**Earnings stability.** Businesses with volatile earnings due to cyclical sales, intense competition, variable input prices, or high operating leverage need to reduce their dividends so they have sufficient cash resources in a downturn.

**Financial leverage.** Companies with high debt ratios are more likely to retain their profits instead of paying dividends because of large interest and principal payments.

**1.5** | **Dividend Theories**

Market imperfections and other factors that influence the dividend decision have resulted in several theories that help explain the dividend policies companies adopt. These include:

**Clientele Effect**

Specific groups of investors prefer different dividend policies, such as paying high or low dividends. They will invest in companies that consistently follow these policies to minimize their transaction costs (i.e. buying and selling shares) as they attempt to meet their cash flow needs. Erratic dividend decisions mean a dividend policy cannot be identified, so investors will buy fewer shares, hurting the share price. Companies are very aware of what their investor clientele wants and are careful to meet their needs consistently.

Investors in higher dividend companies include:

* “Widows and orphans” who need high dividends to meet their living expenses.
* Endowments or trusts that are limited by statute or contract to spending only the dividends earned and not the capital of a fund.
* Investors who are subject to government regulations that encourage safe investing by only allowing investments in companies with established dividend records.
* Mutual funds whose investment strategy is to buy stocks with high dividend yields only.
* Corporations that do not pay tax on inter-corporate dividends but do pay tax on capital gains.

Investors in lower dividend companies include:

* Long-term investors outside of a tax-sheltered account who prefer capital gains due to a lower tax rate and tax deferral.

Investors who are indifferent to dividend levels include:

* Investors in tax-sheltered accounts such as company pension plans, RRSPs, or TFSAs.
* Non-profit organizations and charitable endowments that do not pay taxes.

**Signaling Theory**

When managers and outside investors have the same information about a company, a situation of symmetric information exists. Asymmetric information exists when managers have additional insider information. This is usually the case due to their senior positions in the company, so investors interpret dividend changes as asymmetric information about the company’s future performance. For example:

* Falling dividends mean a company is having difficulty and cannot support its previous dividend level, so share prices fall.
* Increasing dividends means a company has good prospects and can support the higher dividend level in the future, so share prices rise.
* Regular dividend increases have a stronger positive effect on the share price than increases in special or extra dividends, as the increase is viewed as permanent.
* Dividend increases have a greater positive effect on the share price if accompanied by active share purchases by managers, as they are investing their own money.
* Dividend increases have a greater positive effect on share prices for high-growth than low-growth firms because high-growth firms are more difficult to value due to their uncertain futures, thus making the asymmetric information provided by management more valuable.
* Dividend increases are recommended if the share is undervalued and the company wants to increase the share price before going to the equity markets to raise capital.
* Tender offers as opposed to Dutch auction share repurchases are viewed more favourably because the company is committed to paying a large premium, so share prices rise further.

**Residual Dividend Theory**

Companies undertake and finance all positive net present value projects with a combination of retained earnings and debt that maintains their optimal capital structure. They only issue new shares as a last resort due to high equity issuance costs, control issues, and the possibility that new shares will have to be issued when they are undervalued. Any residual income remaining after financing a company’s growth is paid out as dividends, as the company does not need it.

A company’s residual income will increase over its life cycle. It will be minimal in the development and growth stages, as all retained earnings are needed to finance rapid growth, but will rise as the business expands, matures, and potentially declines. A company’s dividend payout ratio increases over time.

**Exhibit 3: Dividend Distributions over the Business Life Cycle**

|  |  |
| --- | --- |
| **Phase** | **Dividend Level** |
| Development | No cash dividends |
| Growth | Low cash dividends |
| Expansion | Low to moderate cash dividends |
| Maturity | Moderate to high cash dividends |

Residual income may vary in the short term depending on the company’s profitability, the volatility of its earnings, and the availability of positive net present value projects in a particular year. Greater profitability means higher dividends can be paid, while more volatile earnings favour paying lower dividends to ensure that funds are always available to finance positive net present value projects.

The term free cash flow to equity holders is sometimes used instead of residual income. Free cash flow to equity holders is equal to cash flows from operations minus cash flows from investing, plus any net borrowing. It is the cash remaining each year after paying for the replacement of depreciated assets and asset growth. If a company only invests in projects with positive net present values, this amount should be what is paid out as dividends, as the company does not need it.

**Managed Dividends Theory**

Investors prefer constant dividends for planning purposes, and falling dividends signal poor company performance. Companies attempt to maintain a record of constantly increasing dividends to maintain investor confidence. Dividends are only increased if they can be sustained in a downturn.

Dividends are kept intentionally low to maintain financial flexibility, which is the ability to deal with unexpected operating problems and to exploit unforeseen investment opportunities quickly. Companies in cyclical, growth, or highly competitive industries are especially concerned about financial flexibility. Dividends will only be reduced in financial emergencies, so companies may use excessive amounts of debt or even delay positive net present value projects to maintain the dividend level.

Extra or special dividends can be paid if the company has surplus cash but does not feel it can maintain that dividend level. Extra or special dividends may be perceived as regular dividends if they are paid too often, and could hurt the share price if they are discontinued. Stock repurchases can be used to prevent this, as shareholders view them as one-time events.

#### Which Dividend Theory is Right?

All four dividend theories have an important role in helping to explain changing corporate dividend policies over a business’s life cycle.

**Exhibit 4: How Dividend Policies Change over the Business Life Cycle**

#### Long-term Horizon

**Residual dividend theory.** Dividend levels increase as companies move through the development, growth, expansion, and maturity phases of the business life cycle, since a declining portion of their earnings is needed to fund operations.

**Clientele effect.** A firm’s shareholder composition changes slowly from those wanting capital gains in the growth and development phases to those wanting dividends in the expansion and maturity phases.

#### Short-term Horizon

**Managed dividends theory.** Dividends are managed so they grow at a steady rate to inspire investor confidence and are kept low enough to maximize financial flexibility. Stock repurchases are used to avoid increasing regular dividends until the company is positive and a higher dividend level can be maintained.

**Signaling theory.** Dividend cuts are avoided due to the negative impact they have on investor confidence and the share price. A steadily increasing dividend reflects positively on a company’s performance.

#### Warning Signs of Future Dividend Declines

Reducing dividends should be avoided as it typically harms a company’s share price. Equity analysts who follow companies view the following as possible warning signs that the regular dividend is not sustainable and will be reduced soon:

* The company is borrowing excessively to finance its dividend.
* Dividend payout or yield ratios are higher than the average of previous years or the current industry average.

Dividend payout and yield ratios should include both regular dividends and share repurchases to measure a company’s payout level properly.

#### 1.6 | Dividend Policy in Practice

Industry research shows that companies are divided into two groups based on their dividend policies. The first group consists of the largest companies that are very profitable and pay large and growing dividends. The second group consists of smaller companies that pay no dividends because they are either 1) experiencing financial difficulties or 2) are growth companies that are substituting stock repurchases for dividends (DeAngelo et al., 2004).

A survey of the managers of these two groups (Brav et al., 2005) indicates the following:

* Maintaining current dividends is critical to dividend-paying companies because the market penalizes dividend cuts very harshly. Only companies with stable and consistently increasing earnings will initiate or increase their dividend. Dividends are only reduced in extreme cases.
* Instead of trying to maintain a constant dividend payout ratio in the long term, companies focus on just maintaining their current dividend and ensuring they have sufficient funds to meet their liquidity and investment requirements. They will not raise dividends until these requirements are met.
* Non-dividend-paying companies are very reluctant to initiate regular dividends because of their reduced financial flexibility. Most dividend-paying companies regret ever beginning to pay dividends and the high amounts they are committed to paying.
* Retail and institutional investors are indifferent between stock repurchases and dividends. Taxes are not an important factor in establishing a dividend policy.

Most managers prefer to rely on stock repurchases exclusively to increase their financial flexibility. In their view, stock repurchases:

* Are not perceived by investors as permanent and can be reduced as needed without a market penalty. However, once a stock repurchase plan is announced publicly, they feel it should be completed.
* Make having sufficient capital to finance changing investment opportunities the focus of the business, and not funding the dividend. Cash is distributed only when profitable projects are not available.
* Ensures that expensive external equity financing is not used to fund dividends but only profitable investment projects.
* Can be used to make money for investors by timing the equity markets.
* Can be used to raise earnings per share, increase or support the share price, or offset stock options dilution.
* Can be used to distribute excess, low-yielding cash balances to shareholders to reduce agency costs.

It is expected that the use of stock repurchases will continue to increase as managers place even greater emphasis on financial flexibility.

**1.7** | **Dividend Policies at Canadian Companies**

All companies have unique dividend policies that are influenced by many factors. To examine the policy of a specific firm, analysts should consult the investor relations or corporate information section of their company website. Here, a company provides important financial information to its different stakeholders through its annual report, annual information form, and management information circular. These documents can also be found on the System for Electronic Data Analysis and Retrieval (SEDAR) website sponsored by Canada’s securities regulators. In the U.S., similar reports are available on the company’s website or through the Electronic Data Gathering Analysis Retrieval (EDGAR) system hosted by the U.S. Securities and Exchange Commission (SEC). By reviewing two companies, Canadian Tire and Lululemon Athletica, students can see examples of the two groups of companies (i.e. those that pay dividends and those that do not) described in the previous section.

**Canadian Tire Corporation**

Canadian Tire Corporation (CTC) is a preeminent Canadian institution consisting of a family of businesses divided into three operating segments. The retail segment is the largest with such famous brands as Canadian Tire, Canadian Tire Gas, Mark’s, PartsSource, Helly Hansen, and Sportcheck. CTC also operates a real estate investment trust (REIT) segment that owns the stores and distribution centres in its retail unit. The financial services segment offers credit cards, insurance, warranties, and other financial services to its customers and the dealers who operate many of its stores. CTC has chosen to focus primarily on Canada because of past difficulties entering the U.S. market.

**Exhibit 5: Select Financial Information for CTC**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2018** | **2017** | **2016** | **2015** | **2014** |
| Share price (CAD) | 147.37 | 165.62 | 131.28 | 106.34 | 107.34 |
| Net income (CAD million) | 692.1 | 735.0 | 669.1 | 659.4 | 604.0 |
| Normalized earnings (CAD million) | 777.5 | 735.0 | 669.1 | 659.4 | 632.0 |
| Dividends (CAD million) | 239.6 | 193.0 | 170.3 | 162.4 | 154.1 |
| Debt ratio (%) | 69 | 64 | 63 | 61 | 61 |
| Basic shares outstanding | 64,887,724 | 68,678,840 | 72,360,303 | 76,151,321 | 78,960,025 |
| Dilutive shares outstanding | 65,062,581 | 68,871,847 | 72,555,732 | 76,581,602 | 79,612,957 |
| Basic EPS (CAD) | 10.67 | 10.70 | 9.25 | 8.66 | 7.65 |
| Diluted EPS (CAD) | 10.64 | 10.67 | 9.22 | 8.61 | 7.59 |
| DRIP (no. of shares) | 73,010 | 60,785 | 68,069 | 65,760 | 62,357 |
| DRIP (CAD million) | 11.9 | 9.4 | 9.3 | 8.3 | 6.9 |
| Repurchases (no. of shares) | 3,661,111 | 4,318,005 | 3,382,275 | 3,450,981 | 2,600,000 |
| Repurchases (CAD million) | 588.9 | 659.30 | 449.4 | 434.6 | 290.6 |
| Basic DPS (CAD) | 3.43 | 2.47 | 2.18 | 2.00 | 1.79 |
| Diluted DPS (CAD) | 3.42 | 2.46 | 2.17 | 1.99 | 1.78 |
| Dividend payout ratio (%) | 29 | 23 | 24 | 23 | 22 |
| Dividend and stock repurchase payout ratio (%) | 103 | 112 | 89 | 88 | 67 |

Dividends are paid at the discretion of the board of directors, who base their decision on CTC’s “current cash position, future cash requirements, capital market conditions, and investment opportunities.” The company pays a regular cash dividend each quarter, which has increased continuously over the past 20 years. In November 2017, the company announced its goal to maintain a dividend payout ratio of 30% to 40% of normalized earnings going forward, which was increased from 25% to 30%. Normalized earnings provide users with a more accurate measure of income by eliminating all non-recurring items from net income.

Computershare is CTC’s transfer agent, which maintains a record of the number of shares each investor owns and distributes their dividends each quarter. CTC’s share price has increased from CAD 8.15 in January 1995 to CAD 147.37 in January 2018. No stock splits, reverse stock splits or stock dividends were used to keep the share price in a preferred trading range.

CTC offers a DRIP to all Class A Non-Voting shareholders who are Canadian residents. They can purchase additional stock at the average share price for the five days preceding the payment date - fractional shares (up to 3 decimal places) are awarded. The DRIP does not offer share price discounts nor an OCP feature, so investors cannot buy additional shares. Shareholders can leave the DRIP at any time if they inform the transfer agent by the cut-off date just before the date of payment each quarter.

Under an NCIB with the TSX, CTC regularly announces stock repurchase plans each November that are to be completed by the end of the following fiscal year. Recent plans have had a 100% completion rate, and CTC also repurchases additional shares as an anti-dilutive measure to negate the effect of new shares issued under the company’s share-based compensation plans. Executives have the option of receiving a cash payment equal to the difference between the share price and a stock option’s exercise price, so few new shares are issued.

Some of CTC’s trust indentures relating to its medium-term notes place restrictions on the size of its dividend payments, but none of these conditions currently apply.

Overall, CTC is a mature company with a stable net income that increased at a modest 3.5% compounded annual growth rate (CAGR) over five years ending in 2018. Although it has made several significant acquisitions recently, such as Helley Hansen, the company still generates sizeable cash surpluses that are not needed to finance its growth. CTC is wisely returning these funds to its shareholders to reduce agency costs by steadily increasing the regular cash dividend and announcing a higher payout ratio range of 30% to 35%. CTC has also returned surplus cash by repurchasing a large number of shares each year. Some additional shares have been issued under a DRIP, but the funds raised are very modest compared to the size of the repurchases. The result is that CTC is paying out over 100% of its normalized earnings if both the regular cash dividends and share buybacks are considered. These high stock repurchases are not sustainable, but CTC is using them to raise their financial leverage to the optimal level. Its debt ratio has risen from 61% to 69% from 2014 to 2018, which now approximates the ratio at some of its comparable companies, such as Walmart at 67% or Target at 73%. CTC has maintained its financial flexibility by not committing to higher regular dividends and using stock repurchases instead. They are also sending a positive signal to the market concerning the company’s performance with its rising earnings and dividends per share and sizable stock repurchases.

**Lululemon Athletica**

Lululemon is a “designer, distributor, and retailer of healthy lifestyle inspired athletic apparel and accessories” headquartered in Vancouver, Canada, that first went public in 2007. It targets women, men, and female youth under the Lululemon and Ivivva brands using an increasing number of company-owned stores and expanding online presence. The company operates primarily in the U.S. and Canada, but it is also growing internationally, particularly in Australia, China, and the United Kingdom.

Lululemon has built a fervent reputation for stylish and high-quality products among its customers, although some critics say the company is cult-like in its human relations and marketing practices and that its products are overpriced. The keys to its success have been a passionate and motivated sales team, making all customers feel great about themselves regardless of their level of fitness; an innovative design team that creates practical new products based on extensive customer feedback; technically advanced fabrics; and outsourcing of all production.

**Exhibit 6: Selected Financial Information for Lululemon**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2018** | **2017** | **2016** | **2015** | **2014** |
| Net income (USD thousands) | 483,801 | 258,662 | 303,381 | 266,047 | 239,033 |
| Dividends (USD thousands) | 0 | 0 | 0 | 0 | 0 |
| Basic shares outstanding  | 133,413,000 | 135,988,000 | 137,086,000 | 140,365,000 | 143,935,000 |
| Dilutive shares outstanding | 133,971,000 | 136,198,000 | 137,302,000 | 140,610,000 | 144,298,000 |
| Basic EPS (USD) | 3.63 | 1.90 | 2.21 | 1.90 | 1.66 |
| Diluted EPS (USD) | 3.61 | 1.90 | 2.21 | 1.89 | 1.66 |
| Repurchases (no. of shares) | 4,900,000 | 1,900,000 | 500,000 | 5,000,000 | 3,700,000 |
| Repurchases (USD thousand) | 598,340 | 100,261 | 29,327 | 274,193 | 147,431 |
| Stock repurchase payout ratio (%) | 124 | 39 | 10 | 103 | 62 |

Lululemon is a growth company whose sales increased at a CAGR of 19.3% over five years ending in 2018. Instead of paying regular cash dividends, Lululemon distributes all of its surplus cash using stock repurchases to enhance its financial flexibility. Not only does Lululemon need this latitude to fund the high R&D, training, and capital expenditures necessary to support its rapid growth, but it must also deal with greater uncertainty due to intense industry competition, rapidly changing fashion trends, and unstable demand stemming from selling higher-priced, consumer-discretionary items. To further improve its financial flexibility, Lululemon maintains a significant amount of unused borrowing capacity by not issuing any long-term debt and keeping a 5-year, backup revolving credit agreement for financial emergencies.

Besides increasing financial flexibility, Lululemon uses stock repurchases for several other reasons. They offset the dilution of earnings per share caused by the issuance of a large number of new shares under the company’s stock-based compensation plans. They are also used to signal to the market that its share price is undervalued and to time the equity markets to benefit their current shareholders. Finally, as a growth company, Lululemon’s clientele likely consists of a significant number of long-term investors who do not want a cash dividend but prefer to remain invested and defer taxes.

The value of Lululemon’s open-market stock repurchases varies markedly each year depending on its cash flow needs. Its board approves all plans of directors and follows the U.S. Securities Exchange Act because Lululemon is a U.S.-listed (NASDAQ) company. The timing and number of shares repurchased depend on market conditions, eligibility to trade, and other factors. The company has a record of completing all its stock repurchase plans and goes to the board to increase the amount of any announced buybacks if economic conditions warrant it.

After going public in 2007, Lululemon implemented a 2-for-1 stock split in 2011 but has not conducted any splits since. Its share price has risen from under CAD 20 in 2007 to approximately CAD 165 in 2019, which indicates that the company does not have a preferred price range for its shares.

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