Payout Policy in the 21st Century

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The authors investigate companies' decision-making processes on dividends and share repurchases through the use of extensive surveys. Their survey results show that maintaining dividend levels is as important as making positive net present value (NPV) investment decisions. In contrast, they find that share repurchases are often enacted only when excess cash flows exist. Over the past years, the relationship between earnings and dividends has softened, primarily because of changes in tax policies and perceived investor preferences.

Changes in the American business environment since Lintner (*American Economic Review*, 1956) and Modigliani and Miller (*American Economic Review*, 1958) inspired the authors to investigate whether Lintner's and M&M's conclusions are still relevant to today's companies. Miller and Modigliani (*Journal of Business*, 1961) established theoretical foundations for dividend payout policies, and this paper evaluates these ideas as well. The authors interview 384 financial executives from 256 public companies and 128 private companies. Of the public companies, 166 pay dividends, 167 engage in share repurchases, and 77 do neither.

Regarding dividends, repurchases, and investment decisions, the authors find that dividend payout levels are decided at the same time as, or immediately prior to, investment decisions. In contrast, share repurchases are made after payout decisions. In terms of priorities, survey responses indicate executives would defer positive net present value (NPV) projects before reducing dividends. Furthermore, 65 percent of executives at dividend-paying companies would raise new funds for profitable projects in preference to reducing payouts. Only 16 percent of executives at repurchasing companies, however, would

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agree to raise funds for profitable projects in preference to decreasing share repurchases. Dividends and repurchases are not viewed as interchangeable; more managers at dividend-paying companies prefer paying down debt to increasing share repurchases.

Considering how payout policies and payout ratios have been affected by 50 years of history, the authors find that decisions are still made in the same conservative manner but that the relative importance of maintaining a target payout ratio has fallen. For share repurchases, there is no evidence of a repurchase ratio; rather, repurchase levels change frequently. Historical perspective shows that if a company experiences a decline in earnings, today's managers are more likely to divest assets and defer positive NPV projects than to cut the dividend rate. Whereas previously, they would cut the dividend to reflect the condition of the business. A greater asymmetrical difference exists between cutting and increasing dividends, with the managers believing little reward to a dividend increase, compared to huge penalties for cuts.

During the time the surveys were taken, dividend tax rates declined, but only 28 percent of chief financial officers surveyed said the tax cut would cause their company to raise dividends. Of those companies that do not currently pay dividends, only 13 percent said that they would start paying dividends in response to the tax cut. Regarding the clientele effect, survey results indicate dividends have greater relative importance to retail, rather than institutional, investors. Executives at dividend-paying companies do not believe that payout policies are an effective means for the board to impose discipline on management. Nearly 75 percent of respondents indicate that raising earnings per share is a consideration for repurchase decisions. Often, repurchase decisions are enacted to offset earnings declines generated by employee stock option compensation or stock purchase plans.

For companies currently neither paying dividends nor repurchasing, managers indicated they would initiate a dividend if institutional investors demanded it or if they had a rapid rise in profits. Furthermore, they would begin to repurchase shares if they believed their stock were undervalued or a dearth of investment opportunities persisted. Their main reason for not initiating a dividend was its inflexibility.

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