Cash Dividend Alternatives

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WHAT'S COVERED

In this lesson, you will learn about the effects of various alternatives to cash dividends on investors. Specifically, this lesson will cover:

1. Stock Splits

A **stock split** or stock divide increases the number of shares in a public company. Suppose a company has 1,000 shares outstanding. The company may want to increase this number to 2,000 shares without issuing new shares. They would split their stock 2-for-1. That means that every shareholder trades in one old share and gets two new shares in return.

The ownership stake for each shareholder remains constant because the number of shares held changes in proportion to the number of shares outstanding. They own the same percentage of the outstanding shares, though the nominal number of shares increases.

The price of the shares, however, changes. Since the market value of the company remains the same, the price of the new shares adjusts to reflect the new number of outstanding shares.

> EXAMPLE A company that has 100,000 shares outstanding that trade at $6 has a market capitalization of $600,000. After a 3-for-1 stock split, the market capitalization of the company remains unchanged at $600,000, but there are now 300,000 shares trading at $2.

IN CONTEXT

Lowering the price per share is attractive to some companies. Berkshire Hathaway has famously never had a stock split and has never paid a dividend. The Berkshire Hathaway Class A shares have never been split, so the price has followed the company’s growth over time. Since the price of a Class A share was over $121,000 on May 2, 2012, smaller investors may have chosen not to invest in Berkshire Hathaway Class A shares because of cash flow or liquidity concerns. There are, however, Class B shares that trade at a lower value.

TERM TO KNOW

Stock Split

A company increases the number of shares by offering several new shares in exchange for old ones.

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2. Stock Dividends

In lieu of cash, a company may choose to pay its dividend in the form of stock. Instead of each shareholder receiving, for instance, $2 for each share, they may receive an additional share. A **stock dividend** (also known as a scrip dividend) can be the economic equivalent of a stock split.

When a stock dividend is paid, no shareholder actually increases the values of his or her assets. The total number of shares outstanding increases in proportion to the change in the number of shares held by each shareholder.

> ↱ EXAMPLE If a 5% stock dividend is paid, the total number of shares outstanding increases by 5%, and each shareholder will receive 5 additional shares for each 100 held. As a result, each shareholder has the same ownership stake as before the stock dividend.

In addition, the value of the shares held does not change for each shareholder. As the number of shares outstanding increases, the price per share drops because the market capitalization does not change. Therefore, each shareholder will hold more shares, but each has a lower price so the total value of the shares remains unchanged.

IN CONTEXT

Adam owns 200 shares of a stock valued at $5/share in a company. The company issues a 4% stock dividend. With this stock dividend, Adam owns 4% more shares. 4% of shares is:

$$0.04(200) = 8$$

So Adam will receive 8 additional shares of stock or a total of 208 shares. However, Adam owns no additional value share of the company. The total value before the dividend was:

$$\$5(200) = \$1,000$$

To find the new value per share, divide this value by the total number of shares after the dividend:

$$\$1,000 \div 208 \text{ shares} = \$4.81/\text{share}$$

The stock dividend is not, however, exactly the same as a stock split. A stock split is paid by switching out old shares for a greater number of new shares. The company is essentially converting to a new set of shares and asking each shareholder to trade in the old ones. A stock dividend could be paid from shares not outstanding. These are the company's own shares that it holds; they are not circulating in the market, but were issued just the same. The company may have gotten these shares from share repurchases, or simply from them not being sold when issued.

Stock dividends may also be paid from non-outstanding stock or from the stock of another company (e.g., its subsidiary). The company would record the stock dividend as a debit to the retained earnings account and credit both common stock and the paid in capital accounts.

BIG IDEA

An advantage of paying stock dividends instead of cash dividends to the shareholder is due to tax considerations. Cash dividends are taxed, while stock dividends are not. Of course, stock dividends don't actually change the asset value of the shareholders so, in effect, nothing of substance has occurred.

TERM TO KNOW

Stock Dividend
A payment to a shareholder paid out in the form of additional stock shares of the issuing corporation, or another corporation (such as its subsidiary corporation).

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3. Reverse Splits

By owning a share, the shareholder owns a percentage of the company whose share they own. A share, however, does entitle the shareholder to a specific percentage ownership; the amount of the company that the shareholder owns is dependent of the number of shares owned and the number of shares outstanding.

EXAMPLE If Jim owns 10 shares of Oracle, and there are 1,000 shares outstanding, Jim effectively owns 1% of Oracle. If the number of shares outstanding were to double to 2,000, Jim's 10 shares would now correspond to a 0.5% ownership stake. In order for Jim's ownership stake to remain constant, the number of shares he holds must change in proportion to change in outstanding shares: he must own 20 shares if there are 2,000 shares outstanding.

That is the premise behind a **reverse stock split**. In a reverse stock split (also called a stock merge), the company issues a smaller number of new shares. New shares are typically issued in a simple ratio, e.g. 1 new share for 2 old shares, 3 for 4, etc.

The reduction in the number of issued shares is accompanied by a proportional increase in the share price.

EXAMPLE A company with a market capitalization of $1,000,000 from 1,000,000 shares trading at $1 chooses to reduce the number of outstanding shares to 500,000 through a reverse split. This leads to a corresponding rise in the stock price to $2.

There is a stigma attached to doing a reverse stock split, so it is not initiated without very good reason and may take a shareholder or board meeting for consent. Many institutional investors and mutual funds, for instance, have rules against purchasing a stock whose price is below some minimum. In an extreme case, a company whose share price has dropped so low that it is in danger of being delisted from its stock exchange might use a reverse stock split to increase its share price. For these reasons, a reverse stock split is often an indication that a company is in financial trouble.

A reverse stock split may be used to reduce the number of shareholders. If a company completes a reverse split in which 1 new share is issued for every 100 old shares, any investor holding less than 100 shares would simply receive a cash payment. If the number of shareholders drops, the company may be placed into different regulatory categories and may be governed by different laws.

TERM TO KNOW

Reverse Stock Split

A company reduces the number of shares outstanding by offering a number of new shares for each old one.

4. Repurchasing Shares

An alternative to cash dividends is share repurchases. In a **share repurchase**, the issuing company purchases its own publicly traded shares, thus reducing the number of shares outstanding. The company then can either retire the shares, or hold them as treasury stock (non-circulating, but available for re-issuance).

When a company repurchases its own shares, it reduces the number of shares held by the public. The reduction of the shares outstanding means that even if profits remain the same, the earnings per share increase. Repurchasing shares when a company's share price is undervalued benefits non-selling shareholders and extracts value from shareholders who sell.

Repurchasing shares will lead to a corresponding increase in price of the shares still outstanding. The market capitalization of the company is unchanged, meaning that a reduction in the number of shares outstanding must be accompanied by an increase in stock price.

There are six primary repurchasing methods:

Repurchasing Methods	Description
Open Market	The firm buys its stock on the open market from shareholders when the price is favorable. This method is used for almost 75% of all repurchases.
Selective Buy-Backs	The firm makes repurchase offers privately to some shareholders.
Repurchase Put Rights	Put rights are the right of the seller to purchase at a certain price, set ahead of time. If the company has put rights on its shares, it may use them to repurchase shares at that price.
Fixed Price Tender Offer	The firm announces a number of shares it is looking for and a fixed price they are willing to pay. Shareholders decide whether or not to sell their shares to the company.
Dutch Auction Self-Tender Repurchase	The company announces a range of prices at which they are willing to repurchase. Shareholders voluntarily state the price at which they individually are willing to sell. The company then constructs the supply curve, and announces the purchase price. The company repurchases shares from all shareholders who stated a price at or below that repurchase price.
Employee Share Scheme Buy-Back	The company repurchases shares held by or for employees or salaried directors of the company.

TERM TO KNOW

Share Repurchase

A company buys its own stock from public shareholders, thus reducing the number of shares outstanding.

4a. Benefits of Repurchasing Shares

A company may seek to repurchase some of its outstanding shares for a number of reasons. The company may feel that the shares are undervalued, an executive's compensation may be tied to earnings per share targets, or it may need to prevent a hostile takeover.

- *Undervaluation:* Repurchasing shares may also be a signal that the manager feels that the company's shares are undervalued. In this event, it will choose to repurchase shares, and then resell them in the open market once the price increases to accurately reflect the value of the company.
- *Executive Compensation:* In some instances, executive compensation may be tied to meeting certain earnings per share (EPS) metrics. If management needs to boost the EPS of the company to meet the metric, s/he has two choices: raise earnings or reduce the number of shares. If earnings cannot be increased, there are a number of ways to artificially boost earnings (called earnings management), but s/he can also reduce the number of shares by repurchasing shares. Strictly speaking, this is a benefit to the management and executives, not the company or the shareholders.
- *Hostile Takeovers:* A company can take over another firm if it holds enough of the other takeover target's shares (the buyer of the shares is called the bidder, and the company it is trying to buy is called the takeover target). The bidder is buying the takeover target's shares in an attempt to purchase enough to own it. Assuming the firm does not want to be taken over this way, the takeover attempt is called hostile. In order to prevent this from happening, the takeover target needs to prevent the bidder from purchasing enough of the shares. To do this, the takeover target will repurchase its own shares from the unfriendly bidder, usually at a price well above market value. Furthermore, it can prevent future takeover attempts. Companies with a lot of cash on their balance sheets are more attractive takeover targets because the cash can be used to pay down the debt incurred to carry out the acquisition. Share repurchases are one way of lowering the amount of cash on the balance sheet.

BIG IDEA

For shareholders, the primary benefit is that those who do not sell their shares now have a higher percent ownership of the company's shares and a higher price per share. Those who do choose to sell have done so at a price they are willing to sell at – unless there was a 'put' clause, in which case they had to sell because of the structure of the share, something they would have already known when they bought the shares.

4b. Drawbacks of Repurchasing Shares

There are a number of drawbacks to share repurchases. Both shareholders and the companies that are repurchasing the shares can be negatively affected.

Shares may be repurchased if the management of the company feels that the company's stock is undervalued in the market. It repurchases the shares with the intention of selling them once the market price of the shares increases to accurately reflect their true value. Not every shareholder, however, has a fair shot at knowing whether the repurchase price is fair. The repurchasing of the shares benefits the non-selling shareholders and extracts value from shareholders who sell. This gives insiders an advantage because they are more likely to know whether they should sell their shares to the company.

Furthermore, share repurchases can be used to manipulate financial metrics. All financial ratios that include the number of shares outstanding (notably earnings per share, or EPS) will be affected by share repurchases. Since compensation may be tied to reaching a high enough EPS number, there is an incentive for executives and management to try to boost EPS by repurchasing shares. Inaccurate EPS numbers are not good for investors because they imply a degree of financial health that may not exist.

From the investor's perspective, one negative consequence of a share repurchase is it is difficult to foresee how this will impact that company's valuation. It is common for companies to announce a repurchase agreement but not fully complete the repurchase. This can create additional difficulty for shareholders to accurately evaluate the value of the organization.

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5. Dividend Reinvestments

In some instances, a company may offer its shareholders an alternative option to receiving cash dividends. The shareholder chooses to not receive dividends directly as cash; instead, the shareholder's dividends are directly reinvested in the underlying equity. This is called a dividend reinvestment program or **dividend reinvestment plan (DRIP)**.

The purpose of the DRIP is to allow the shareholder to immediately reinvest their dividends in the company. Should the shareholder choose to do this on their own, they would have to wait until enough cash accumulates to buy a whole number of shares and they would also incur brokerage fees.

> ↪ EXAMPLE Brokerage firms like Charles Schwab earn money by charging a brokerage fee for executing transactions. Thus, participating in a DRIP helps shareholders avoid some or all of the fees they would occur if they reinvested the dividends themselves.

Participating in a DRIP, however, does not mean that the reinvestment of the dividends is free for the shareholder. Some DRIPs are free of charge for participants, while others do charge fees and/or proportional commissions.

Regardless, DRIPs have become more and more popular for a variety of investors. Chief among these is due to dollar-cost averaging, typically with regard to corporate dividends. This creates a scenario in which the investor is guaranteed the return of the dividend yield, as well as whatever amount the stock may appreciate to. The risk involved is the possibility the stock may depreciate, as well.

There is also an advantage to the company managing the DRIP. DRIPs inherently encourage long-term investment in the shares, which helps to mitigate some of the volatility associated with active trading. DRIPs help to stabilize the stock price.

HINT

The name "DRIP" is generally associated with programs run by the dividend-paying company. However, some brokerage firms also offer similar plans where shareholders can choose to have their cash dividends reinvested in stocks for little or no cost. This is called a synthetic DRIP.

TERM TO KNOW

Dividend Reinvestment Plan (DRIP)

The shareholder chooses to not receive dividends directly as cash; instead, the shareholder's dividends are directly reinvested in underlying equity.

SUMMARY

In this lesson, you learned about five alternatives to cash dividends that a company can use to compensate investors and manage its stock price. **Stock splits** increase the total number of shares outstanding by exchanging old shares for a greater number of new ones. **Stock dividends** distribute additional non-outstanding shares to current investors. **Reverse splits** reduce the total number of shares outstanding while preserving shareholders' proportional ownership. Companies can also reduce their number of shares outstanding by **repurchasing** their own publicly traded shares. A fifth option is to offer shareholders a **dividend reinvestment** program or dividend reinvestment plan (DRIP), which allows shareholders to immediately reinvest their dividends in the company. All of these options have advantages and disadvantages that must be considered by managers of firms.

Best of luck in your learning!

TERMS TO KNOW

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