



## 2024 Level 2 - Corporate Issuers

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## Analysis of Dividends and Share Repurchases

- a. describe the expected effect of regular cash dividends, extra dividends, liquidating dividends, stock dividends, stock splits, and reverse stock splits on shareholders' wealth and a company's financial ratios
- b. compare theories of dividend policy and explain implications of each for share value given a description of a corporate dividend action
- c. describe types of information (signals) that dividend initiations, increases, decreases, and omissions may convey
- d. explain how agency costs may affect a company's payout policy
- e. explain factors that affect dividend policy in practice
- f. calculate and interpret the effective tax rate on a given currency unit of corporate earnings under double taxation, dividend imputation, and split-rate tax systems
- g. compare stable dividend with constant dividend payout ratio, and calculate the dividend under each policy
- h. compare share repurchase methods
- i. calculate and compare the effect of a share repurchase on earnings per share when 1) the repurchase is financed with the company's surplus cash and 2) the company uses debt to finance the repurchase
- j. calculate the effect of a share repurchase on book value per share
- k. explain the choice between paying cash dividends and repurchasing shares
- l. describe broad trends in corporate payout policies
- m. calculate and interpret dividend coverage ratios based on 1) net income and 2) free cash flow
- n. identify characteristics of companies that may not be able to sustain their cash dividend

**LOSs will match between the video and the MM PDFs, but may be in a different order than the CFAI readings**

## Cash vs. Non-Cash Dividends

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- describe

**Dividends**

```

graph TD
    Dividends --> Cash
    Dividends --> Non-Cash
    
```

**Cash**

- regular
- extra
- liquidating

**Non-Cash**

- stock dividend
- stock split
- reverse stock split

⇒ **Regular Cash Dividends/**

- quarterly (U.S., Canada) semi-annual (Europe, Japan) or annual (China, Thailand)
- companies strive to maintain or increase their dividends (consistency & stability over time signals consistent profitability)
- mgmt. can use dividend announcements to communicate confidence in the company's future

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⇒ **Regular Cash Dividends/**

- DRiPs - Dividend Reinvestment Plans - rather than cash dividends, more shares are paid out
- ① open-market DRP - company purchases shares in the open market to deliver
- ② new-issue DRP - shares to deliver are issued
- ③ hybrid - either ① or ②

**Company benefits/**

- may encourage a more diverse shareholder base (smaller shareholders have an easy means to accumulate shares)
- may stimulate longer-term investment
- new-issue DRPs allow the company to raise new equity capital without floatation costs

⇒ **Regular Cash Dividends/**

- DRiPs – Dividend Reinvestment Plans

**Shareholder benefits/**

- allow the accumulation of shares using cost averaging
- typically no transaction costs
- new-issue DRPs (but not exclusively) may allow shares at 2%-5% market discount

**Shareholder disadvantages/**

- extra record keeping (ACB)
- still taxable

- ⇒ **Extra (Special) Dividends/** a dividend paid by a company that does not pay a div. on a regular schedule or a div. in addition to a regular cash div.

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⇒ **Extra (Special) Dividends/**

- a means of distributing more earnings only during strong earnings years

⇒ **Liquidating Dividends/** - used when a company

- 1/ goes out of business & the net assets are distributed to shareholders
  - 2/ sells a portion of its business for cash and the proceeds are distributed to shareholders
  - 3/ pays a dividend that exceeds its accum. Ret. Earnings
- is a return of capital rather than a distribution from earnings

- ⇒ **Stock Dividends/** - company distributes additional shares
- sh. total cost basis remains the same, cost/sh. is reduced

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⇒ Stock Dividends/

- generally not taxable to shareholders
- will not affect sh. proportional ownership
- also will not affect the value of each sh. ownership position

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	Before Dividend	After Dividend
Shares outstanding	1,000,000	1,030,000
Earnings per share	\$1.00	\$0.97 (1,000,000/1,030,000)
Stock price	\$20.00	\$19.4175 (20 × 0.9709)
P/E	20	20
Total market value	\$20 million	\$20 million (1,030,000 × \$19.4175)
Shares owned	100,000 (10% × 1,000,000)	103,000 (10% × 1,030,000)
Ownership value	\$2,000,000 (100,000 × \$20)	\$2,000,000 (103,000 × \$19.4175)

- Adv./ • favours long-term investors which may lower the company's cost of equity financing (basically issuing shares = cash div.)
- helps increase the stock's float, improves liquidity, dampens price volatility

⇒ Stock Dividends/

- more likely to keep a share price within an optimal range

- Cash Div. affect Capital Structure, no so with stock Div.

- |                                                 |                                                                                                                |
|-------------------------------------------------|----------------------------------------------------------------------------------------------------------------|
| • reduce assets                                 | • do not affect assets                                                                                         |
| • reduce Sh. Equity                             | • do not affect Sh. Equity                                                                                     |
| • liquidity ratios decrease                     | $\left( \begin{array}{l} \text{Ret. Earn. } \$\downarrow \\ \text{Cont. Cap. } \$\uparrow \end{array} \right)$ |
| • financial leverage ratios increase (D/A, D/E) |                                                                                                                |
|                                                 | - no affect on liquidity or leverage ratios                                                                    |

⇒ Stock Splits/ 2-for-1      ① price/2      ② shares × 2

EPS/2    P/E - unch.    MV<sub>e</sub> - unch.    Div yield - unch.

- no affect on any shareholder accounts

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⇒ **Stock Splits/**

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	Before Split	After Split
Number of shares outstanding	4 million	8 million
Stock price	€40.00	€20.00 (€40/2)
Earnings per share	€1.50	€0.75 (€1.50/2)
Dividends per share	€0.50	€0.25 (€0.50/2)
Dividend payout ratio	1/3	1/3
Dividend yield	1.25%	1.25% (€0.25/€20.00)
P/E	26.7	26.7 (€20.00/€0.75)
Market value of equity	€160 million	€160 million (€20.00 × 8 million)

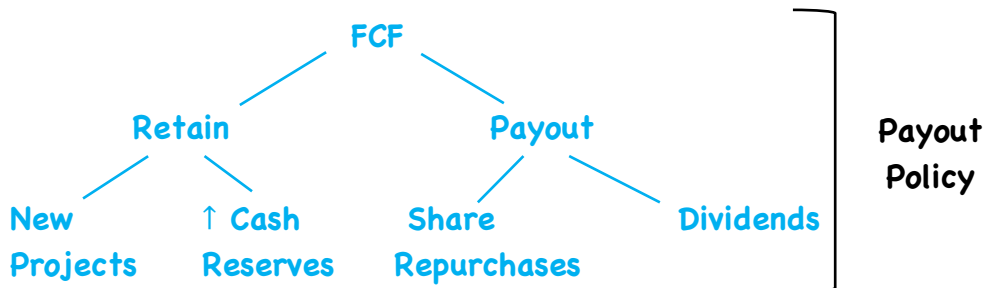
⇒ **Reverse Stock Splits/**

- increases the share price and reduces the # of outstanding shares
- no affect on  $MV_e$  or sh. total cost basis

**Dividend Policy Theories**

- ⇒ **Does a dividend payment increase or decrease the value of a firm to its owners?**  
- if so, what should a firm's payout policy be?

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- to answer these questions, first start by making the payout policy irrelevant

### 1) Dividend Irrelevance Theory/

- Miller, Modigliani (1961)

- assume perfect capital markets

- 1) no taxes
- 2) no transaction costs
- 3) no agency costs
- 4) information symmetry

- div. policy will have no effect on CoC or shareholder wealth

⇒ Investors can create their own dividend

∴ company div. policy adds no value

- div. & sh. repurchases are interchangeable
- value of firm depends only on net income produced by assets, not on how this income is split (Div. vs. RE)

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LOS b

- compare
- explain

need  
1 & 2  
above

### 2) Dividend Preference Theory

- Gordon (63), Lintner (62)

⇒ stocks risk declines as

dividends increase i.e.  $r_e \downarrow$ , WACC  $\downarrow$

- dividends are a sure thing, retained earnings are risky  
'a bird in the hand' argument

∴ shareholders prefer dividends and are willing to accept a lower required return on equity

- also reduces agency costs (reduces the risk that mgmt. will misuse the cash)

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### 3) Tax Effect Theory

- if  $T_D > T_{CG}$ , investors prefer low payout ratios or repurchases as a form of distribution
  - investors would be willing to pay more for low payout companies
- if  $T_D < T_{CG}$  - investors prefer cash dividends
- if  $T_D = T_{CG}$  - investors still prefer capital gains to dividends (time value of money)

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- compare  
- explain

### Dividend Signals

- MM  $\Rightarrow$  information symmetry
- in reality, asymmetry between mgmt. & investors
  - $\therefore$  may be some info in dividend policy changes
- dividend initiations/increases  $\Rightarrow$  signal that mgmt. expects higher earnings in the future
  - mgmt. may be motivated to initiate/increase if they believe shares to be undervalued
- dividend omissions/decrease/failures to increase - convey negative information

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## Clientele/Agency Issues

### ⇒ Agency Costs/

- Jensen's FCF hypothesis/ by paying out a high ratio of earnings, mgmt. is constrained from overinvestment
- if the company is leveraged, high payout ratio may constrain available cash leading to underinvestment
  - high payout ratio increases agency costs to creditors
  - typically have debt covenants restricting the level/amount of dividends

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## Factors Affecting Dividend Policy

### 1) Investment opportunities/

- a company with many inv. opportunities will tend to payout less in dividends
- internally generated cash flows are a cheaper source of equity funding

### 2) Expected volatility of future earnings/

- the more volatile earnings are, the greater the risk that a dividend increase may not be met by future earnings

### 3) Financial flexibility/

- may use share repurchases rather than initiate/increase a dividend

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#### 4) Tax Considerations/

##### - Taxation Methods

- double taxation system
  - earnings taxed at corporate level, then again at individual level
- dividend imputation tax system
  - corporate profits are taxed just once, at the shareholder tax rate
- split-rate tax system
  - corporate profits destined as dividends are taxed lower than profits to be retained

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LOS e

- explain

#### 5) Floatation Costs/

- fees a company must pay to sell new shares plus the negative market price reaction
- higher (as a %age of funds raised) for smaller firms
  - ∴ try to avoid a level of dividends that would create the need to raise new equity to finance NPV<sup>+</sup> projects

#### 6) Contractual/Legal Restrictions

- some countries ⇒ companies must pay a div.
- other restrict payment (i.e. impairment of capital rule)
- bond covenants as well
- cumulative divs. on preferred shares before common are paid

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LOS e

- explain