

Corporate Dividend and Share Repurchase Decisions

Roni Michaely
Cornell and IDC

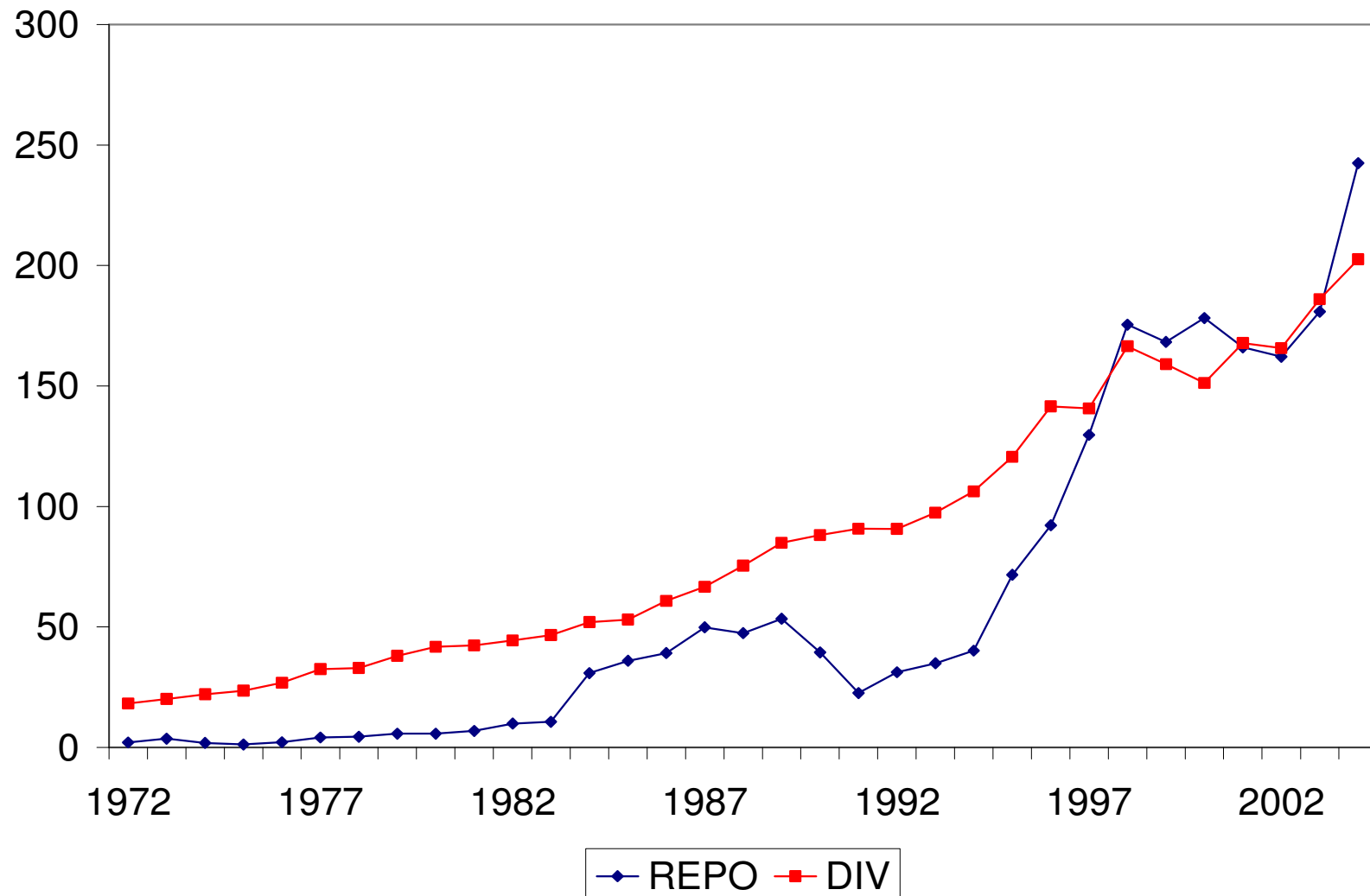
March, 2006

Recent trends in dividends and share repurchases

Repurchases became a dominant force

- Share repurchases were relatively unimportant until the mid-1980s, but since then have become an important form of payment
- Average annual growth of 26.1% for repurchases vs. 6.8% for dividends

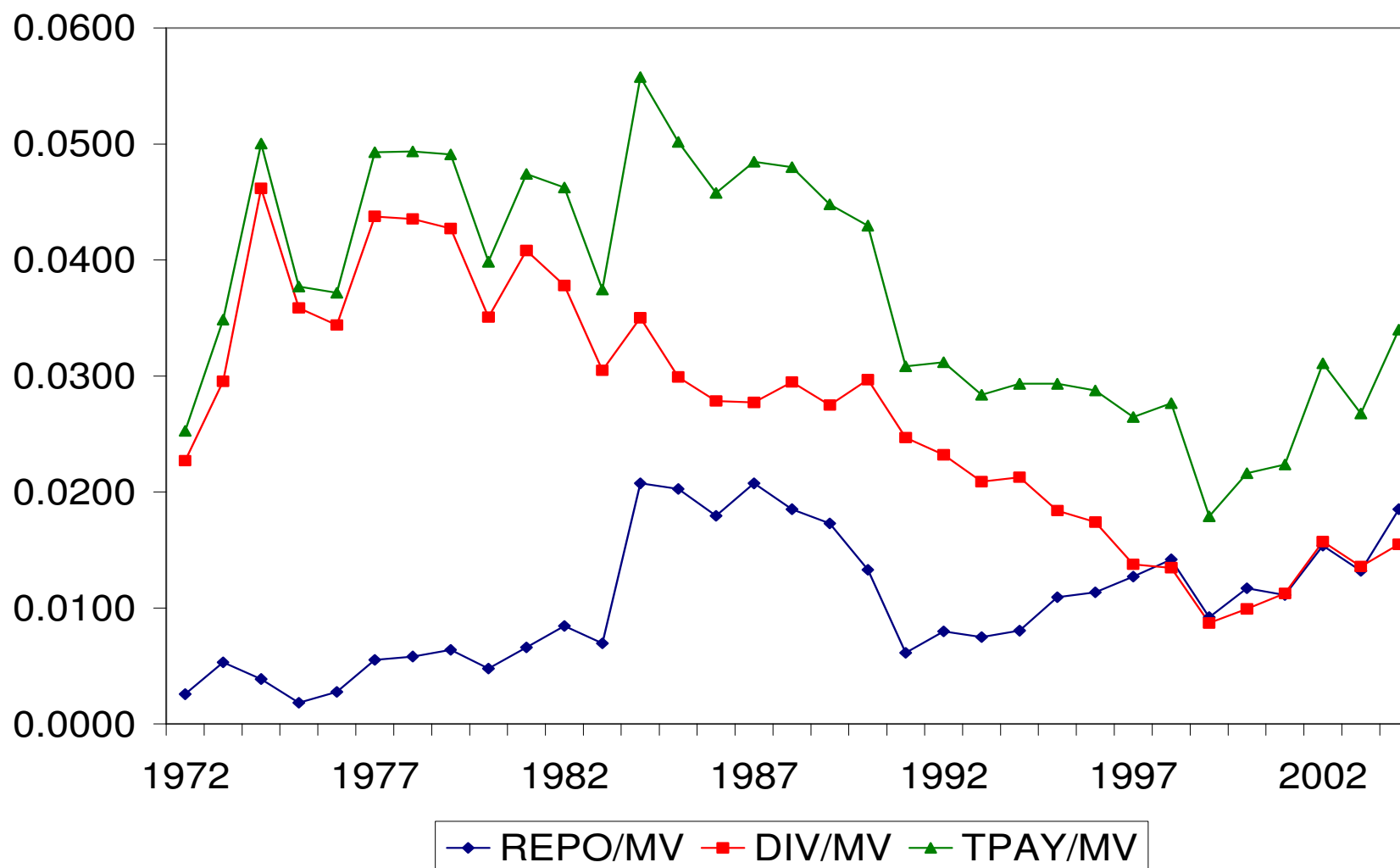
Aggregate Dividends and Share Repurchases



Recent trends in dividends and share repurchases

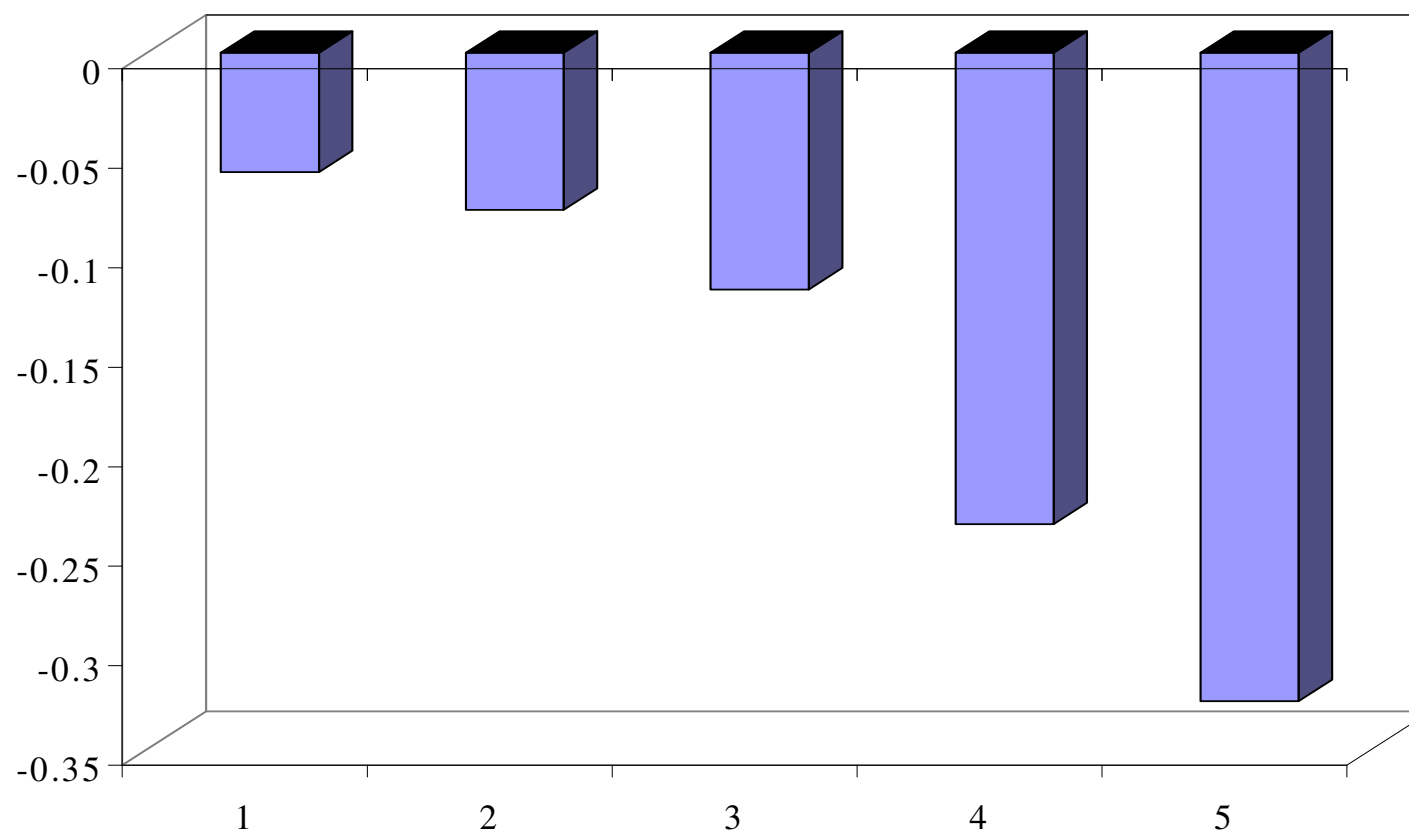
Dividend yield steadily declined

The Aggregate Dividend Yield, Share Repurchase Yield, and Total Payout Yield



Recent trends in dividends and share repurchases

Firms substituting repurchases for dividends

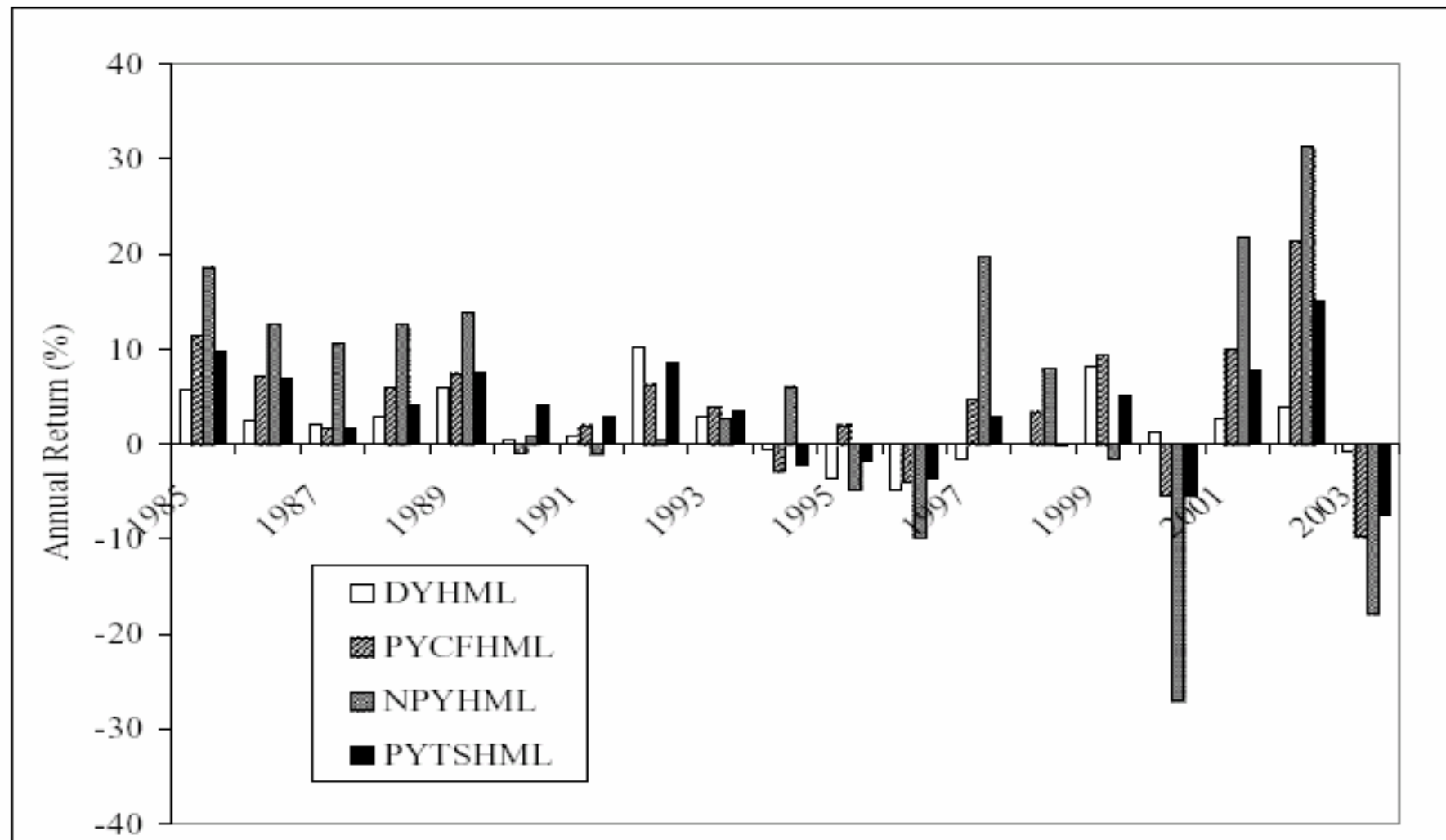


Recent trends in dividends and share repurchases

Profile of high-payout firms

- Large Cap.
- Low (er) growth
- Low (er) risk
- Large (er) institutional holdings
- Relatively under-valued

Performance and payout



Management perspective on dividends and share repurchases

Payout Policy in the 21st Century

- Research survey

384 usable survey responses

- 256 public, 128 private
- Response rate of 16%

Interview 23 CFOs/CEOs

- 40–90 minutes in length

Several follow-up surveys

How are payout decisions made?

Fund investment

Liquidity and possible contingencies

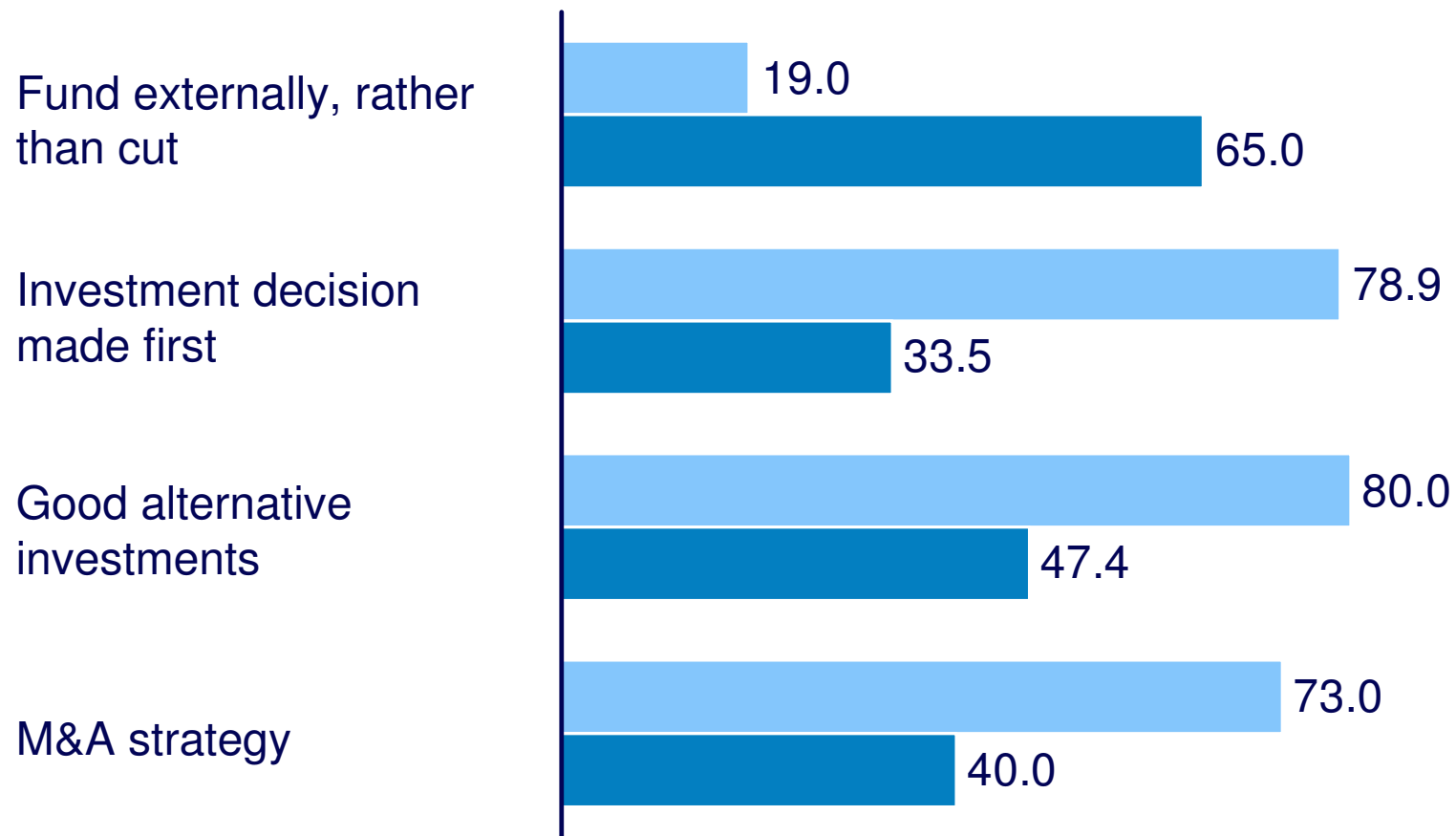
Payout decisions are second-order

Exception

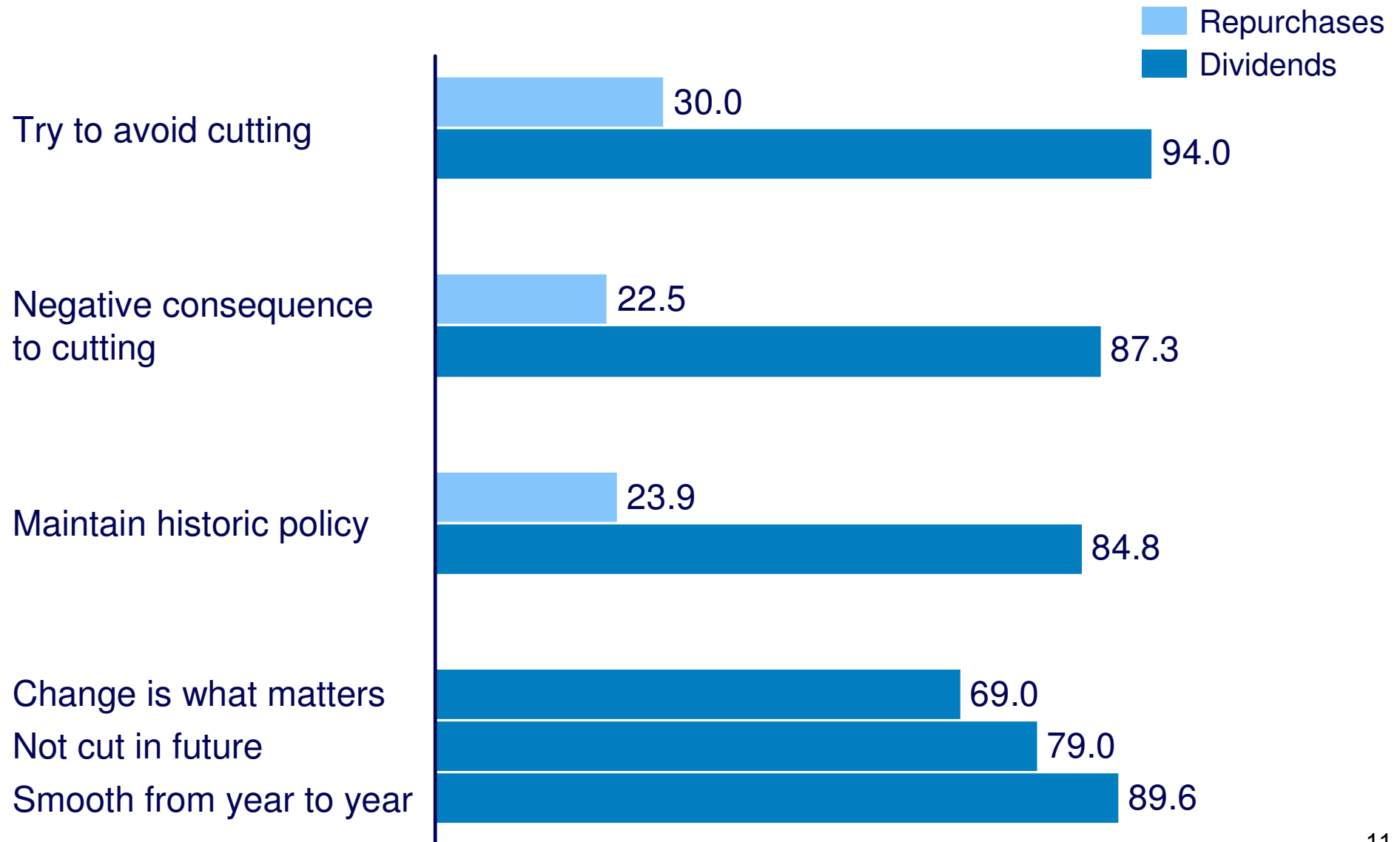
Do not cut dividends ranks equal to or above all of these items

Payout vs. investment decisions

Repurchases
Dividends

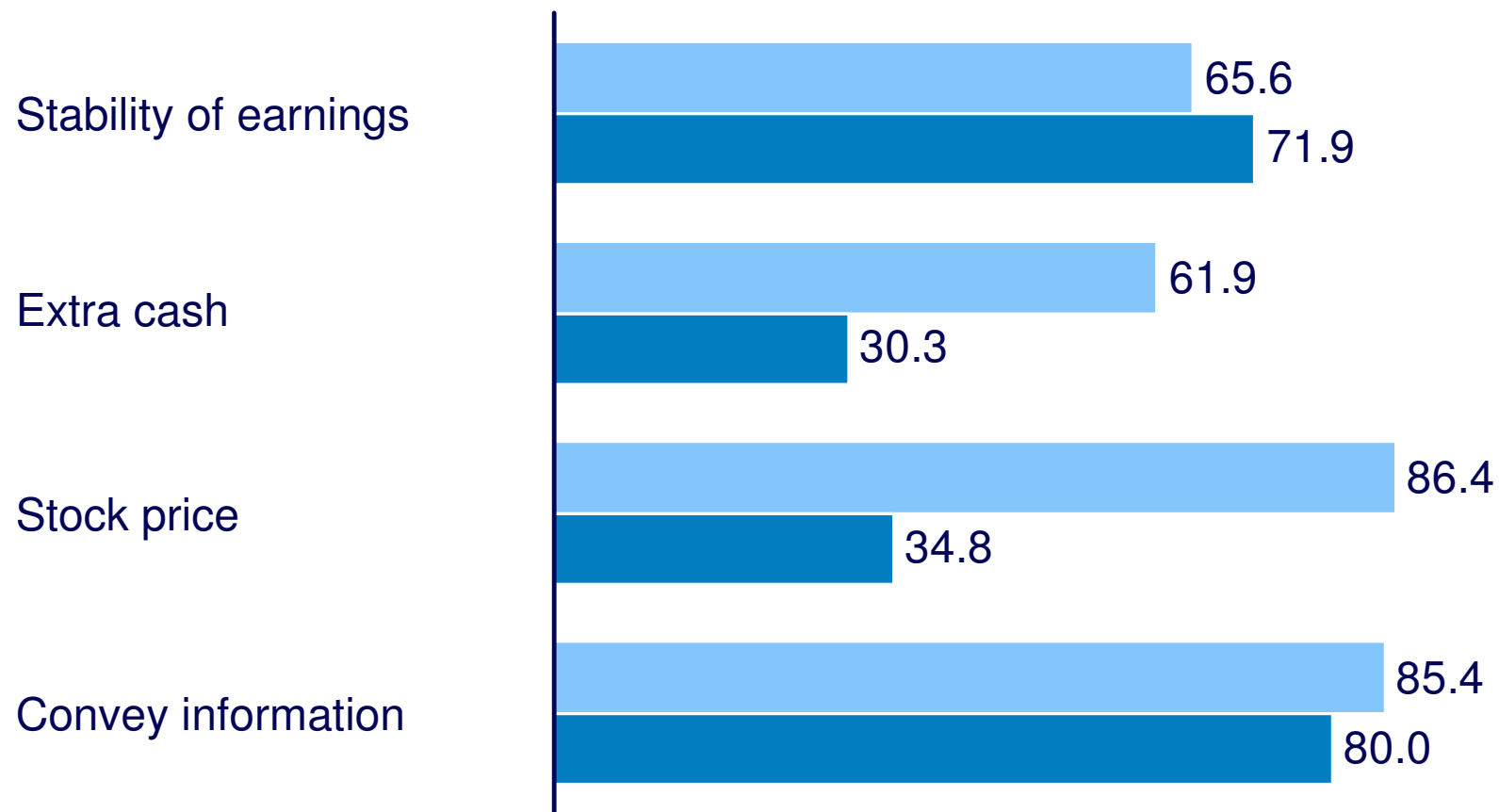


Are payout decisions conservative?



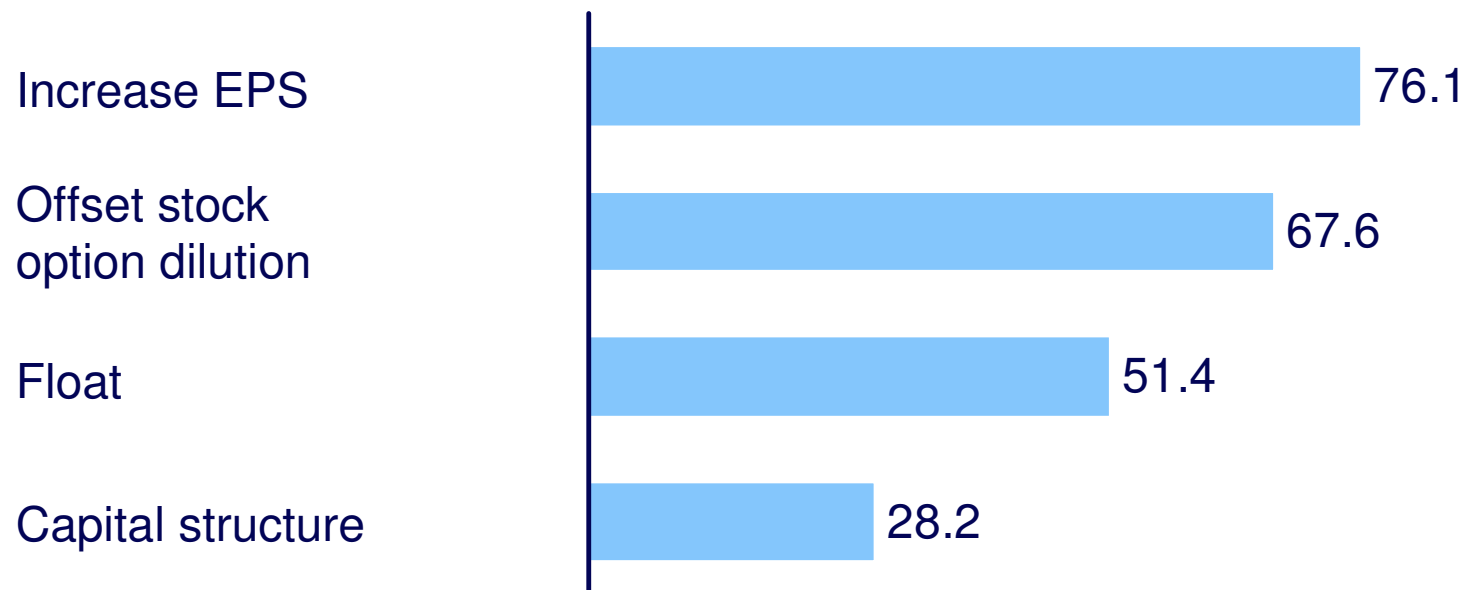
Other payout factors

Repurchases
Dividends



Repurchase factors

Repurchases



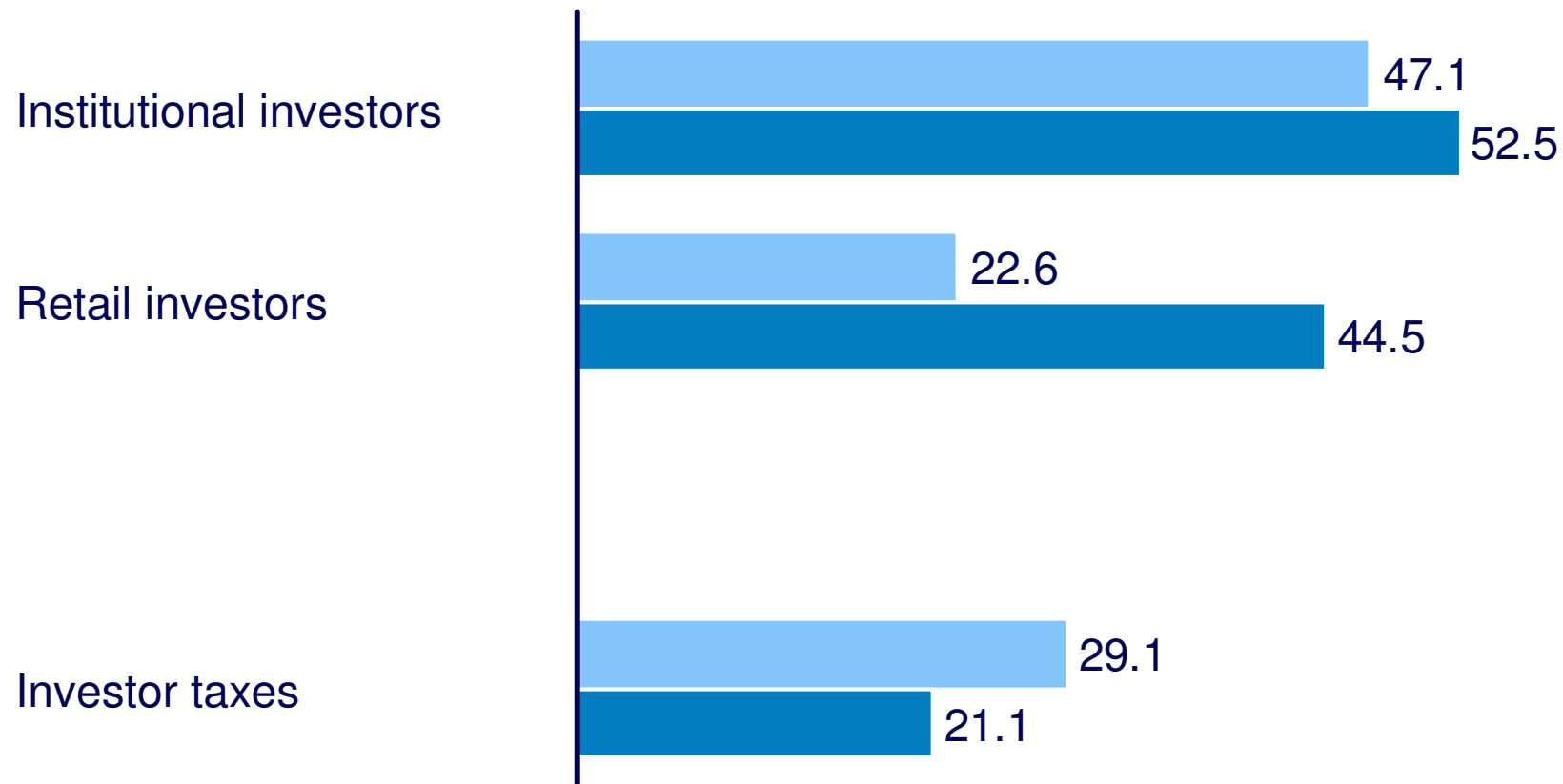
Do taxes affect payout decisions?

Yes – but 2nd order effect

Recent press (and some academic research) suggests otherwise

Investors and Taxes

Repurchases
Dividends



May 2003 tax cut

Dividend tax rate reduced to 15%

- from 38%

Capital Gains tax rate reduced to 15%

Applies to taxable, retail investors

Set to expire in 2009

Popular press

THE WALL STREET JOURNAL.

FRIDAY, JANUARY 6, 2006

New Cash Cows: Biggest Stocks

*Rising Dividends, Tax Changes
Give S&P Companies' Shares
Fatter Yields Than Treasuries*

By IAN McDONALD

STOCK DIVIDENDS are growing so much that even bond investors are taking notice as they hunt for income.

Record corporate dividend payouts—along with lowered federal taxes on those checks and paltry bond yields—are making dozens of big-

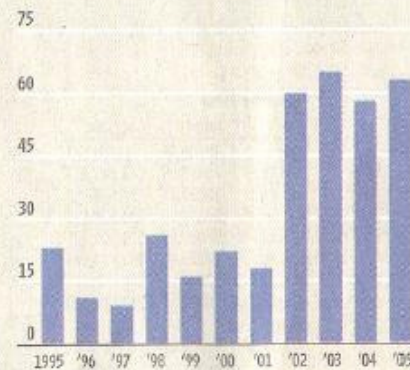
**HEARD ON
THE STREET**

company stocks better cash cows than bonds after federal taxes. More than 60 stocks in the Standard & Poor's 500-stock index, including companies such as Citigroup Inc., H.J. Heinz Co. and Pfizer Inc., have a higher after-tax dividend yield than the 10-year Treasury, according to Standard & Poor's.

And with many big, dividend-paying companies sitting on mountains of cash and trading at moderate multiples of their per-share earnings, there is reason to expect that group of S&P 500 companies to grow in number. Investors who long focused on bonds may start eyeing and buying

Rising Dividends

Number of S&P 500 stocks yielding more than the 10-year Treasury after federal taxes.



Source: Standard & Poor's

stocks that offer the same, or better, yield with the opportunity for capital appreciation as well.

"I'm a bond guy excited about stocks. What's the world coming to?" says Barry Evans, chief fixed-income officer at Sovereign Asset Manage-

ment in Boston, where he helps manage the \$1 billion John Hancock Sovereign Investors Fund. Dividend-payers General Electric Co., International Business Machines Corp. and Lowe's Cos. were top holdings at the end of November.

A stock's dividend yield is the company's per-share dividend payout over the past 12 months divided by the stock's current market price. A big part of stocks' new allure for bond investors is the lower tax rate on that dividend income.

Interest paid by Treasuries is taxed federally at as high as the top rate of 35%, but taxes on most types of corporate dividends were lowered to 15% in 2003 and are scheduled to stay at that tax rate through 2008. So, excluding state or local taxes on dividends, if a stock's yield is higher than 3.3% today, after taxes at the 35% federal rate, it is out-yielding the 10-year Treasury's 4.354% rate. Dividends would be far less attractive, of course, if lawmakers don't extend the 15% dividend-tax rate beyond 2008.

With the 10-year Treasury's yield well off its more than 7% average yield since 1962, topping that payout is a lower bar than usual. Yields may stay moderate with the Federal Reserve's policy makers signaling that its string of interest-rate increases may be nearing an end.

S&P 500 companies such as Dominion Resources Inc., DuPont Co. and American Electric Power Co.

Please Turn to Page C3, Column 1

Academic

Chetty and Saez

- QJE Aug 2005

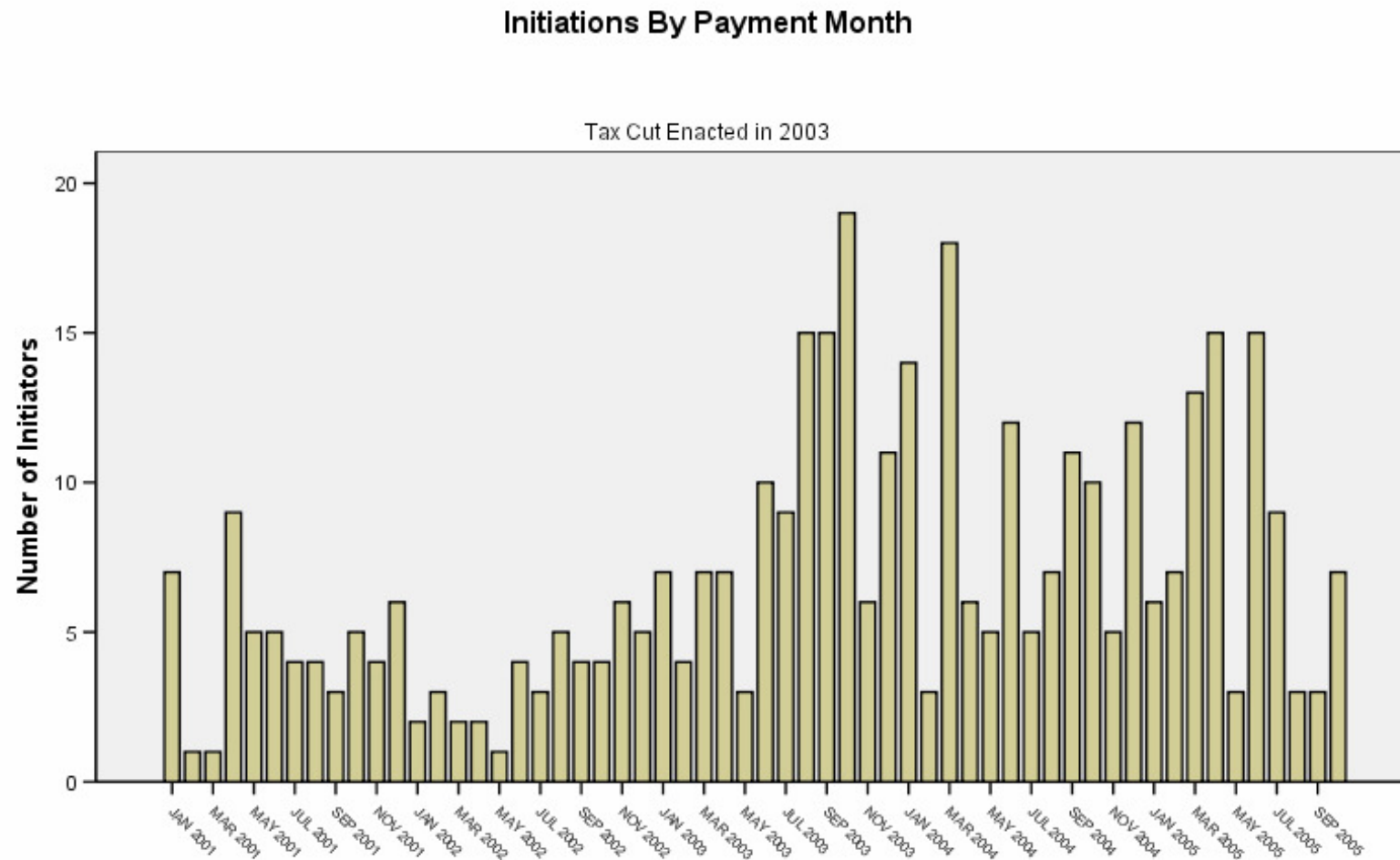
Surge in initiations in 2nd half of 2003

- More at firms where execs own stock
- Fewer at firms where execs hold options
- More at firms with taxable, retail investors

Brown et al.

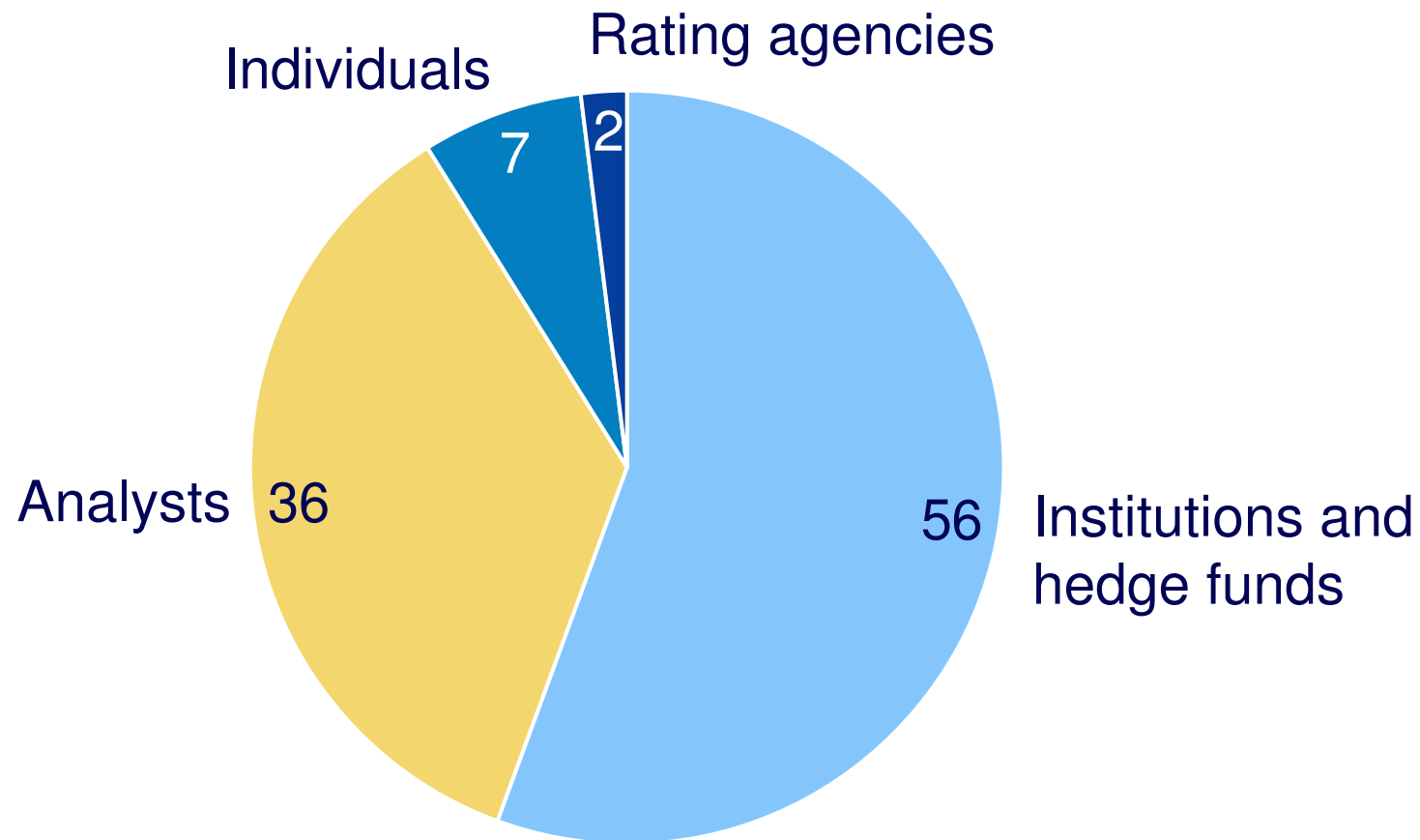
- Stock/option effects change in 2nd half 2003

Dividend initiations

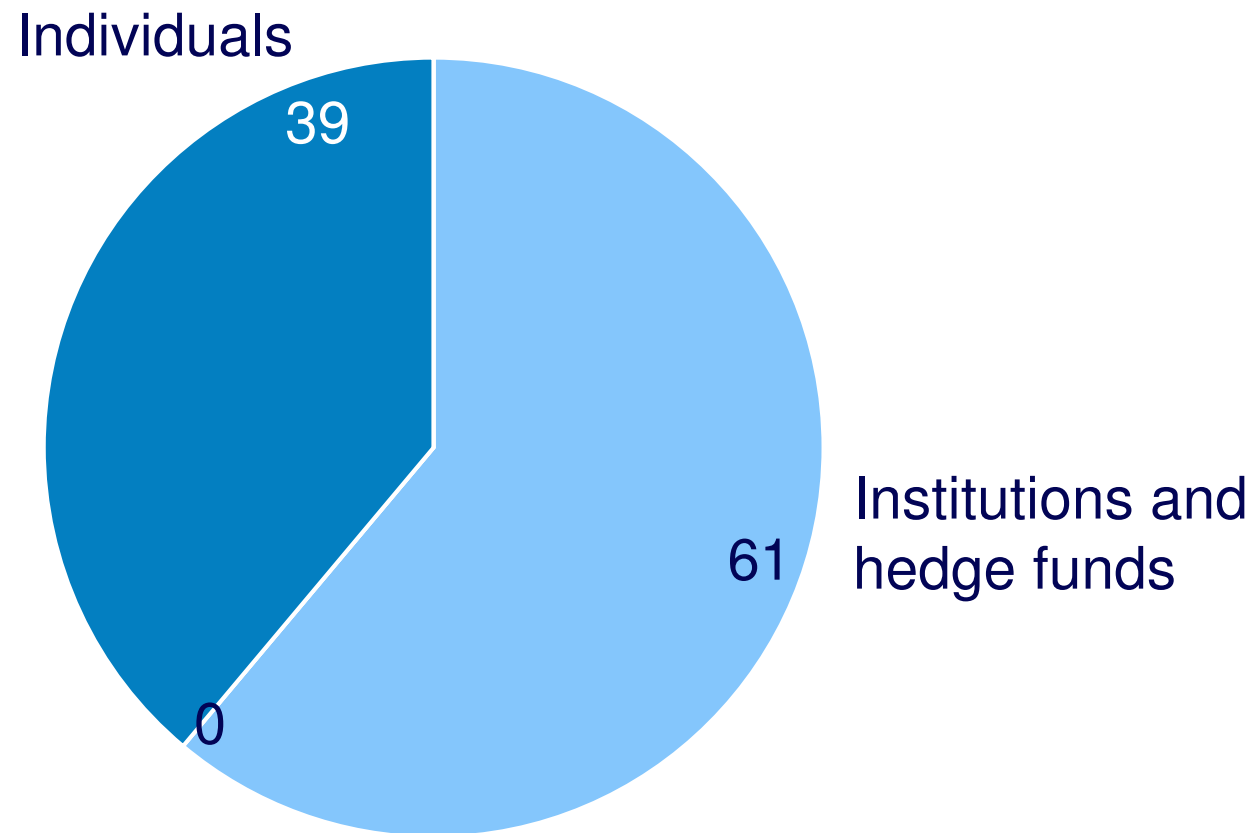


This figure depicts the number of firms initiating dividend payments for each month from January of 2001 to October of 2005. The sample is the constant number of firms sample as described in Chetty-Saez (2005).

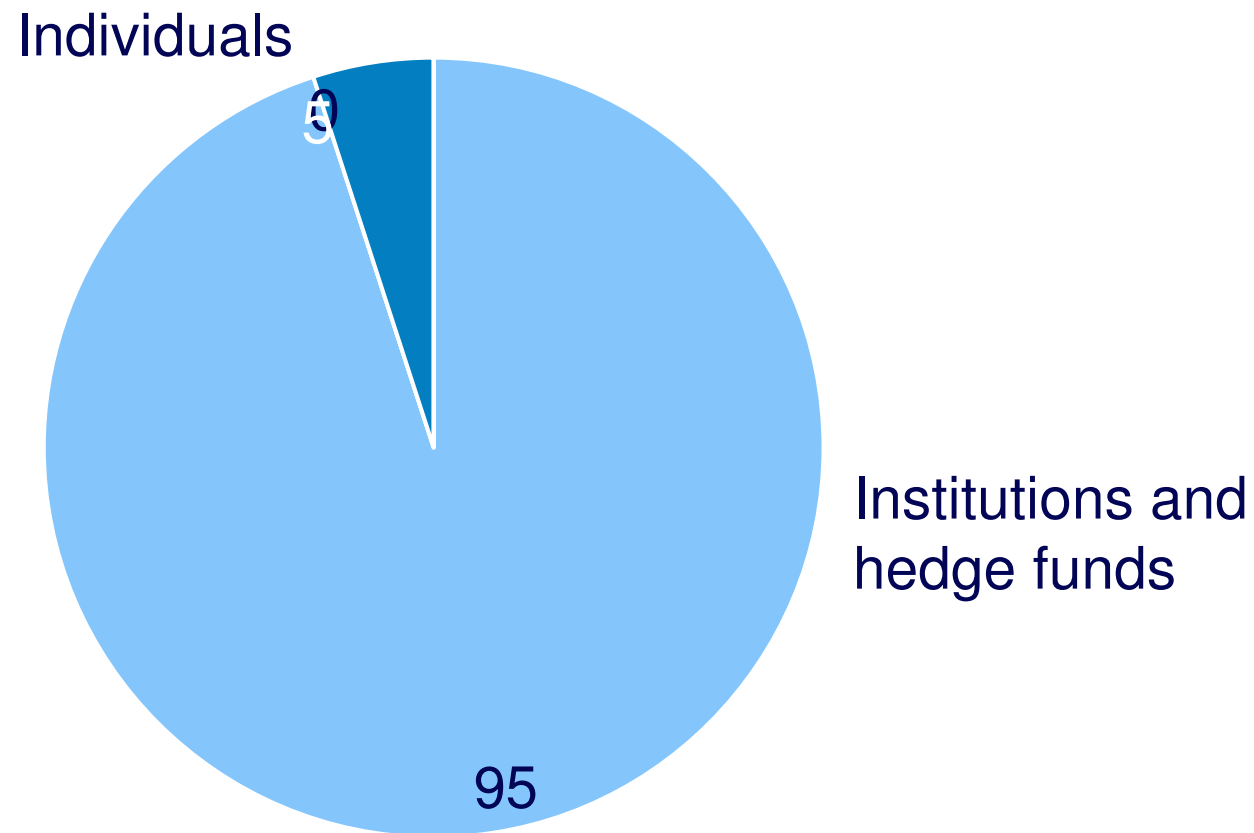
Who sets stock price?



Who sets stock price? (holdings data)



Who sets stock price? (NYSE trading data)



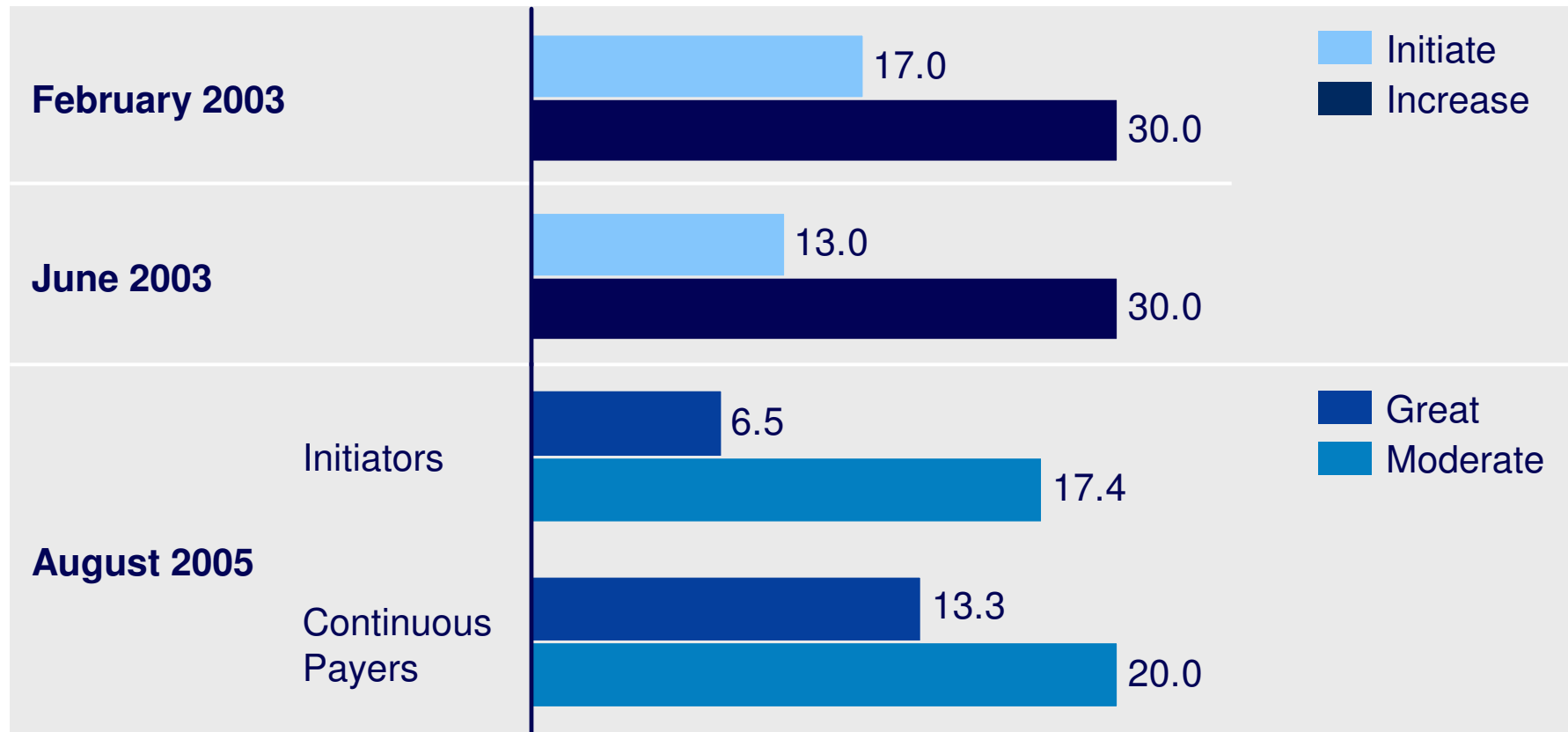
2003 Tax cut not a 1st order concern

Series of surveys asking about effects of tax cut

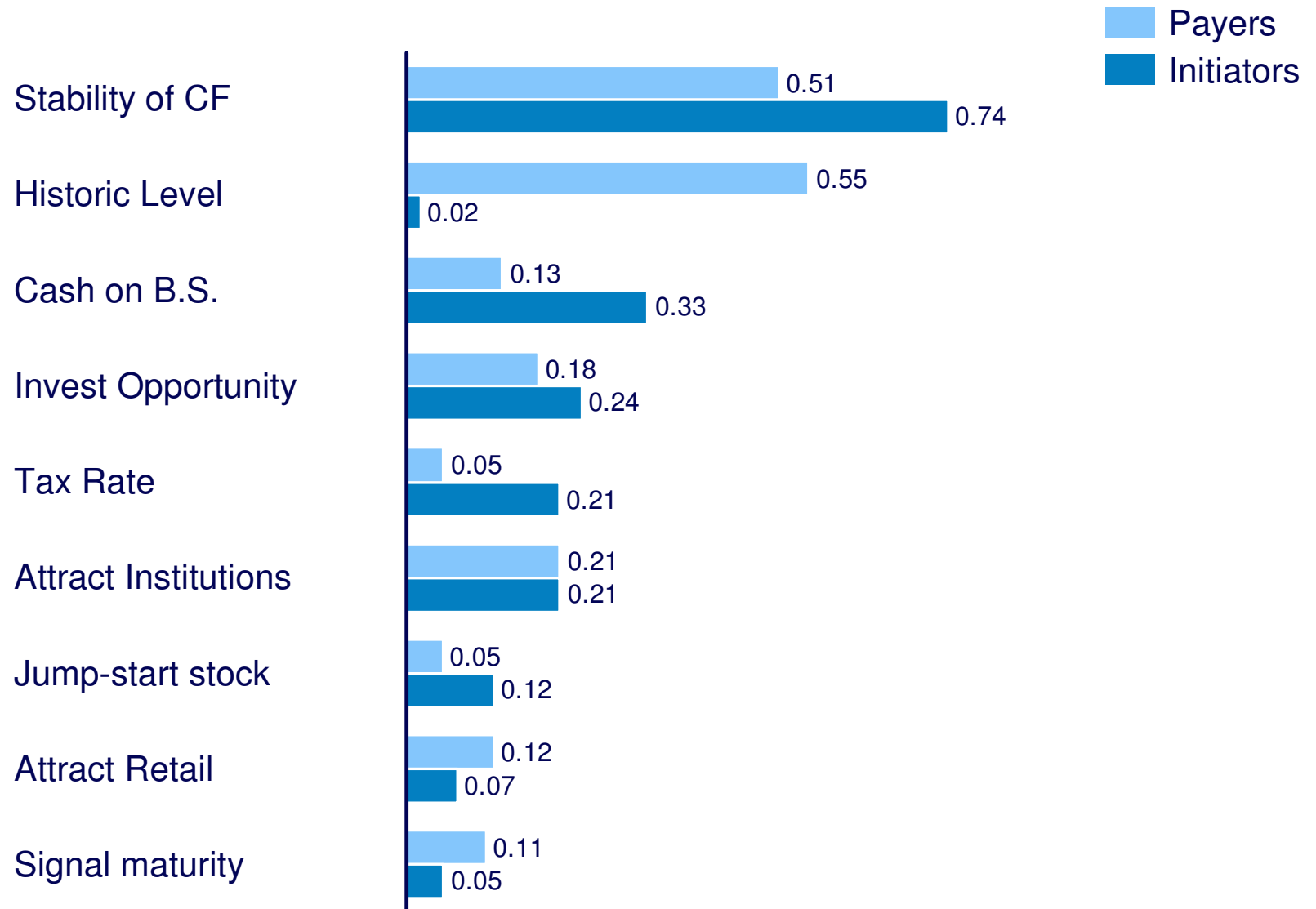
- Before details known (Feb 2003)
- After law signed (June 2003)
- >2 years after law in effect (August 2005)

<= 30% of firms say tax cut will lead to dividend initiation/increase

Taxes affect dividend decisions?

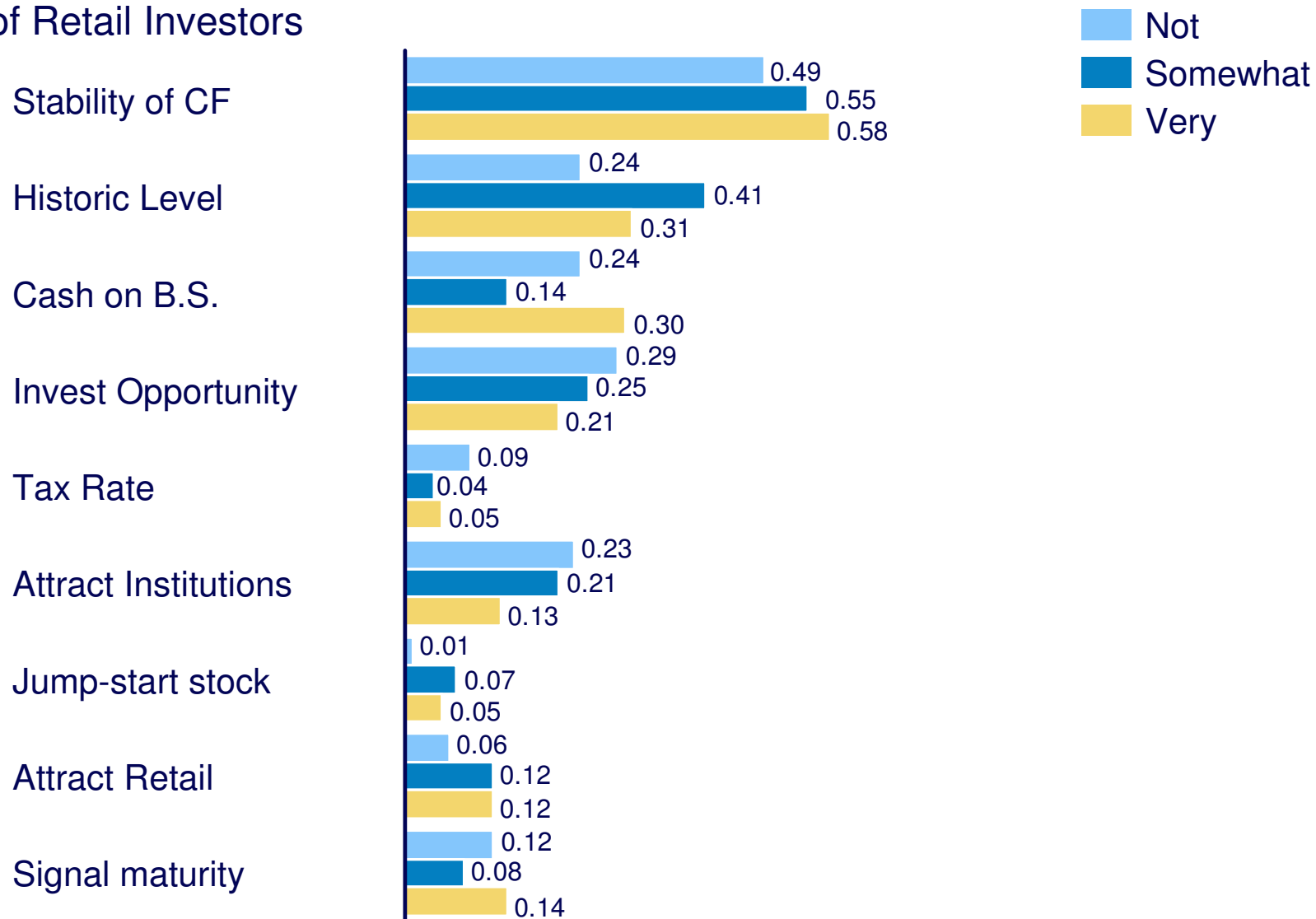


Taxes still second-order concern



Differential taxation does not seem to have much impact on dividend policy

Importance of Retail Investors



What has happened?

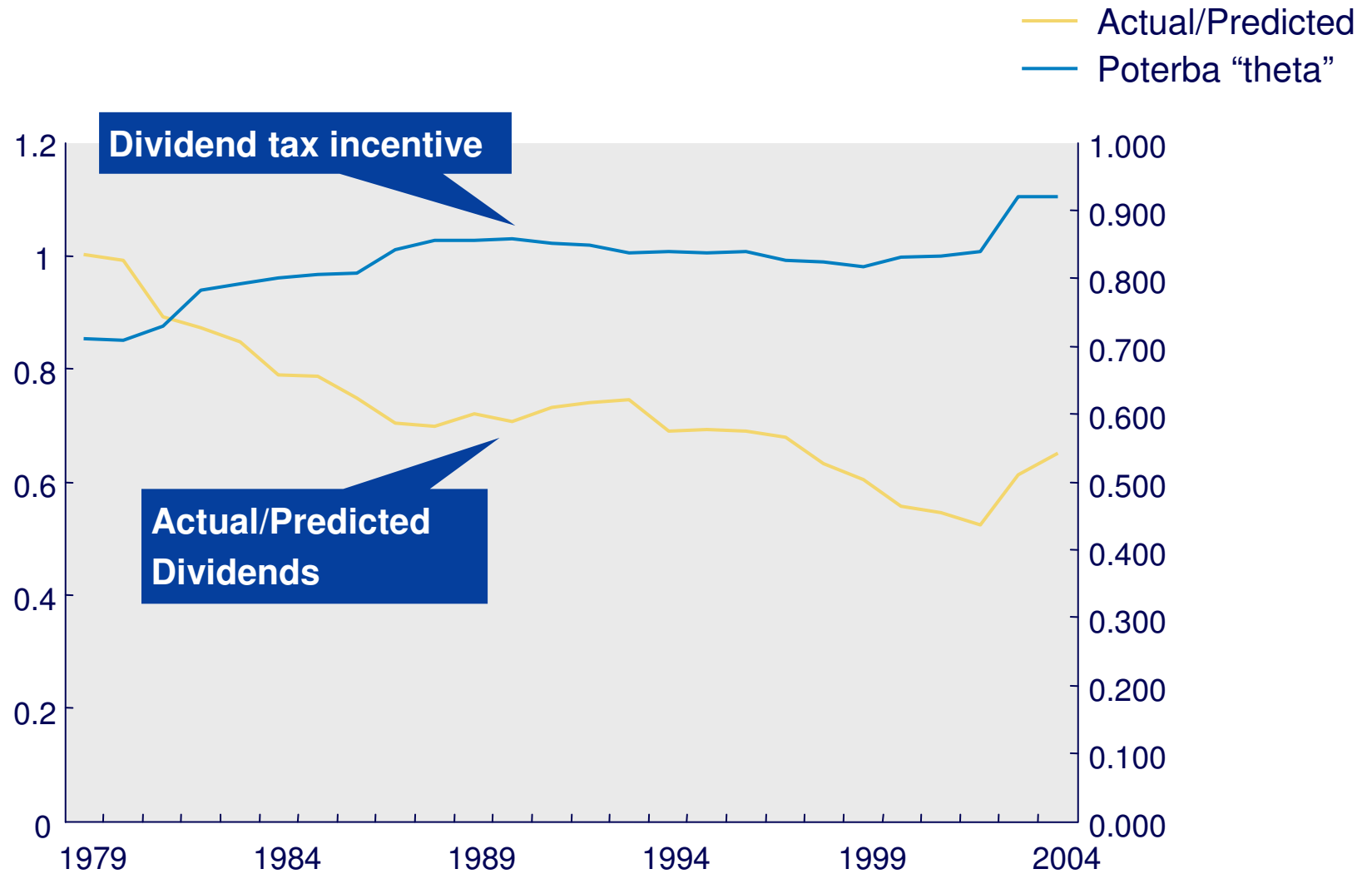
Initiations

- Accelerated initiations by firms that would have initiated fairly soon anyway

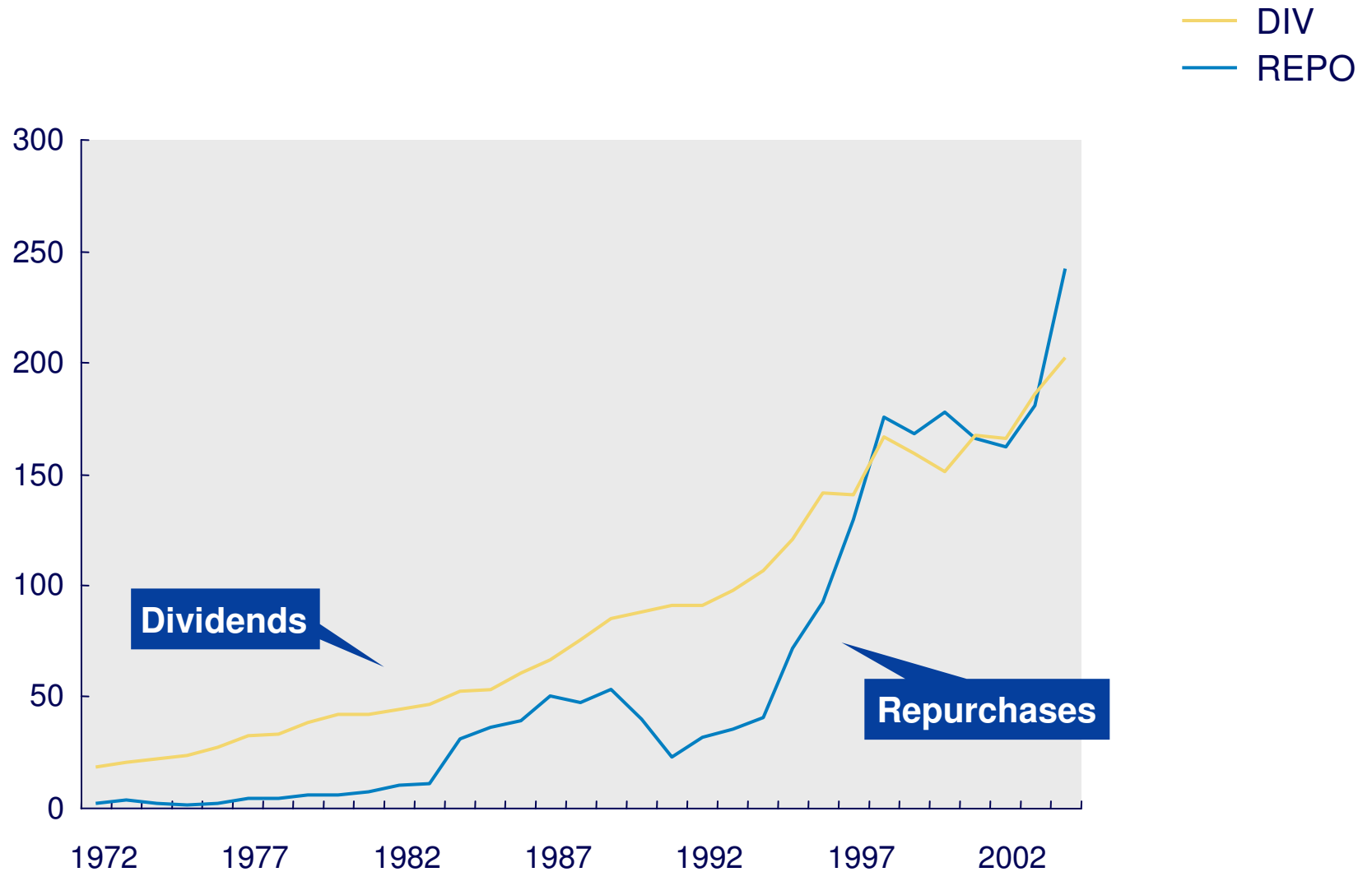
Dividend increases

- Rapid growth ... but more than just taxes at work

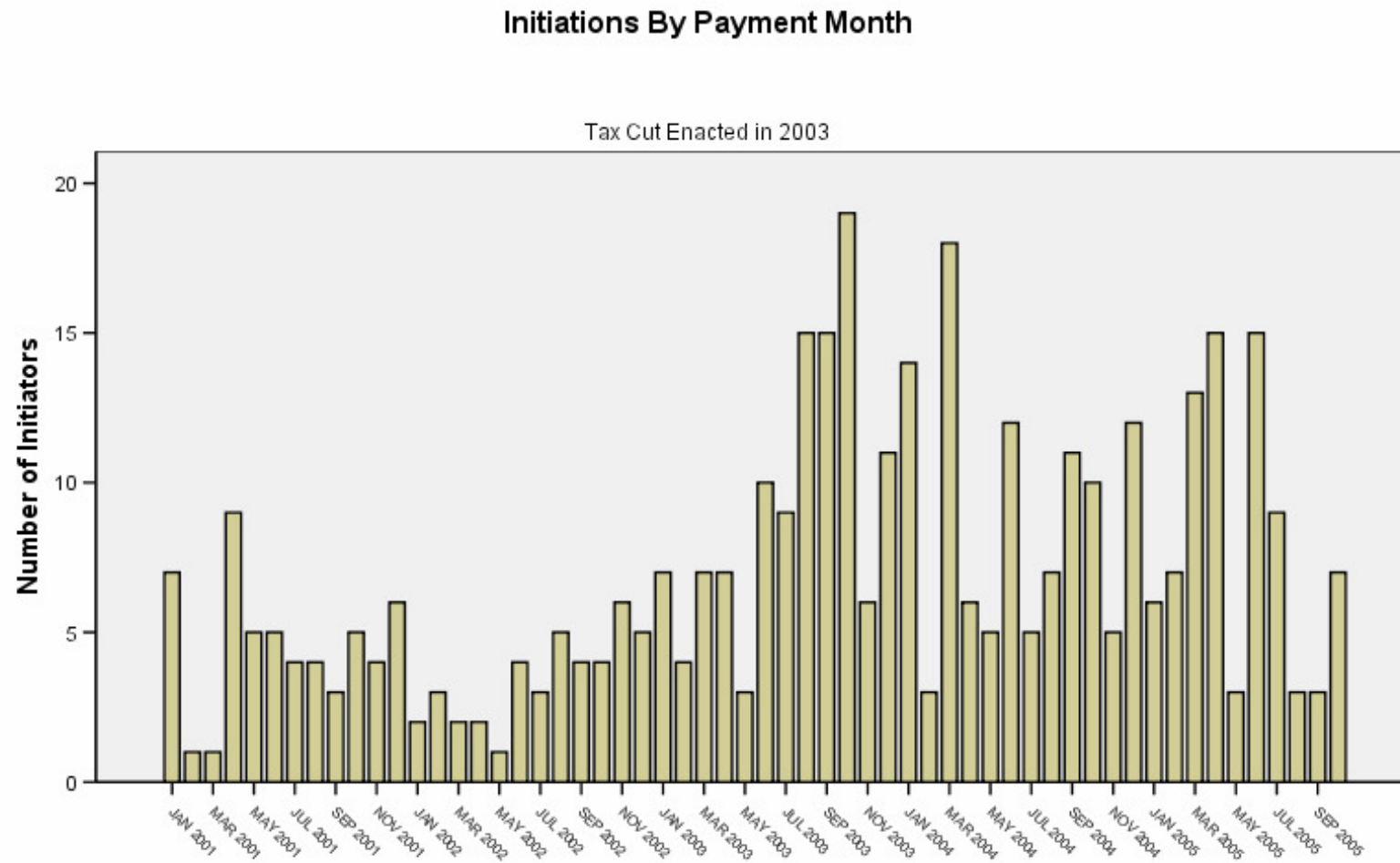
Actual vs. predicted dividends



Aggregate dividends and repurchases



Dividend initiations

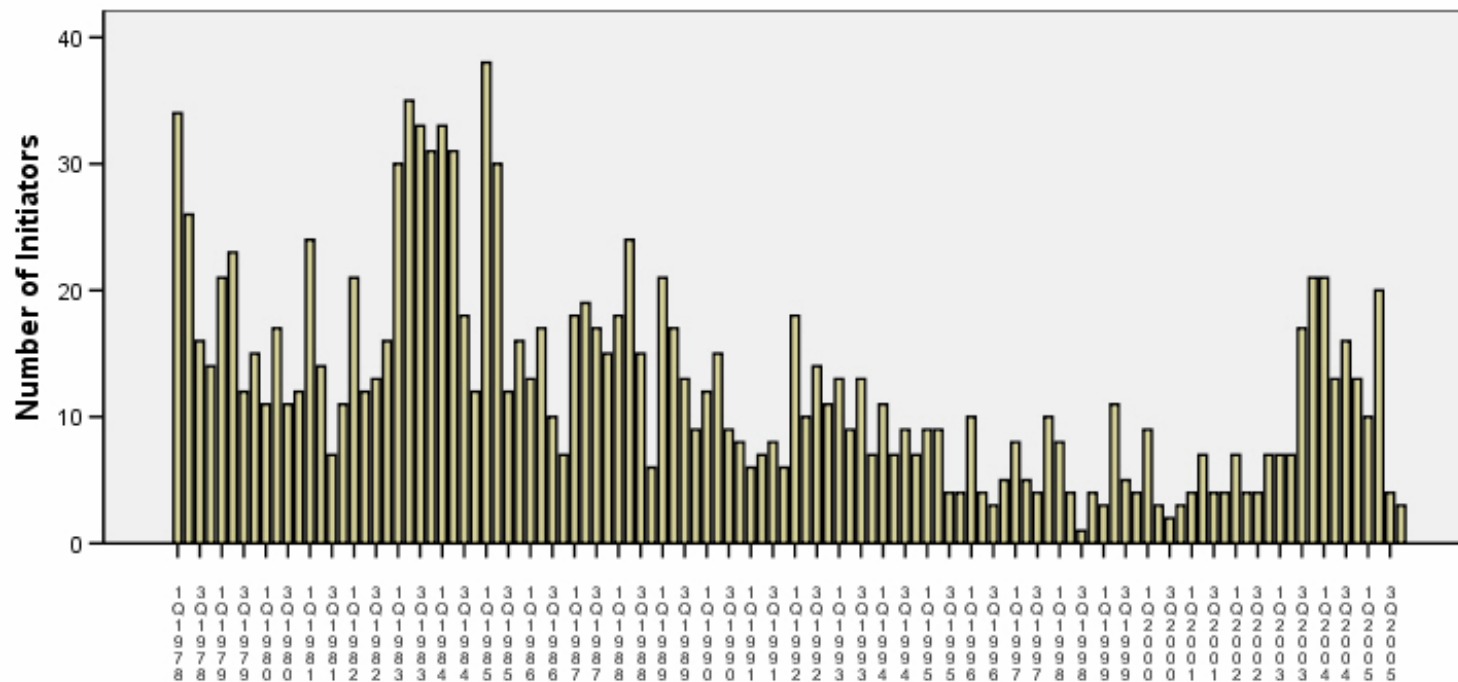


This figure depicts the number of firms initiating dividend payments for each month from January of 2001 to October of 2005. The sample is the constant number of firms sample as described in Chetty-Saez (2005).

Initiations since 1978 (quarterly)

Initiations By Payment Quarter

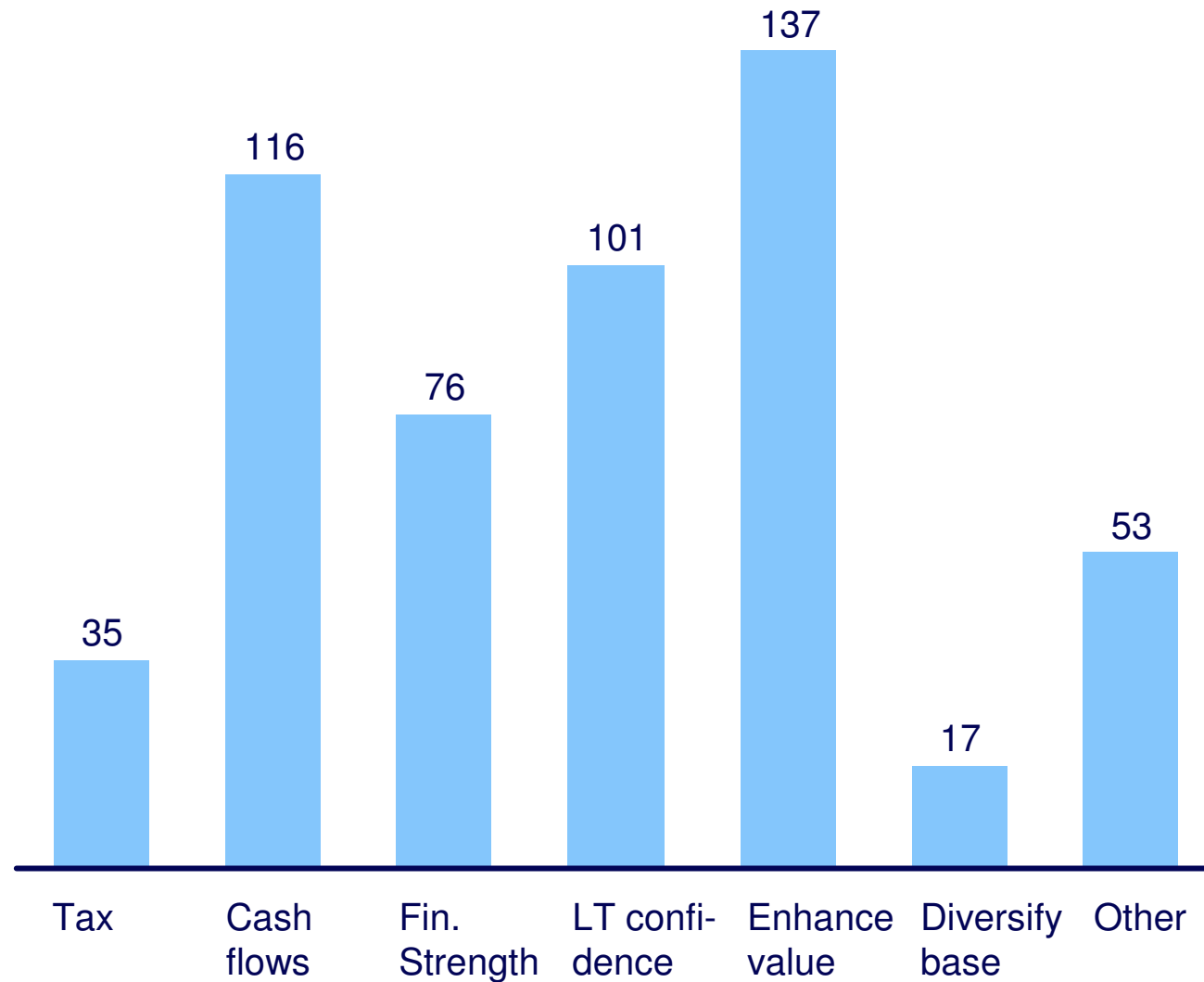
Tax Cut Enacted in 2003



This figure depicts the number of firms initiating dividend payments for each quarter from the first quarter of 1978 to the fourth quarter of 2005. The sample is the constant number of firms sample as described in Chetty-Saez (2005).

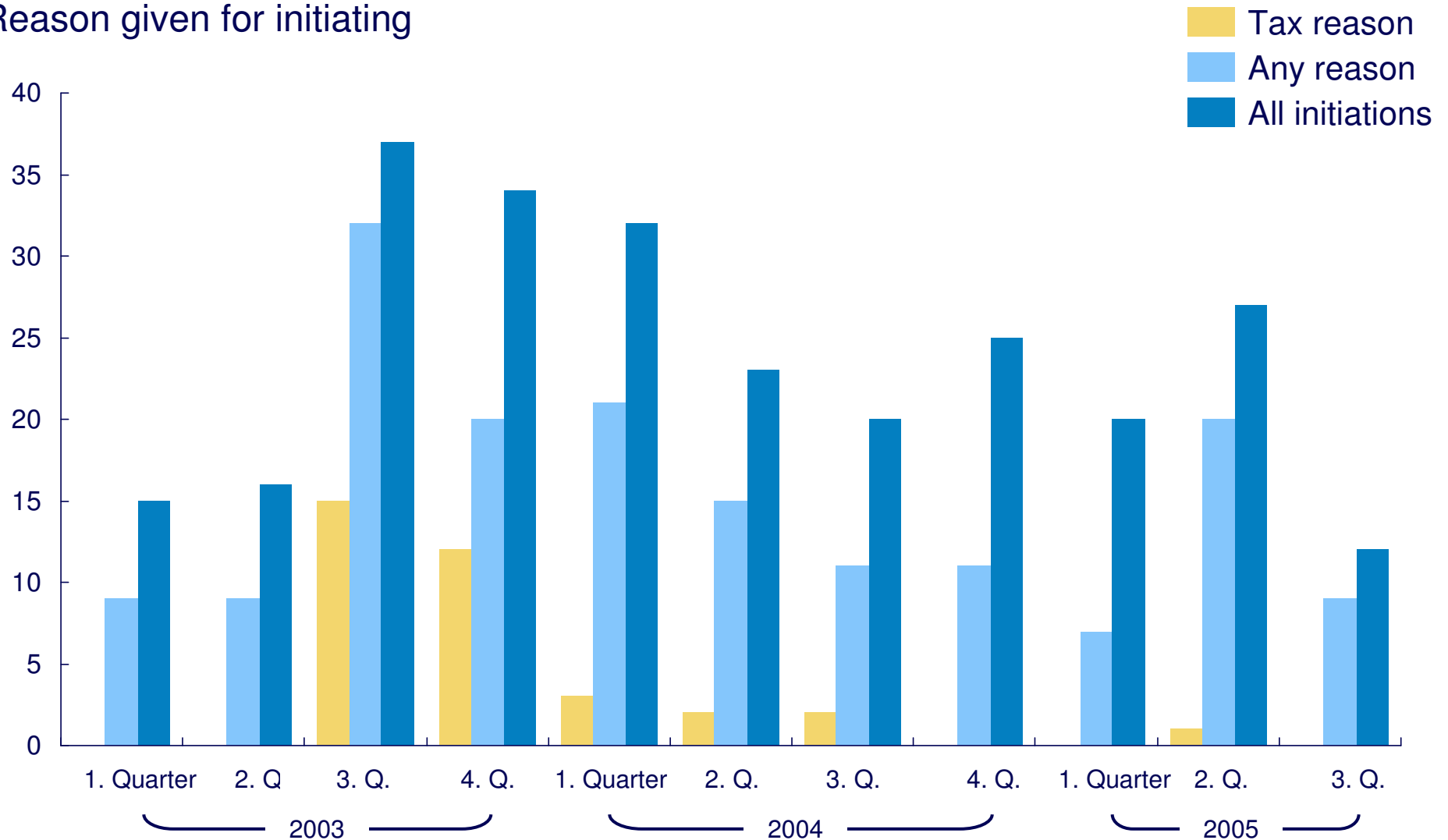
Reasons given for initiating

For all dividend initiations, 2003–2005



Tax-driven initiations?

Reason given for initiating



Stock market reaction

Not much reaction to tax cut

- in U.S. market
- in U.S. market vs. European market
- relative to REITS

Non-payers more positive reaction than payers

- Cap gains effect bc nonpayers more likely to issue stock?

High div-yield stocks react more than low div stocks

- But cumulative difference disappears within two months

Conclusion: Modest, short-lived market reaction

Stock market reaction (2)

Overall: Implication that effect of tax cut was “second-order” is consistent with market reaction

Conclusions

- **Big change in the dividends-repurchase mix over the last 20 years**
- **Repurchases are as important as dividends**
- **Firms that increase payout typically experience reduction in growth and a change in their risk profile**
- **Maintaining dividends more important than investment**
- **Stable future earnings 1st order**
- **Taxes matter but are 2nd order**
 - Retail investors not that important
 - Surge in initiations affected by non-tax factors, too
 - Stock market shrugged off tax cut