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Buybacks vs. Dividends: Corporate Choice and Firm Characteristics

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Corporations with high cash reserves have traditionally rewarded their stockholders with cash dividends or share repurchases. According to Yardeni et. al (2017) cash dividends paid by the S&P 500 companies have steadily increased to over $ 400 billion over the past twenty years. In May 2017, Apple Inc. announced a 10% increase in cash dividends, surpassing ExxonMobil's large payout to stockholders. Share repurchases have also grown over the past twenty years to more than $ 500 billion, Recent expectations of tax breaks have raised the possibility that companies would repatriate large amounts of cash from foreign tax havens. Stock markets anticipate that companies will then use that cash for share repurchases. Analysts believe that buybacks could hit a historic high of more than $ 700 million in 2017(Dirousseau, 2017).

Such high numbers are not really unusual. Companies routinely buy back stock when they think that their stock is undervalued; this helps to use excess cash, and to reduce their outstanding shares that may have increased because of new issues or executive compensation. Investors like the cash influx and the increase in stock prices. Cash dividends are also a way of increasing shareholder wealth in the immediate future, rather than with the growth possibility in the future. New companies and high growth companies do not usually payout dividends – they are reinvested within the corporation. Mature, established companies in sectors like basic materials, oil and gas, and pharmaceuticals, have a consistent dividend policy.

Share prices tend to increase when a company repurchases stock (Chuang, 2007). Dittmar and Field (2015) show that firms tend to use buybacks when they think they are undervalued. According to Hribar et. al (2006) buybacks may be used as an earnings management measure. Opler and Titman (1996) show that repurchases affect the leverage ratio of firms; Bagwell (1991) suggests that repurchases may be used as a defense against takeovers. Additionally, Ditmar (2000) finds that firms also buyback shares as a counter measure to the dilutive effects of compensation.

Cash dividends however are primarily used as a signal to the market. Agency theory suggests that payment of dividends reduces income available to pay managers, thus reducing problems of goal incongruence (Easterbrook, 1984). Poterba and Summers (1984) found that dividends signaled the availability of private

information about a firm. According to DeAngelo (1996) and Leftwich and Zmijewski (1994) varying firm circumstances signal differing information to investors through dividends.

Research has also studied the relationships between the choices of buybacks versus dividend payouts. Lee and Suh (2008) report that repurchases are viewed as a more flexible means of investor reward. Lai et. al (2017) show that repurchases are negatively correlated (though weakly) with future profitability while dividends are positively associated. Kulchania (2016) reiterates that repurchases are more flexible, and relates the decision between buyouts and payouts to cost structure. Jacob and Jacob (2013) show an international correlation between taxation of dividends versus capital gains and the willingness of firms to make a choice. Shocks to growth and the structure of a company's governance policies also affect payout choices (Bhabra and Luu, 2015).

There are obvious differences between the reasons companies choose to repurchase stock or pay cash dividends. This would indicate basic differences in the characteristics of such firms especially as Lee and Suh (2008) found that repurchases are not used as a substitute for dividends. Their study also looked at companies that only repurchase stock and compared them to companies that do both, and found significant differences in firm characteristics. However prior research has not linked the firm characteristics of profitability, size, efficiency and risk to the specific choice between buybacks and payouts.

This study proposes to analyze S&P 500 firms to determine if there are differences in firm characteristics between firms that choose repurchases as compared to firms that choose to pay dividends. The following are the firm characteristics linked to firm choice of payouts:

Baseline measures of company value (V): This is the value that an investor expects from the company. This is measured by using

- Market capitalization
- Enterprise value (market value of common stock + market value of preferred equity + market value of debt + minority interest – cash and investments).
- Total Sales

Profitability Ratios(P): Investors measure performance of the company by using the following key ratios:

- Return on Assets
- Return on Equity

Risk (R): Financial metrics also provide information about the risk of a company as measured by:

- Debt ratio
- Beta

- Total Sales x risk metric (beta)

Market willingness to pay for the company (W): Based on performance and earnings, these ratios measure the market's willingness to pay for company stock:

- Price Earnings (PE) ratio
- Price to Book (PB) ratio

Market valuation (M): The following measures over or undervaluation of a company's stock:

- PEG ratio
- Tobin's q

In 2016, S&P 500 companies showed an increase of nearly 8% in their cash reserves from last year, totaling $ 1.54 trillion (Birstingi, 2016). Tax regulations are also poised to change, reducing the tax burden for foreign cash transfers. Under these circumstances, this study aims to identify distinguishing characteristics of companies that choose between a buyback and a payout. This is particularly important under current conditions as corporations deal with their excess cash and the need to reward investors while keeping in mind tax and other implications.

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