

Dividend Policy

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Dividend Policy: A Business Perspective

BY

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Preface

“Our goal is to increase enterprise value. Which would you rather have us be? A company with our stock price, and \$40 billion in the bank? Or a company with our stock price and no cash in the bank?” – Steve Jobs replied when he was asked about Apple’s dividend policy. Under this philosophy, the world’s largest technology company did not pay dividends from 1996 to 2011. After Tim Cook succeeded Jobs to be the CEO, Apple started to pay dividends in 2012. Although Cook stated: “We can still maintain a war chest for strategic opportunities and have plenty of cash to run our business” (dividends are also considered as residuals), to some extent this dividend payment was interpreted that Cook “actually meets with and listens to investors and shareholders” (Paczkowski, 2012). In fact, dividend decisions are much more complicated in corporations. For example, Boeing Corporation’s dividend per share tends to increase steadily while earning per share and stock price experience many fluctuations over the period from 2000 to 2013. Remarkably, dividend per share exceeds earnings per share in the year of 2002. Therefore, dividends are not only residuals and not only completely determined by investment opportunities to some extent. In fact, dividend policy has many determinants from different levels of business environment.

A proper understanding of dividend paying policy is essential for other fields of financial economics including capital structure, mergers and acquisitions, and capital asset pricing (Allen & Michaely, 1995). Firstly, firms paying more dividends tend to use external funds including new share issues and debt to finance their investment projects. On the other hand, paying dividends is considered as a means to disgorge abundant cash which is available for managers to invest in negative net present value projects. Therefore, dividend policy is relevant to capital structure theories including transaction cost theory, pecking order theory, residual theory, and agency cost theory. Secondly, dividend policy is also related to the probability of takeover. The free cash flow theory suggested by Jensen (1986) posits that managers do not use retained earnings to maximize shareholder wealth optimally. High dividends are considered as a signal to the markets that firm managers act prudently and the likelihood of takeover is reduced. For example, to defend Scottish and Southern Energy against a possible takeover, its leaders announced a new dividend policy with an increase in the payout ratio by 18% in the year 2007 and an annual growth rate of at least 4% over three following years (Shelley, 2007). Thirdly, dividends have employed commonly to estimate the intrinsic value of shares over more than 40 years since Gordon (1962)

initially suggested the dividend growth model. Fama and French (2015) also use the dividend growth mode to explain the impact of profitability and investment on average returns and add these two factors to their three-factor model to establish a five-factor model. Therefore, understanding dividend policy is useful to asset pricing.

In a classic work, Black (1976) fails to find a reasonable argument to explain why firms distribute cash dividends to their stockholders and consider dividends as a “puzzle.” Since then, dividend policy is studied intensely by financial economists and has become one of the most debatable topics in corporate finance. Most prior books consider dividend policy as financial decisions and investigate both theories and practices in dividend policy from a financial perspective, for example, “Dividends and dividend policy” by Baker (2009), “Dividend policy: Theory and practice” by Frankfurter et al. (2003) and “Dividend Policy and Corporate Governance” by Correia da Silva et al. (2004). However, this book analyzes cash dividend decisions and related issues from a business perspective. Cash dividends are a distribution of cash to shareholders; therefore, dividend decisions affect business activities through reducing corporate cash reserves or investors’ behavior. On the other hand, dividend decisions are also affected by firms’ business environment – the main source of information for managers’ decision-making process. Consequently, this book focuses on how different levels of business environment determine cash dividend policy. Particularly, dividend decisions are made under the impacts of internal environment, industry environment, and macro-environment. Besides, we also present how corporate dividend policy affects shareholders’ wealth through stock price.

This book is structured as follows. The first three chapters present fundamentals of dividend policy. Chapter 1 introduces corporate dividend policy from a business perspective. Chapter 2 describes dividend policy around the world. Chapter 3 presents dividend theories – the mechanism through which market frictions determine dividend decisions – and their empirical evidence. The next four chapters analyze how firms make dividend decisions under the three levels of business environment. Chapter 4 analyzes the effect of internal environment (i.e., internal management and internal stakeholders) on dividend policy. Chapter 5 presents the relationship between industry environment and dividend decisions. Industry environment includes participants in both the product market and the financial market. Chapter 6 focuses on how macro-environment including political, economic, social, environmental, and legal factors influence corporate dividend policy. Especially, Chapter 7 examines the effect of business environment on dividend smoothing – a special dividend decision. Finally, Chapter 8 presents the reaction of stock price to dividend payments. It provides readers with comprehensive understandings in dividend policy and related issues under the impact of business environment. In this book, dividend policy is examined as both business-related and financial decisions. Therefore, it is attractive to both academics (e.g., researchers, lecturers, and students) in Finance and Business Administration and practitioners (e.g., investors, managers and policymakers).

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This book is for my little son and daughter, Yoyo and Pony. You made me take this leap. You study hard every day and so do I. I hope you grow up safe, strong, free, and fearless. Thank you for being my children. I love you.

Although I have spared no efforts to write this book and made it as perfect as possible, mistakes and errors may be unavoidable. Therefore, I hope that colleagues and readers sympathize with me for these problems. I look forward to your valuable comments and criticisms so that I can improve it in the future.