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The Pressure Relief Theory
Of Dividend Policy

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Abstract:
Several theories have been forwarded to explain firms’ payout behavior and the ‘abnormal’ positive effect of dividend initiations/increases and repurchases on stock prices. This paper theoretically develops a strand of thought that has awkwardly introduced itself in the literature, namely: the avoidance of overinvestment, into an alternative theory. Mature firms with limited growth potential avoid undertaking negative net present value projects by paying out the majority of their earnings; these firms may even reduce their equity base through stock repurchases. When such firms announce that they will initiate dividends the downward pressure on their valuation, due to the market forecasts of overinvestment, is relieved leading to abnormal positive returns. The relative relevance of one or the other of the theories of dividend policy depends on the relative prevalence of the conditions assumed under each.

In their seminal paper Miller & Modigliani (1961) show that, in a world described by perfect markets and rational behavior, dividend policy is irrelevant. Two understated assumptions underlie their conclusion.

First, that future dividend policy of a firm “… is independent of the actual dividend decision in t.” This implies that dividend policy need not be stable. This is a view opposed and evidence against reported by many researchers, e.g. (Lintner, 1956), (Fama & Babiak, 1968), and (Brav et. al., 200)). From a complementary viewpoint DeAngelo et al (1992: 1838) find that persistent losses are “… essentially a necessary, but not sufficient, condition for dividend reductions in firms with established earnings and dividend records.” Jensen & Johnson (1995) indicate that firms that drop dividends cannot escape from this fate because they suffer from chronic problems that continue to linger after the drop and which force them to restructure. In similar vein, Brav et. al. (2005) argue that the inflexibility of dividends acts as a strong deterrent to dividend initiation and that management tends to raise external funds before cutting dividends. They also explain why repurchases are not perfect substitutes for dividend payments. Repurchases are made out of residual volatile cash flow, are more flexible than dividends, can be used to time the equity market, to increase earnings per share,

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or to offset stock-option dilution.

The second understated assumption is that firms can offset any effect of their dividend decisions on the amount of internal financing available for their ‘given’ investment opportunities by obtaining additional external equity financing. However, many researchers have found that firms prefer internal financing and use external equity financing only as a last resort. The reason is that a new equity issuance might convey the perception that the firm is taking advantage of the overpricing of its stock and/or that the firm wants new investors to carry the burden of an unpromising future with current investors. Asquith & Mullins (1986: 38), for example, find that in a sample of 128 offerings of new equity issues 80% “…experienced price reductions associated with the equity issue announcement.” Also, new equity issuances entail considerable floatation costs. Thus, eliminating or reducing payouts can be used in lieu of external financing to avoid underinvestment (Deshmukh, 2003).

Given this backdrop one can envisage that firms, generally, prefer adoption of a stable dividend policy (once dividends are initiated) and the avoidance, as much as possible, of new equity issuances, that is they prefer following an ‘internal financing model’. Such firms might ask themselves at the start of each new period: “is it better to start payments now or to delay for a (given) number of periods.” The current paper outlines the valuation consequences of such a decision.

Miller & Modigliani (1961) make it clear that they do not favor the ‘internal financing model’, describing it as a ‘special’ and ‘treacherous’ case in which “…dividend policy is indistinguishable from investment policy.” This implies, of course, that external financing is the degree-of-freedom which allows for the ability to distinguish. Nevertheless, the empirical evidence shows that dispositions toward internal financing and a stable payout policy are real phenomenon and should be taken into consideration when analyzing the subject of dividend policy.

Several theories have been forwarded to explain why dividend policy might be relevant in the real world. None of them has gone unchallenged. Those theories include, among others, Clientele theories, Catering theory, Signaling theory, and Agency theory.

One version of Clientele theory is based on differential tax treatment of capital gains and dividends, favoring the earlier. Agents in high tax brackets will favor low-payout stocks while those in low tax brackets will favor high-payout stocks. This version of Clientele theory was challenged by several researchers. For example, Miller & Scholes (1978) argue that these tax effects might not be too large because dividend receipts can be transformed into delayed capital gains using complicated tax differentials. The argument that “…dividend payout ratio and leverage ratio are positively correlated” because leverage is more beneficial when all earnings are paid out.

(1) Chang & Rhee (1990) propose that dividend policy and debt policy are related through tax differentials. The argument that “…dividend payout ratio and leverage ratio are positively correlated” because leverage is more beneficial when all earnings are paid out.
setups.

Another version of Clientele theory is based on “prudent man rule” or the constraints placed on institutional investors that induce them to hold high payout stocks.

Other versions of Clientele theory are possible by specifying different clienteles and their motives.

Catering theory argues that firms tend to initiate and increase dividends when investors put a high price on the shares of payers and to avoid initiating/increasing payments when investors prefer non-payers. However, trying to explain why investors might prefer or not prefer dividends would probably reduce this theory to an appendix of Clientele theory.

Asquith & Mullins (1983) find that dividend initiation and subsequent dividend increases are “… associated with a significant positive excess return.” They interpret this finding as indicating “… that dividends convey to investors valuable information.” Asquith & Mullins (1986: 27) argue that there is support for the notion that “… dividends and repurchases are perceived by investors as signals of management’s assessment of a company’s performance and prospects.” The positive abnormal returns associated with dividend initiation are directly proportional to the size of dividend which they interpret as support for their signaling theory where response is proportional to size of signal. Wansley and Lane (1987) also find evidence that the signals are about a brighter future and that firms initiate dividends to differentiate themselves from non-initiators. In similar vein, Nissim & Ziv (2001) find that, after controlling for expected changes in future earnings, dividend increases are positively associated with future profitability.

The signaling theory is firmly based on the assumption of presence of asymmetric information and managers’ desire to convey the real worth of the firm, through paying dividends, to the market (Allen & Michaely (2002)). However, with asymmetric information, raising external equity capital might be very costly.

Several researchers provide evidence against the notion that dividend initiations are signals of a brighter future. Dyl & Weigand (1998) argue that dividend initiation conveys that the firm has reached the mature stage and its earnings, though not going to grow too much, have stabilized leading to a reduction in riskiness following the announcement. Boehme & Sorescu (2002) find that firms belonging to the largest size decile and comprising the bulk of the U.S. market capitalization do not experience a positive post-dividend price drift. Deshmukh (2003: 354) find that the probability of a dividend initiation “… is negatively related to the level of asymmetric information and growth opportunities and positively related to cash flow.” In similar vein, Bulan et al (2007: 63) find that “… initiators are large and stable firms with relatively high profitability and cash balances, and low growth rates”, which are the characteristics of
Crutchley & Hansen (1989) argue that dividend policy is one part of a policy mix used to reduce various agency costs. The other elements of the mix are leverage policy and managerial stock ownership. When increasing the level of one of the elements becomes too costly management will increase its use of the other elements instead. They suggest that paying (higher) dividends can reduce equity agency costs because, given an investment program, it will probably entail raising external equity capital with its attendant monitoring by various interested parties.

Allen et al (2000) present a framework which is an amalgam of clientele, signaling, and agency theories and which attempts to explain why some firms pay dividends rather than repurchase shares. Stronger firms pay dividends to attract institutions, which are relatively less taxed, which are generally perceived to be better at detecting strong firms, and which can ensure that firms are well managed.

Other miscellaneous explanations for observed dividend policies have been offered. For example, Ferris et al (2009) argue that the legal system has an effect on firms’ propensity to pay dividends. They find that higher dividend payments reassure minority investors in civil law countries that their wealth will not be expropriated due to the weak investor protection laws in those countries. This is contrasted to the lesser propensity to initiate and increase dividends in common law countries.

The current paper provides an alternative explanation for the observed positive abnormal returns associated with dividend initiations. The idea is that mature firms with no significant growth prospects and that do not pay dividends have their equity market value depressed. As they announce dividend initiation this downward pressure on their equity market value is relieved. The finding by Boehme & Sorescu (2002) that firms belonging to the largest size decile do not experience a positive post-dividend price drift in association with dividend initiation might be due to the fact that such firms usually have growth opportunities due to their ability to rejuvenate themselves through new products resulting from R&D activity and/or acquisitions of young firms. Thus if these ‘largest’ firms do not pay dividends they do not suffer from a downward pressure on their equity market value that would be relieved upon dividend initiation.

The findings/arguments of some researchers can be construed, though not intended to, to provide support for the pressure relief theory proposed in the current paper.

Kalay (1982) reports evidence that negotiation of bond indentures leads to dividend constraints which generally materialize to be non-binding. That is, firms try to give themselves slack with respect to paying dividends which they usually don’t use. A “…precommitment to pay no dividends… can result in overinvestment (i.e. forced acceptance of projects with negative NPV) in the future. To avoid such costs, stockholders would choose a constraint which allows for dividend payment,” (pp. 227).

Brickley (1983) finds that the positive effect on returns of regular dividend
increases is greater than the effect of specially designated dividends. He explains this as reflecting that the information signal of the earlier is more positive than that of the latter. However, the findings can be construed, from the current paper’s perspective, as reflecting that the pressure relief afforded by the earlier is perceived to be longer-term and more stable than that afforded by the latter. Allen & Michaely (2002) argue that “… dividends and repurchases seem to be paid to reduce potential overinvestment by management.” “An alternative interpretation” for the positive effect of initiation/increases “is that the market is relieved that managers will no longer acquire cash that can be squandered,” (pp. 118).

The rest of the paper is organized as follows. Section I presents the analytical framework. Section II provides some numerical examples. Section III provides some empirical support, and Section IV concludes.

I- The Model:

Empirical evidence shows that most firms initiate dividends only when their earnings have stabilized. This point in the lifecycle of the firm is taken as time zero in the model.

The internal financing model is assumed such that starting from t = 0 no external financing is raised.

At time zero the earnings of the firm are E0. The expected earnings process is assumed to follow the following pattern:

\[ E_t = E_0 + (1 - P_t)E_0 R_t \] , generally

\[ E_{t+1} = E_t + (1 - P_t)E_t R_{t+1} \]

(1)

Where:

E_t are the total expected earnings during period t

P_t is the payout ratio to be decided upon at the end of period t

(1- P_t) E_t are the expected retained earnings at the end of period t

R_t is the expected return on equity during period t

\[ Div_0 = P_0 E_0 \] and generally, \[ Div_t = P_t E_t \]

(2)

Where Div_t are the expected dividends at the end of period t

Note, for example, that

\[ Div_1 = P_1 E_1 = P_1 [E_0 + (1 - P_0)E_0 R_1] = E_0 [P_1 + (1 - P_0)P_1 R_1] \]

(3)
Assuming that higher order terms are negligible the general expression for \( \text{Div}_t \) is given by:

\[
\text{Div}_t = E_0 \left[ P_t + \sum_{t=1}^{\infty} P_t (1 - P_{t-j}) R_{t-j+1} + \sum_{t=1}^{\infty} P_t (1 - P_{t-j}) (1 - P_{t-j-1}) R_{t-j-1} R_{t-j} \right]
\]

Where the first summation starts from \( t = 1 \) and the second from \( t = 2 \).

Using the simplifying assumptions of a constant \( P \) and a constant \( R \):

\[
\text{Div}_t = E_0 \left[ P + t P (1 - P) R + (t - 1) P (1 - P)^2 R^2 \right]
\]

If dividend payments are initiated immediately (at \( t = 0 \)) the value of the firm is given by

\[
\text{PV}_0^I = E_0 P \left[ \frac{1}{1+k} + (1-P) R \sum_{t=0}^{N} \frac{t}{(1+k)^t} + (1-P)^2 R^2 \sum_{t=1}^{N} \frac{t-1}{(1+k)^t} \right]
\]

\( \text{PV}_0^I \) is the firm’s value at \( t = 0 \) in case of immediate initiation of payments

\( k \) is the discount rate

The first summation is the sum of a geometric series while the second and third summations are sums of arithmetico-geometric series. For finite \( N \):

\[
\text{PV}_0^I = E_0 P \left[ \frac{(1+k)^{N+1}-1}{k(1+k)^N} + (1-P) R \left[ \frac{-N}{k(1+k)^N} + \frac{(1+k)^N-1}{k^2(1+k)^{N-1}} \right] \right.

+ \left. (1-P)^2 R^2 \left[ \frac{-(N-1)}{k(1+k)^N} + \frac{(1+k)^N-1}{k^2(1+k)^{N-1}} \right] \right]
\]

Differentiating \( \text{PV}_0^I \) with respect to \( P \) and equating to zero yields the following first order condition:

\[
(1+k)^{N+1} - 1 + \left(-N + \frac{(1+k)^N - (1+k)}{k} \right)(R - 2PR)

+ \left(-N + 1 + \frac{(1+k)^N - (1+k)}{k} \right)(R^2 - 4PR^2 + 3P^2R^2) = 0
\]

\[-214-\]
For given \( k, N, P, \) and \( R \) this equation can be solved for \( P \) which maximizes \( PV_0 \).

The following example illustrates that \( P \) which results from equation (9) is indeed a maximizer for \( PV_0 \), and not a minimizer.

For \( k = 0.12 \), \( R = 0.2 \), \( N = 150 \), the \( P \) resulting from eq. (9) equals 0.77328 or 4.2934. The first value (0.77328) is the only logical value. Plugging this value in eq. (8) yields

\[
PV_0 = 10.055.
\]

Trying values for \( P \) on both sides of 0.77328 yields:

\[
\begin{array}{c|c}
P & PV_0^1 \\ 
0.5 & 8.9028 \\ 
0.6 & 9.6 \\ 
0.85 & 9.9698 \\ 
0.95 & 9.6122
\end{array}
\]

A firm needs to make a decision as to whether it is better to initiate dividends immediately or to delay initiation for a (given) number of periods.

If the firm delays initiation for \( M \) periods

\[
E_M = E_0(1 + R)^M
\]

\[
Div_{M+t} = E_0(1 + R)^M \left[ \alpha P + t \alpha P(1 - \alpha P)(1 - \alpha P)^2 R \right]
\]

Where \( \alpha P \) is the payout ratio for the case of delayed initiation; \( \alpha \) is a modifying factor to be applied to the optimum payout ratio \( P \) for the case of immediate initiation.

\( PV_0^M \) is the firm’s value at \( t = 0 \) in case of delaying initiation of payments for \( M \) periods.

\[
PV_0^M = E_0 \frac{(1 + R)^M}{k(1 + k)^N} \alpha P \left[ (1 + k)^{N-M+1} - 1 \right] + \frac{(1 - \alpha P)^2 R^2}{k} \left[ -N + M + 1 + \frac{(1 + k)^{N-M-1}}{k} \right]
\]

Differentiating \( PV_0^M \) with respect to \( \alpha \) and equating to zero yields the following first order condition:

\[
(1 + k)^{N-M+1} - 1 + (1 - \alpha P)R \left[ -N + M + \frac{(1 + k)^{N-M+1}}{k} - 1 \right] + (1 - \alpha P)^2 R^2 \left[ -N + M + 1 + \frac{(1 + k)^{N-M-1}}{k} \right] + \alpha \left[ -PR \left[ -N + M + \frac{(1 + k)^{N-M+1}}{k} - 1 \right] + \left[ -N + M + 1 + \frac{(1 + k)^{N-M-1}}{k} \right] \left( 2\alpha P^2 R^2 - 2PR \right) \right] = 0
\]

\[
-215-
\]
II- Numerical Examples:

The following sequence of calculations was followed for a set of examples:

1- Specify \( k, R, N, M \)

2- Calculate the optimum payout ratio in the case of immediate initiation using equation (9)

3- Calculate the value of the firm in case of immediate initiation using equation (8)

4- Using the information in part (1) and \( P \) derived in part (2) the optimal modifying factor for the payout ratio in case of delayed initiation, \( \alpha \), is calculated using equation (12).

5- Calculate the value of the firm in case of \( M \)-period-delayed initiation using equation (11), for both steps 3 and this one assume \( E_0 = 1 \).

6- If \( \text{PV}_0^M > \text{PV}_0^I \) then delaying initiation would be optimal, while if \( \text{PV}_0^M < \text{PV}_0^I \) then immediate initiation would be optimal.

The following list summarizes the examples and the results

<table>
<thead>
<tr>
<th>Example</th>
<th>Given Information</th>
<th>( P )</th>
<th>( \text{PV}_0^I )</th>
<th>( \alpha )</th>
<th>( \text{PV}_0^M )</th>
<th>( \frac{\text{PV}_0^M - \text{PV}_0^I}{\text{PV}_0^I} )</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>( k= 0.12, R= 0.35 ) ( N=20, M= 5 )</td>
<td>0.6808</td>
<td>10.136</td>
<td>1.0678</td>
<td>22.220</td>
<td>12.084</td>
</tr>
<tr>
<td>2</td>
<td>( k= 0.12, R= 0.35 ) ( N=60, M= 5 )</td>
<td>0.6216</td>
<td>12.900</td>
<td>1.0013</td>
<td>32.704</td>
<td>19.808</td>
</tr>
<tr>
<td>3</td>
<td>( k= 0.12, R= 0.35 ) ( N=60, M= 15 )</td>
<td>0.6216</td>
<td>12.900</td>
<td>1.0065</td>
<td>208.760</td>
<td>195.860</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Example</th>
<th>Given Information</th>
<th>( P )</th>
<th>( \text{PV}_0^I )</th>
<th>( \alpha )</th>
<th>( \text{PV}_0^M )</th>
<th>( \frac{\text{PV}_0^M - \text{PV}_0^I}{\text{PV}_0^I} )</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>( k= 0.12, R= 0.35 ) ( N=150, M= 15 )</td>
<td>0.6204</td>
<td>12.960</td>
<td>1</td>
<td>213.500</td>
<td>200.540</td>
</tr>
<tr>
<td>5</td>
<td>( k= 0.12, R= 0.2 ) ( N=60, M= 15 )</td>
<td>0.7756</td>
<td>10.024</td>
<td>1.0099</td>
<td>27.911</td>
<td>17.887</td>
</tr>
<tr>
<td>6</td>
<td>( k= 0.12, R= 0.16 ) ( N=60, M= 15 )</td>
<td>0.8622</td>
<td>9.534</td>
<td>1.0114</td>
<td>16.011</td>
<td>6.477</td>
</tr>
<tr>
<td>7</td>
<td>( k= 0.12, R= 0.12 ) ( N=150, M= 10 )</td>
<td>1</td>
<td>9.333</td>
<td>1</td>
<td>9.333</td>
<td>0</td>
</tr>
<tr>
<td>8</td>
<td>( k= 0.12, R= 0.1 ) ( N=20, M= 5 )</td>
<td>1.3541</td>
<td>9.030</td>
<td>1.1375</td>
<td>8.036</td>
<td>-0.994</td>
</tr>
<tr>
<td>9</td>
<td>( k= 0.12, R= 0.1 ) ( N=60, M= 5 )</td>
<td>1.1166</td>
<td>9.418</td>
<td>1.0028</td>
<td>8.604</td>
<td>-0.814</td>
</tr>
<tr>
<td>10</td>
<td>( k= 0.12, R= 0.1 ) ( N=150, M= 15 )</td>
<td>1.1116</td>
<td>9.420</td>
<td>1</td>
<td>7.189</td>
<td>-2.231</td>
</tr>
</tbody>
</table>
It is clear from the table that if \( R > k \) then \( PV_0^M > PV_0^I \) and if \( R < k \) then \( PV_0^M < PV_0^I \). Retaining earnings in the latter case (\( R < k \)) amounts to undertaking negative NPV projects which, of course, have an adverse effect on firm value.

The purpose of the examples is to quantitatively provide an explanation for the abnormal positive returns associated with dividend initiation. Such abnormal positive returns would be a ‘normal’ market reaction in situations such as those illustrated in examples 8 to 10, where \( R < k \). The market would update its valuation of the firm from the pre-announcement level \( PV_0^M \) to the higher post-announcement level \( PV_0^I \). The fact that ‘abnormal’ returns are empirically found to persist for a relatively long time after dividend initiation is probably due to the fact that the market does not revise its valuation in one shot but rather gradually as market participants become more confident about the firm’s change of policy. The downward pressure on the firm’s value due to non-payment would be relieved. When a firm reaches the stage in its lifecycle where \( R < k \) it has an incentive to not only pay dividends but to reduce its equity base, by stock repurchases, as evidenced by the values of \( P > 1 \).

Comparing examples 2 and 3 it is clear that for young (or rejuvenated) firms, for which \( R > k \), which forecast a long bright future ahead of them longer delays of initiation would be preferable.

It is clear from example 7 that if \( R = k \) then \( PV_0^M = PV_0^I \). Example 7 is a numerical illustration of the comment made in Miller & Modigliani (1961) that dividend policy is indeed irrelevant in “…a situation in which the firm’s internal rate of return is the same as the external or market rate of return.” They argue that it is ‘wrong’ to confine irrelevance to this special situation. The examples above, however, show that, in an internal financing framework with stable payout policy, irrelevance indeed has to be confined to this special situation.

III- Empirical Support:

Twelve issues of the S&P 500 index\(^2\) constituents initiated dividends during the year 2010. For a subset of those firms’ the financial results prior to and surrounding initiation do not support the contention that the firms were trying to signal a brighter future. The dividend initiation, more credibly, must have been a signal of a more conservative and retrenched or stable future. The signal was successful (at least for some time) in improving the market perceptions of the firms as evidenced by improvements in the P/E ratio. This subset includes: Carnival Corporation, Iron

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Mountain, Mariott Int’l, Patterson Companies, Time Warner Cable, and Viacom Inc. The summarized results for those companies are shown in Table 1.

For the other subset, whose summarized results are shown in Table 2, the dividend initiation might have been a botched attempt at signaling. The companies were indeed experiencing a rising trend in revenues and net income but their P/E ratio deteriorated following dividend initiation. Dividend initiation for firms which are expecting a bright future is not optimal as the numerical examples of section II illustrate. This subset includes: Broadcom Corporation, Expedia Inc., and Starbucks Corporation.

Sufficient information was not available for the remaining three firms: Host Hotels & Resorts, Tellabs Inc, and Whole Foods Market.

Given the coarse nature of the data one cannot be absolutely sure that the changes in P/E are due solely to dividend initiation for either subset. However, the data in its given form is non-contradictory to the pressure relief theory and very contradictory to the signaling theory.

Table (1)
Firms Included in S&P 500 Index That Initiated Dividends in 2010 And Experienced Some Improvement in P/E Ratio Associated with Initiation Revenue and Net Income in Million $.

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Carnival Corp.</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>13033</td>
<td>14646</td>
<td>13157</td>
<td>13900</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>NA</td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td>2408</td>
<td>2330</td>
<td>1790</td>
<td>1900</td>
<td>14.3</td>
<td>16.88</td>
<td>17.09</td>
<td>12.99</td>
<td>18.8</td>
</tr>
<tr>
<td>EPS</td>
<td>2.95</td>
<td>2.9</td>
<td>2.24</td>
<td>2.4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Iron Mountain</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>2730</td>
<td>3055</td>
<td>3013</td>
<td>3100</td>
<td>0.062</td>
<td>0.062</td>
<td>0.062</td>
<td>NA</td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td>153</td>
<td>82</td>
<td>221</td>
<td>-26</td>
<td>21.07</td>
<td>25.85</td>
<td>26.74</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>EPS</td>
<td>0.76</td>
<td>0.4</td>
<td>1.08</td>
<td>-0.14</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Mariott Int’l (A)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>12990</td>
<td>12879</td>
<td>10908</td>
<td>11400</td>
<td>0.04</td>
<td>0.04</td>
<td>0.04</td>
<td>NA</td>
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<td>Patterson Comp.</td>
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<td>3094</td>
<td>3237</td>
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Table (1)- Firms Included in S&P 500 Index That Initiated Dividends in 2010 And Experienced Some Improvement in P/E Ratio Associated with Initiation Revenue and Net Income in Million $:

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<td>1900</td>
<td>P/E</td>
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Table (2)

Firms Included in S&P 500 Index That Initiated Dividends in 2010 And Experienced Deterioration in P/E Ratio Associated with Initiation Revenue and Net Income in Million $.

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<tr>
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<td>4658</td>
<td>4490</td>
<td>6200</td>
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<tr>
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<td>Starbucks Corp.</td>
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<td>946</td>
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IV- Conclusion:

The purpose of this paper is to elucidate an alternative explanation for firms’ dividend policies and the abnormal positive returns associated with dividend initiations (and increases). The framework for the explanation is based on the, empirically supported, arguments that firms prefer to follow a stable payout policy and to avoid financing using external equity. The explanation is based on an idea that has recently introduced itself in the literature on the subject, albeit only qualitatively and awkwardly. Firms which have reached the mature stage of their lifecycles and have limited growth opportunities avoid undertaking negative NPV projects, i.e. they avoid overinvestment, by paying out the majority of their earnings. They may even pay out more than their earnings through stock repurchases. Upon announcing initiation of dividend payments the market would update its valuation of the firm from the pre-announcement level to a higher post-announcement level. The downward pressure on the firm’s value due to non-payment would be relieved. A simple analytical model is developed which quantitatively illustrates the arguments.

The numerical examples show that for young (or rejuvenated) firms which forecast a long bright future ahead of them longer delays of initiation would be preferable.

The empirical data, pertaining to dividend initiations in the S&P 500 constituents during year 2010, provide preliminary support for the proposed theory.
References


