DIVIDENDS: FOLLOW UP

Changing dividend policy is hard to do, but not doing it can be worse.
The Investment Decision
Invest in assets that earn a return greater than the minimum acceptable hurdle rate

The Financing Decision
Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations

The Dividend Decision
If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business

Hurdle Rate
4. Define & Measure Risk
5. The Risk free Rate
6. Equity Risk Premiums
7. Country Risk Premiums
8. Regression Betas
9. Beta Fundamentals
10. Bottom-up Betas
11. The "Right" Beta
12. Debt: Measure & Cost
13. Financing Weights

Investment Return
14. Earnings and Cash flows
15. Time Weighting Cash flows
16. Loose Ends

Financing Mix
17. The Trade off
18. Cost of Capital Approach
19. Cost of Capital: Follow up
20. Cost of Capital: Wrap up
21. Alternative Approaches
22. Moving to the optimal

Financing Type
23. The Right Financing

Dividend Policy
24. Trends & Measures
25. The trade off
26. Assessment
27. Action & Follow up
28. The End Game

Valuation
29. First steps
30. Cash flows
31. Growth
32. Terminal Value
33. To value per share
34. The value of control
35. Relative Valuation

36. Closing Thoughts
A Practical Framework for Analyzing Dividend Policy

- How much did the firm pay out? How much could it have afforded to pay out?
  - What it could have paid out
  - Net Income
  - (Cap Ex - Depr’n) (1-DR)
  - Chg Working Capital (1-DR)
  = FCFE
  - What it actually paid out
  = Dividends
  + Equity Repurchase

- Firm pays out too little
  - FCFE > Dividends
  - Do you trust managers in the company with your cash?
    - Look at past project choice:
      - Compare ROE to Cost of Equity
      - ROC to WACC

- Firm pays out too much
  - FCFE < Dividends
  - What investment opportunities does the firm have?
    - Look at past project choice:
      - Compare ROE to Cost of Equity
      - ROC to WACC

- Firm has history of good project choice and good projects in the future
  - Give managers the flexibility to keep cash and set dividends

- Firm has history of poor project choice
  - Force managers to justify holding cash or return cash to stockholders

- Firm has good projects
  - Firm should cut dividends and reinvest more

- Firm has poor projects
  - Firm should deal with its investment problem first and then cut dividends
A Dividend Matrix

<table>
<thead>
<tr>
<th>Quality of projects taken: ROE versus Cost of Equity</th>
<th>Cash Surplus + Poor Projects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poor projects</td>
<td>Significant pressure to pay out more to stockholders as dividends or stock buybacks</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Good projects</th>
<th>Cash Surplus + Good Projects</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Maximum flexibility in setting dividend policy</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash Deficit + Poor Projects</th>
<th>Cash Deficit + Good Projects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cut out dividends but real problem is in investment policy.</td>
<td>Reduce cash payout, if any, to stockholders</td>
</tr>
</tbody>
</table>

Dividends paid out relative to FCFE

Cash Surplus

Cash Deficit
Case 1: Disney in 2003

- **FCFE versus Dividends**
  - Between 1994 & 2003, Disney generated $969 million in FCFE each year.
  - Between 1994 & 2003, Disney paid out $639 million in dividends and stock buybacks each year.

- **Cash Balance**
  - Disney had a cash balance in excess of $4 billion at the end of 2003.

- **Performance measures**
  - Between 1994 and 2003, Disney has generated a return on equity, on its projects, about 2% less than the cost of equity, on average each year.
  - Between 1994 and 2003, Disney’s stock has delivered about 3% less than the cost of equity, on average each year.
  - The underperformance has been primarily post 1996 (after the Capital Cities acquisition).
Can you trust Disney’s management?

- Given Disney’s track record between 1994 and 2003, if you were a Disney stockholder, would you be comfortable with Disney’s dividend policy?
  a. Yes
  b. No

- Does the fact that the company is run by Michael Eisner, the CEO for the last 10 years and the initiator of the Cap Cities acquisition have an effect on your decision.
  a. Yes
  b. No
Following up: Disney in 2009

- Between 2004 and 2008, Disney made significant changes:
  - It replaced its CEO, Michael Eisner, with a new CEO, Bob Iger, who at least on the surface seemed to be more receptive to stockholder concerns.
  - Its stock price performance improved (positive Jensen’s alpha)
  - Its project choice improved (ROC moved from being well below cost of capital to above)

- The firm also shifted from cash returned < FCFE to cash returned > FCFE and avoided making large acquisitions.

- If you were a stockholder in 2009 and Iger made a plea to retain cash in Disney to pursue investment opportunities, would you be more receptive?
  a. Yes
  b. No
Final twist: Disney in 2013

- Disney did return to holding cash between 2008 and 2013, with dividends and buybacks amounting to $2.6 billion less than the FCFE (with a target debt ratio) over this period.
- Disney continues to earn a return on capital well in excess of the cost of capital and its stock has doubled over the last two years.
- Now, assume that Bob Iger asks you for permission to withhold even more cash to cover future investment needs. Are you likely to go along?
  a. Yes
  b. No
## Case 2: Vale – Dividends versus FCFE

<table>
<thead>
<tr>
<th></th>
<th>Aggregate</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>$57,404</td>
<td>$5,740</td>
</tr>
<tr>
<td>Dividends</td>
<td>$36,766</td>
<td>$3,677</td>
</tr>
<tr>
<td>Dividend Payout Ratio</td>
<td>$1</td>
<td>$1</td>
</tr>
<tr>
<td>Stock Buybacks</td>
<td>$6,032</td>
<td>$603</td>
</tr>
<tr>
<td>Dividends + Buybacks</td>
<td>$42,798</td>
<td>$4,280</td>
</tr>
<tr>
<td>Cash Payout Ratio</td>
<td>$1</td>
<td></td>
</tr>
<tr>
<td>Free CF to Equity (pre-debt)</td>
<td>($1,903)</td>
<td>($190)</td>
</tr>
<tr>
<td>Free CF to Equity (actual debt)</td>
<td>$1,036</td>
<td>$104</td>
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<tr>
<td>Free CF to Equity (target debt ratio)</td>
<td>$19,138</td>
<td>$1,914</td>
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<tr>
<td>Cash payout as % of pre-debt FCFE</td>
<td>FCFE negative</td>
<td></td>
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<tr>
<td>Cash payout as % of actual FCFE</td>
<td>4131.08%</td>
<td></td>
</tr>
<tr>
<td>Cash payout as % of target FCFE</td>
<td>223.63%</td>
<td></td>
</tr>
</tbody>
</table>
Vale: It's your call..

☐ Vale’s managers have asked you for permission to cut dividends (to more manageable levels). Are you likely to go along?
   a. Yes
   b. No

☐ The reasons for Vale’s dividend problem lie in it’s equity structure. Like most Brazilian companies, Vale has two classes of shares - common shares with voting rights and preferred shares without voting rights. However, Vale has committed to paying out 35% of its earnings as dividends to the preferred stockholders. If they fail to meet this threshold, the preferred shares get voting rights. If you own the preferred shares, would your answer to the question above change?
   a. Yes
   b. No

<table>
<thead>
<tr>
<th>Summary of calculations</th>
<th>Average</th>
<th>Standard Deviation</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free CF to Equity</td>
<td>$571.10</td>
<td>$1,382.29</td>
<td>$3,764.00</td>
<td>($612.50)</td>
</tr>
<tr>
<td>Dividends</td>
<td>$1,496.30</td>
<td>$448.77</td>
<td>$2,112.00</td>
<td>$831.00</td>
</tr>
<tr>
<td>Dividends+Repurchases</td>
<td>$1,496.30</td>
<td>$448.77</td>
<td>$2,112.00</td>
<td>$831.00</td>
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<tr>
<td>Dividend Payout Ratio</td>
<td>84.77%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Paid as % of FCFE</td>
<td>262.00%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROE - Required return</td>
<td>-1.67%</td>
<td>11.49%</td>
<td>20.90%</td>
<td>-21.59%</td>
</tr>
</tbody>
</table>
BP: Just Desserts!

B.P.’s Shares Plummet After Dividend Is Slashed

By MATTHEW L. WALD

British Petroleum said yesterday that it would cut its dividend by 80 percent, take a $3.33 billion write-off for the second quarter and lay off 14,000 employees, or 10 percent of its worldwide workforce. The moves came five weeks after Robert B. Horton, B.P.’s chairman, resigned under pressure from the company’s outside directors.

Analysts anticipated a dividend cut by the oil company, the world’s third largest, but the one announced was at the low end of their expectations. In response, shares of the company’s American depositary rights, each of which represents 13 shares of the London-listed company, dropped 43 2/3, or 74.6 percent, to 44.97. It was the most active issue on the New York Stock Exchange, with 36 million shares traded.

The Royal Dutch/Shell Group also reported a disappointing quarter yesterday, with earnings on a replacement-cost basis — excluding gains or losses on inventory holdings — of $668 million, down 32 percent.

Quick Recovery Seems Unlikely

Adding to the gloom at B.P., the new chief executive, David A. C. St. John, said the prospects for a quick recovery were poor. “External trading conditions are expected to remain difficult, particularly for the downstream oil and chemicals businesses, with growth prospects for the world’s economies remaining uncertain,” he said in a statement. “Downstream oil is an industry term for refining and marketing operations, as distinct from oil production.

Low downstream margins in the United States would be buttressed later this year, he predicted, when clean air rules take effect and gasoline must be reformulated to reduce pollution. “In Europe, recovery will depend upon overall housing oil demand,” Mr. St. John said. The crude oil market, he predicted, would remain balanced unless large oil was allowed to reenter the market. The company said it would be well positioned to 10% advantage of any increase in oil prices, but the company’s oil production in the United States is declining. B.P. is the largest producer in Alaska.

The market for petrochemicals in Europe remains weak. B.P.’s second quarter profits, before one-time transactions, declined to $113 million from $125 million, raising investors on a replacement-cost basis.

James J. Murrine, an analyst at Standard & Poor’s, estimated that after exceptional items, earnings per share fell to 20 cents in the second quarter, compared with 41 cents a year earlier.

Analysts attributed B.P.’s problems to the company’s exploration in the last few years, and heavy capital expenditures. “Summing up the company’s recent history,” Frank P. Rowland of Pavilion Securities Research said, “Debt row, interest rate row, and profits have gone to hell.”

Mr. Murrine, who worked for Standard Oil of Ohio and then B.P. after B.P. acquired Standard, said. “What you’ve got is a company that put too much money down and spent it like it was there. It was all just based on one day of oil prices.”

Another analyst at a large stock brokerage house, who spoke on the condition of anonymity, said: “They took all the old Shell profits and turned them into money. B.P. stations; they took all the B.P. stations and turned them into low-volume stations.”

The analyst said that while some of the targets were clearly not the same as the old Shell stations, “the market will see this as a good thing.”

Theft of B.P. stock by brokers was also reported yesterday. It was reported to be the result of a coerced crime, as it was reported in depression.

Another analyst at a large stock brokerage house, who spoke on the condition of anonymity, said: “They took all the old Shell stations and turned them into low-volume stations.”
## Managing changes in dividend policy

<table>
<thead>
<tr>
<th>Category</th>
<th>Prior Quarter</th>
<th>Announcement Period</th>
<th>Quarter After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simultaneous announcement of earnings decline/loss ($N = 176$)</td>
<td>−7.23%</td>
<td>−8.17%</td>
<td>+1.80%</td>
</tr>
<tr>
<td>Prior announcement of earnings decline or loss ($N = 208$)</td>
<td>−7.58%</td>
<td>−5.52%</td>
<td>+1.07%</td>
</tr>
<tr>
<td>Simultaneous announcement of investment or growth opportunities ($N = 16$)</td>
<td>−7.69%</td>
<td>−5.16%</td>
<td>+8.79%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Average</th>
<th>Standard Deviation</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Free CF to Equity</strong></td>
<td>($34.20)</td>
<td>$109.74</td>
<td>$96.89</td>
<td>($242.17)</td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
<td>$40.87</td>
<td>$32.79</td>
<td>$101.36</td>
<td>$5.97</td>
</tr>
<tr>
<td><strong>Dividends+Repurchases</strong></td>
<td>$40.87</td>
<td>$32.79</td>
<td>$101.36</td>
<td>$5.97</td>
</tr>
<tr>
<td><strong>Dividend Payout Ratio</strong></td>
<td>18.59%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash Paid as % of FCFE</strong></td>
<td>-119.52%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>ROE - Required return</strong></td>
<td>1.69%</td>
<td>19.07%</td>
<td>29.26%</td>
<td>-19.84%</td>
</tr>
</tbody>
</table>
Growth Firms and Dividends

- High growth firms are sometimes advised to initiate dividends because it increases the potential stockholder base for the company (since there are some investors - like pension funds - that cannot buy stocks that do not pay dividends) and, by extension, the stock price. Do you agree with this argument?
  a. Yes
  b. No

- Why?
## 5. Tata Motors

<table>
<thead>
<tr>
<th></th>
<th>Aggregate</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>$421,338.00</td>
<td>$42,133.80</td>
</tr>
<tr>
<td>Dividends</td>
<td>$74,214.00</td>
<td>$7,421.40</td>
</tr>
<tr>
<td>Dividend Payout Ratio</td>
<td>17.61%</td>
<td>15.09%</td>
</tr>
<tr>
<td>Stock Buybacks</td>
<td>$970.00</td>
<td>$97.00</td>
</tr>
<tr>
<td>Dividends + Buybacks</td>
<td>$75,184.00</td>
<td>$7,518.40</td>
</tr>
<tr>
<td>Cash Payout Ratio</td>
<td>17.84%</td>
<td></td>
</tr>
<tr>
<td>Free CF to Equity (pre-debt)</td>
<td>($106,871.00)</td>
<td>($10,687.10)</td>
</tr>
<tr>
<td>Free CF to Equity (actual debt)</td>
<td>$825,262.00</td>
<td>$82,526.20</td>
</tr>
<tr>
<td>Free CF to Equity (target debt ratio)</td>
<td>$47,796.36</td>
<td>$4,779.64</td>
</tr>
<tr>
<td>Cash payout as % of pre-debt FCFE</td>
<td>FCFE negative</td>
<td></td>
</tr>
<tr>
<td>Cash payout as % of actual FCFE</td>
<td>9.11%</td>
<td></td>
</tr>
<tr>
<td>Cash payout as % of target FCFE</td>
<td>157.30%</td>
<td></td>
</tr>
</tbody>
</table>

Negative FCFE, largely because of acquisitions.
Application Test: Assessing your firm’s dividend policy

- Compare your firm’s dividends to its FCFE, looking at the last 5 years of information.

- Based upon your earlier analysis of your firm’s project choices, would you encourage the firm to return more cash or less cash to its owners?

- If you would encourage it to return more cash, what form should it take (dividends versus stock buybacks)?
Task
Compare the cash returned at your company to what is could have & make a judgment on whether its policies have to change.