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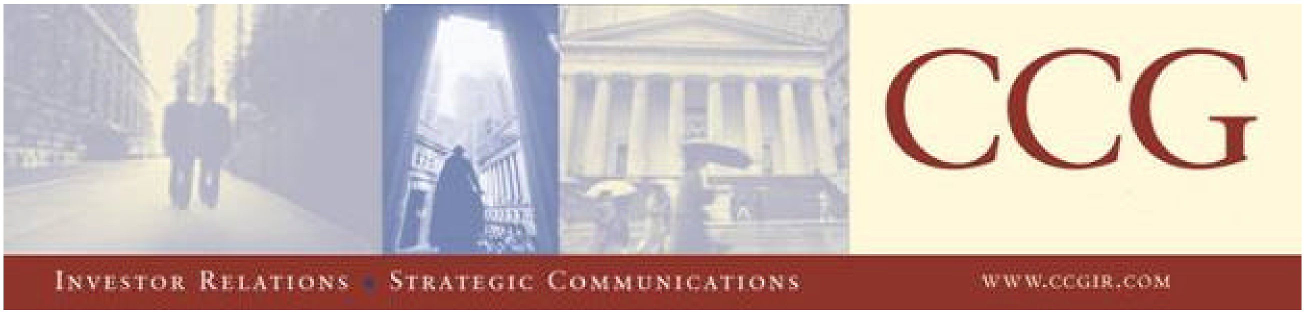

IR Strategy Series

The Return of the Missing Dividend

And its impact on small-cap equities

Introduction

The elimination of the double tax on dividends has clearly changed corporate behavior as it relates to increased dividend distributions and share buyback programs. This is particularly true in 2005 as 66% of the - - increased their total payout of dividends and/or share buybacks of particular interest is the fact that an increasing number of "small cap" companies as implementing modest cash dividend policies or stock buyback programs as a technique to improve stockholder return and redeploy excess cash.

Prior tax policy has long been criticized as contributing to unfavorable economic distortions including:

- The policy creates a bias toward issuing debt vs. equity because interest payments are deductible while dividends are not;
- Double taxation on corporate profits encourages retention of cash rather than distribution of free cash in the form of dividends, distorting equity investment returns and capital investment decisions;
- Share repurchases have become a dividend proxy because they permit the corporation to "in effect" distribute earnings at reduced capital gains rates;
- Double taxation encourages corporations to stretch accounting rules and engage in expensive and/or complex transactions for the sole purpose of minimizing tax liability.[1]

The new tax proposal, public or private corporations would be allowed to distribute tax-free dividends to their shareholders to the extent that those dividends are paid out of previously taxed income. To compute the dividends that can be paid to shareholders without tax, a corporation would calculate an Excludable Dividend Amount (EDA). The EDA reflects corporate income that has been fully taxed. The proposal also includes a provision that treats dividends and retained earnings alike. ***If a corporation's Excludable Dividend Amount exceeds the dividend it pays, each shareholder's basis in its stock would be increased each December 31st by the amount retained per share.*** Such information on Excludable Dividends and Share Basis Adjustments would be reported to shareholders and to the IRS on Form 1099.

Capital gains on the sale of stock would continue to be taxed at a 20% rate. Should a corporation retain part or all of its after-tax income instead of distributing it as a dividend, shareholders would be permitted to increase their tax basis and, upon sale, the higher basis security would be taxed at the capital gain rate of 20%, lowering the amount of taxes paid. The tax rules regarding retirement plans would not change.

This significant tax policy, if passed, has important implications for investors and corporations, including small-capitalization companies. It will also change the rules with respect to the competition for capital among companies, forcing management and the board of directors to carefully consider the pros and cons of a cash dividend policy vs. a cash retention policy.

The purpose of this report is to review the recent trends within the small-cap universe regarding cash dividend policy, and to match that against the opposing influences of a dividend tax policy change.

Cash Dividends Have Been Declining

The proportion of U.S. companies paying dividends dropped dramatically during the 1980's and 1990's. In 1978, data from the NYSE, AMEX and NASDAQ showed that 66% of exchange-listed companies paid dividends. In 1999, only 20% of such firms paid dividends.[2]

Influencing this trend toward lower cash dividends included adverse tax policy (double tax on dividends), the increased number of smaller, less profitable companies going public, and the larger equity holdings through stock or options by insiders who preferred capital gains to dividends.

Responding to the tax disadvantage of dividends, companies increasingly used free cash to repurchase shares, which, to some extent, reduced the negative impact of aggressive stock option programs, and provided a vehicle to return capital to shareholders. For the periods of 1973-1977 and 1978-1982, aggregate share repurchases averaged 3.4% and 5.1%, respectively, of aggregate common stock earnings. For the period 1983 to 1998, repurchases increased to 32% of earnings. In addition to the tax efficiency of share buybacks during that period, numerous studies also refer to the positive "signaling effect" of a stock buyback program, similar to the "signaling effect" of a stock dividend program.[3] In such cases, the market presumes that the company would not engage in such a program unless it was confident about future results. As a result, share prices of companies that engaged in stock buybacks, compared to comparable companies that did not, were almost universally higher by 15% to 20%, contributing to a lower cost of capital.[4]

What Will Investors Prefer In 2006?

In the context of unsettled markets this market history, combined with geopolitical risk, how should small-cap companies address the issue of cash dividends? Should dividends be paid at all? If so, what percentage of taxed earnings should be considered for distribution, and how should concentrated shareholdings be considered in evaluating dividend policy?

Based on a survey of recent literature, as well as recent interviews with numerous institutional portfolio managers, the following conclusions are valid:

1. Investment professionals are likely to place a higher value on dividend-paying companies vs. non-dividend-paying companies or companies that repurchase shares from the market as a dividend proxy.
2. The initial size of the dividend is less important than the action to initiate a dividend.[5]
3. Communicating dividend policy and target cash levels will become an important part of the company's investment thesis.

Perhaps in reaction to the broad range of investment uncertainties facing the market today, investment professionals tasked with selecting equities on the basis of GARP (Growth At a Reasonable Price) or QARP (Quality At a Reasonable Price) are currently increasing the weighting of dividends as an investment consideration. Equally important for evaluating quality are the level and growth of free cash flow, and the amount of that cash returned to the shareholder in the form of dividends. Investors are advancing the point of view that faced with the prospect of a muted economy, growth-oriented companies producing free cash flow will generally be more attractive investments because they should produce a higher return on equity, have less debt and produce faster earnings-per-share growth. In addition, managers who are also required to measure total returns to the funds' owners will be able to point to dividends as one important form of current return. And for them, dividends will be an influencing factor in determining the time horizon to hold such a security.

Further, in the aftermath of high-profile scandals as well as new federal and stock exchange corporate governance requirements, a number of influential companies have emerged to provide independent reviews in the form of ratings of corporations for use by investors. While much of the metrics relate to corporate governance, such as the quality of the board of directors, a number of services such as Standard and Poor's and Institutional Shareholder Services ("ISS") will also include qualitative factors such as dividend policy. Therefore, paying dividends will provide an additional imprint of quality on the subject company, opening it up to a broader range of investors.[6]

Shareholders now realize that while it has been relatively easy for companies to manipulate operating earnings, cash dividends cannot be faked. In view of the increased scrutiny that portfolio managers are under from their investors, the "due diligence" component of securities analysis is becoming increasingly important to determine whether a firm is well run or poorly managed. One solid way to make the case for a well-run company is the fact and consistency of a cash dividend policy. Historically, non-taxed institutional investors such as universities, foundations and certain corporations require dividends as part of their stock selection process. The much larger share of institutional investors are taxed and therefore more impacted by the double tax policy. If tax law changes eliminate the disincentive to distribute dividends, there is little doubt that, all things being equal, the increased diligence process now required by many investors will weigh investment decisions toward dividend-paying securities.

Does Size Matter?

If a dividend is to be paid by a growth-oriented company producing pre-tax income in excess of debt obligations, what is the optimum balance so as to maximize shareholder value? Part of the answer to this question is "what is the optimum cash holding amount?" In recent years, many companies have been criticized for holding accumulated cash in excess of obvious operating needs. An often cited example is Microsoft, which presently holds $8 billion in cash. In general, the S&P industrial companies are in far better position to pay shareholder dividends today than in the late 1990's. These companies have accumulated about $414 billion in cash, up from $261 billion in 1999.

However, to maximize shareholder wealth, management theory suggests that companies should aim to set the level of cash holdings so that the marginal benefit of an incremental dollar of cash equals the marginal cost. The principal benefit of holding the cash is to avoid the need to raise funds or sell assets to maintain operations. The second benefit is to finance activities and investments when other sources are not available or are excessively costly. The costs to be considered are: lower return on equity, potential for wasteful management decisions in low-return investments, and the tax disadvantage of dividends. This analysis allows two alternative cases to be made. The first is that the company is restricted in the short run from paying a dividend because it has no choice due to retirement of debt or capital investment obligations. The second case is that management has a plan to utilize that excess cash so as to produce a higher return than would otherwise occur by implementing a dividend policy. In this case the communication of the plan to shareholders is critical.[7]

Since eliminating the tax disadvantage will cause dividend-paying equities to be inherently more attractive, it is likely that investors will lower the risk premium and pay more for dividend-paying stock, cutting the company's cost of capital.

Therefore the size of the dividend may not matter as much as the policy of paying the dividend so as to be included in this investment category. Such action also takes advantage of the signaling effect, which suggests that a company would not initiate such an action unless it had the proper balance of debt to cash flow, plus reasonable expectations for stable cash generation and future growth. Lower initial dividend rates are particularly applicable to companies with concentrated insider ownership unless such dividend distributions are offset by a lower salary structure and more modest option plan. It is possible that dividend payment policies could change the holding period behavior of inside shareholders to lengthen their time horizon and reduce insider selling, since dividends would provide a current return.

Will Communicating Cash Target Levels Become Part Of Investment Thesis?

The new tax policy has also influenced management to prefer equity capital vs. debt for expansion purposes since the risk premium for equity has been lowered. Therefore, companies that have discretionary taxable income will need to communicate the benefits of holding cash for potential acquisitions, rainy-day funds, or capital spending programs at the cost of dividends.

Experienced management will begin to incorporate capital investment, leverage and cash holdings targets into their presentations to provide investors with their rationales for the amount, if any, of dividends they expect to pay.[8]

Summary

The elimination of the double tax on dividends has caused managements of small cap companies to consider strategies of dividend distributors and share repurchases to enhance total returns. Shareholders of small-cap companies would benefit either way, either in the form of tax-free cash distributions, or adjustments in their basis that reduce the tax liability upon sale.

Institutional investors faced with volatile markets will have a larger voice in the dividend argument and will generally prefer dividend distributions if the company cannot articulate a need for their cash position and/or ROI on capital investments. Share repurchases may become less attractive, or companies may decide to use excess cash to both pay a dividend and repurchase shares.

In advance of these important trends, managements are well advised to:

1. Form an ad-hoc committee of the board of directors to evaluate the impact of this tax bill on their company so such analysis can be made available to shareholders.
2. Complete a sensitivity analysis to determine the costs and benefits of such a policy, taking into consideration among other things, capital and investment needs, and potentially a higher share price offset by lower average cash holdings.
3. Poll major shareholders as to their attitudes so as to minimize the risk of shareholder turnover and allow for better investor targeting in the future.
4. Incorporate into the investment thesis targets for excess cash and the rationale for a dividend/no-dividend policy.
5. Evaluate the disclosure for taxes and translate this into "plain English" so investors are better aware of the difference between the provision for taxes vs. the actual amount of taxes paid.

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[1] Bear Stearns Public Affairs Report, January 2003

[2] Eugene F. Fama and Kenneth R. French, "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay," *Journal of Applied Corporate Finance*, Vol. 14, No. 1, Spring 2001.

[3] Kathleen Fuller, University of Georgia and Anjan Thakor, University of Michigan Business School, "Signaling, Free Cash Flow, and 'Nonmonotonic' Dividends," White Paper, June 2002.

[4] Fama and French

[5] Fuller and Thakor

[6] Clifford Griep and Solomon Samson, "The Evolving Role of Corporate Governance in Credit Rating Analysis," *Standard & Poor's* (reprinted from RatingsDirect), October 2002

[7] Tim Opler, Lee Pinkowitz and Rohan Williamson, "Corporate Cash Holdings," *Journal of Applied Corporate Finance*, Vol. 14, No. 1, Spring 2001.

[8] Doron Nissim and Amir Ziv, "Dividend Changes and Future Profitability," *The Journal of Finance*, December 2001.