

THE MARKET VALUATION OF CASH DIVIDENDS A Case to Consider

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Since early 1956 Citizens Utilities Company has had two classes of common stock which are virtually identical in all respects except dividend payout. One class pays only stock dividends, the other class pays only cash dividends, and the corporate charter requires that the dividends per share on the two classes be of equivalent value. Under an I.R.S. ruling granted to Citizens Utilities in 1955 and a 'grandfather clause' in the 1969 Tax Reform Act, the stock dividends are not taxable as ordinary income. (No other publicly held firm has such a ruling and, in general, the 1969 Act made stock dividends of this type taxable.) Given these circumstances, the price-dividend history of the Citizens Utilities shares provides a view of the effects of alternative payout policies which, to an exceptional degree, is free of confounding factors. Close examination of this history implies that, if anything, claims to cash dividends have commanded a slight premium in the market over claims to equal amounts (before taxes) of capital gains.

1. Introduction

At least since Miller and Modigliani's (1961) seminal article on dividend policy, students of financial economics have been cautioned not to confuse dividend policy with investment policy—or with any other aspects of the firm that can obviously affect market value independently of dividend policy. To avoid this kind of confusion (which makes it impossible to 'isolate' the relation between cash dividends and share prices), Miller and Modigliani (MM) chose to narrowly define dividend policy choice within a given firm as the choice from among the alternative (stochastic) cash payout sequences that are consistent with a *given* (stochastic) sequence of net cash flows for the firm. Since net cash flows are directly affected by such things as investment

*I have received many comments and suggestions from my colleagues at the University of Rochester, in seminars at UCLA and Ohio State University, and in a joint Stanford–Berkeley seminar. I have not always agreed with or incorporated these suggestions, but I hope that in all cases the article has been improved by the stimulus they provided. I am especially grateful for information related to the case provided by the referee, Fischer Black; Richard L. Rosenthal, Chairman and Chief Executive Officer of Citizens Utilities; and Robert Litzenberger, and for the detailed criticisms of earlier drafts provided by Gregg Jarrell, Jerold Warner, Ross Watts, and Jerold Zimmerman. Finally, I would like to thank Ken French for excellent programming assistance and the Managerial Economics Research Center of the University of Rochester for financial support of this research.

policy and taxes, this generally implies that 'alternative' dividend policies in the MM sense are such that the sequence of changes in cash payouts involved in 'switching' from one alternative to another are always 'financed' by an identical sequence of changes in the dollar amounts of equity financing. Thus, for example, if a firm changes its dividend policy (in the MM sense) to increase the current and future level of total cash dividends, it does so by increasing (relative to previous plans and expectations) the current and future dollar amounts of new shares sold rather than by reducing outlays for new investment or selling more bonds (which affects taxes). From the perspective of investors at the time of this policy change, shares in the firm now (relative to the old dividend policy) represent a declining fractional claim on a sequence of larger total cash payouts. The question of the relation between share value and dividend policy *per se* is the question of whether the current with-dividend value of the initially outstanding shares is higher or lower as a result of the policy change.

To clearly illustrate their analysis of the value effects of alternative dividend policies, MM (1961, pp. 428–430) construct an example of two firms that are 'identical' except for their dividend policies. Given their definition of dividend policy, the sense in which the two firms are 'identical' is that their net cash flow sequences are identically distributed and perfectly correlated. The differences between the two firms' total cash payouts are then exactly matched by the differences in the dollar amounts of new shares sold by the two firms. This hypothetical example is deliberately constructed to 'isolate' dividend policy in the sense that MM intended. Conceptually, examination of the relative total values of shares in the two firms is the 'experiment' by which the value effects, if any, of alternative dividend policies are determined.

Almost as nearly as one could possibly expect of actual experience, the case presented below is a real-world analog of the MM two-firm example. Moreover, it is to my knowledge the only such analog if one requires any great degree of exactness in the analogy. This is unfortunate but, on the other hand, the case now covers a time span of 22 years in which the stocks involved have been actively traded and widely held. The case has been described on a number of occasions in the national financial media (e.g., *Business Week* and *Fortune*) and is monitored by at least three major investor advisory services (Moody's, Standard and Poor's, and Value Line). Given these conditions of time series sample size, trading activity, and public availability of information about the case, the presumption of semi-strong market efficiency implies that the case should offer reliable evidence of any truly general and systematic relation between dividend policies and share prices.

Section 2 below outlines the historical and institutional background of the case. Section 3 then provides some general *a priori* hypotheses to be examined with particular emphasis on the role of income taxation in the

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