



IR Strategy Series

Using Stock Dividends and Stock Splits to Lower the Cost of Capital and Improve Small-Cap Liquidity

“You’d better make it four; I don’t think I can eat six pieces.”

—Yogi Berra, when asked if he wanted his pizza cut into four or six pieces.

An unintended consequence of the May 2003 signing of the Jobs and Growth Tax Relief Reconciliation Act by President Bush was a renewed focus on the use of stock dividends and stock splits as tools to lower the cost of capital and improve liquidity in publicly traded equities. The principal beneficiaries of this act within investor classes are shareholders who receive cash dividends. Under the act, tax rates for qualifying dividends have been reduced from the maximum tax rates to the same rates as net capital gains, 5% for taxpayers in the 10% to 15% brackets, or 15% depending on income. And the tax rates on these capital gains are going down—from 20% to 15%, and from 10% to 5%, until 2008. The 5% rate ultimately will be zero in 2008. This reduction of the onerous taxation on dividends has resulted in a sharp turnaround in the proportion of U.S. companies paying cash dividends since the enactment of the bill. In 1980, data from the New York Stock Exchange, AMEX and NASDAQ showed approximately 66% of exchange-listed companies paid cash dividends. In 1999, only 20% of such firms paid dividends.¹ Since the enactment of the bill, over 1,700 companies on these exchanges have announced cash dividend policies, and about 800 companies have announced increases in existing cash dividends.

However, this leaves approximately 70% of companies that do not pay cash dividends. Those that could pay dividends may choose to reinvest free cash into growth initiatives, which may result in higher shareholder returns in the long run. Others may have leveraged balance sheets or marginal

cash flows taking this option off the table. That being the case, how can small-cap companies that haven’t paid a cash

dividend, but at the same time are desirous of maximizing shareholder value, reward shareholders in such a way as to preserve internally generated cash flows and lower the risk premium applied to non-cash-dividend-paying companies?

One way is to provide shareholders regular distributions in the form of stock splits and stock dividends. As we will review in this white paper, if executed properly, stock splits/dividends can be a powerful tool to increase the liquidity of a stock, which in turn lowers equity cost of capital and maximizes shareholder value.

As we know, stock splits/dividends involve the partitioning of the outstanding shares of a corporation into a larger number of shares, while proportionately decreasing the market price. Stock splits/dividends do not affect the equity of the company.

There is little practical difference between dividends and stock splits, although investors, when asked, prefer stock dividends. Stock dividends, in contrast to stock splits, do affect the “distributable equity” (or the equity that can be distributed to shareholders in the form of cash dividends) of the company. A stock dividend is a reduction of distributable equity. Distributable equity includes the balance in retained earnings and/or accumulated paid-in capital, depending on the state of incorporation. Stock splits do not have any effect on distributable equity. Therefore, companies that have minimal

or accumulated retained earnings may not pay stock dividends but can effect stock splits.

The most common distributions of stock split/dividends are:

<u>Percent of all Stock Split/Dividends</u>		<u>Stock Split/Dividend Ratio</u>
15%		5%
15%		10%
30%	5 for 4	25%
25%	3 for 2	50%
15%	1 for 1	100%

The mechanics of the stock split/dividend are simple. Assume that the company has an adequate number of shares authorized, and assume the company has 5,000,000 shares of \$1.00 par value common stock outstanding. Further, assume that at the time of the stock split/dividend, the price of the stock is \$15.00 per share, and that the company is splitting its stock 25% (5 for 4). After the stock split/dividend, the company will have 6,250,000 shares of stock outstanding at a par value of \$0.75 per share, and the stock price will be \$12 per share. The market value before the stock split/dividend was \$75 million, and the market value after the stock split/dividend is \$75 million. The only fundamental changes are in the number of shares outstanding and the share price.

Given the lack of significant value-creating change, why go to the trouble and expense for something with all the apparent economic significance of changing a \$20 bill into two \$10 bills? The short answer is: liquidity and signaling.²

A number of studies support the premise that a properly executed stock split/dividend continues to move the nominal stock price into an “optimal trading range.”³ Positioning a stock within its optimal trading range increases liquidity for four reasons. First, it lowers the nominal share price, which lowers the cost of a round lot of stock. This makes the stock more attractive to retail investors who otherwise are reluctant to purchase an adequate initial position to warrant transaction costs.

The second reason a stock split/dividend creates liquidity is that the number of new shareholders generally increases afterward. Quite simply, the lower share price makes the stock more attractive to the 75 million individual investors in

America, according to the unsupported belief that a \$10 stock can more easily double to \$20, than a \$20 stock double to \$40. The third reason for potential improvement in liquidity is that stock dividends provide stronger financial incentives for intermediaries such as stockbrokers and dealers to promote the stock.⁴ While the trading cost for many investors has declined due to electronic trading competition, larger volume due to a greater number of shares traded tends to attract broker/dealer attention, which in turn attracts additional investor attention.

The fourth important reason cited for abnormal long-run returns in liquidity and share price appreciation after a stock split/dividend is the “signaling effect.” The announcement and execution of a stock split/dividend is viewed by the investment community as a positive signal about the prospects for the firm, since it is often followed by higher earnings per share and cash dividends. Since stock splits/dividends often occur after a stock has increased in value, the stock split/dividend can be interpreted as a sign from management that future growth can be expected.

The practical effect of this strategy to enhance shareholder value is to produce “positive abnormal returns,” or returns that exceed the company’s historical trend line of P/E multiple and liquidity of the float.⁵ This phenomenon has also been described as a “positive drift in share price” subsequent to a stock split/dividend announcement. The opposite is true for reverse stock splits. While the abnormal return in share price is very company- and fact-specific, numerous studies suggest that positive returns in excess of peer group performance of from 10% to 30% are not unreasonable over a two-year period. This means, in the example noted earlier, that the company with a market capitalization of \$75 million has the potential to increase its capitalization by between \$7.5 million and \$22.5 million, and to enhance the liquidity and trading volume of its float, simply by introducing a stock split/dividend policy.⁶

A preponderance of business literature and academic studies confirms that stock split/dividend strategies play an important role in providing abnormal shareholder returns and improved trading liquidity. However, the application of this strategy can be very company-specific and influenced by broader market conditions. Here are a few questions to consider when deciding the appropriateness of a stock split/dividend policy.

1. Do you want more marketing support for your stock from the brokerage community?

If your daily trading volume measured in number of shares or dollar value is below an optimum level, discouraging sophisticated institutional investors from

taking position in the stock, then a stock split/dividend policy is an appropriate consideration. A lower share price will encourage retail investors and stockbrokers to take an interest in the company's securities. Larger trading volume may also attract other brokers and investors.

2. Do you want more retail shareholders?

Although small shareholder accounts can be more expensive to administer, often an expansion of a retail shareholder base can stabilize and improve the company's daily trading volume. Also, in the case of companies substantially owned by institutional investors, there may be an interest in re-balancing the ratio of institutional investors to retail investors at a more optimum level. A stock split/dividend policy would facilitate this.

3. Should you wait to split the stock?

There are strong arguments for waiting for the share price to appreciate to a higher level so that one large stock split/dividend can replace several smaller splits. On the other hand, equally reasonable arguments can be raised that a program of regular small stock split/dividends over a longer period of time provides continuing returns to investors that offset the alternative of paying cash dividends. In addition, there is strong support for companies that split their shares on a regular basis, even if the stock split/dividend is nominal, i.e., 10%.

compared to a targeted investor balance, are important factors. The trading range over the last 12 months to 24 months should be considered so that should an unexpected decline in earnings occur, the share price will not decline to too low a level.

2. Review business and company trends.

Because an important element of a stock split/dividend policy is the signaling effect, it is important to consider short- and intermediate-range trends specific to the company and the industry. If there are significant challenges facing the company and/or the industry, and earnings visibility is extremely limited by those challenges, then it may be wise to defer such a stock split/dividend policy until more clarity emerges. On the other hand, if the company is emerging from a trough in its company or industry business cycle and there appear to be improving conditions on the horizon over the next several years, then a stock split/dividend policy can be a perfect solution to reward shareholders in the short run, and preserve cash that otherwise might be paid in the form of cash dividends.

3. Establish a long-term dividend policy, not a one-time split.

The maximum effect achieved from such a policy is the payment of smaller, regular stock splits/dividends accompanied by increases in cash dividends. The second most effective solution is payment of regular stock splits/dividends over a reasonable period of time. If a stock split/dividend policy is to be established then it should be considered an integral part of the company's capital structure and communicated as such to the shareholders and investment community.

4. Plan the communication cycle.

One of the most important effects of such a program is the anticipation of the stock split/dividend between the announcement and payment date. Often 10% to 15% in incremental shareholder value is added during this period of time.⁷ It's important to plan this communication cycle carefully. In addition to a press release and 8-K filing, the stock split/dividend should be highlighted in the quarterly conference call. Management could make personal calls to significant buy- and sell-side investors to discuss the rationale behind the stock split/dividend. Often earnings estimates are increased following announcement of a stock split/dividend because of the positive inference from such a strategy.

If the above analysis continues to support consideration of a stock split/dividend policy, it may be appropriate to establish a management study group to focus attention on the following four points.

1. Determine the optimum capital structure.

The most powerful determinant of optimum capital structure is the range of peer firms' capital structures, particularly in terms of size, visibility and risk. Younger companies that are growing more rapidly may be in a position to model themselves in relation to other similarly situated companies so as to re-price their shares at the lower trading range of peers, and consider more aggressive sizes of stock splits/dividends. More mature companies that are subject to less trading volatility and experiencing reasonable average trading liquidity may consider a more modest stock split/dividend policy. The specific elements to consider in this analysis include the number of shares outstanding relative to peers and the impact on shares outstanding of a stock split/dividend policy over a period of time. In addition, the float of free-trading shares, and the distribution of that float between institutional and individual shareholders

The evidence supports the premise that stock splits/dividends can be another important tool to enhance the liquidity and shareholder value of a small-cap equity.



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

² James Angel, "Picking Your Tick: Toward a New Theory of Stock Splits," *Journal of Applied Corporate Finance*, Vol. 10, No. 3, Fall 1997.

³ Ibid

⁴ Ibid

⁵ Hemang Desai and Prem Jain, "Long-Run Common Stock Returns following Stock Splits and Reverse Splits", *Journal of Business*, Vol. 70, 1997.

⁶ Yakov Amihud and Haim Mendelson, "The Liquidity Route to a Lower Cost of Capital," *Journal of Applied Corporate Finance*, Vol. 12, No. 4, Winter 2000.

⁷ Oranee Tawatnuntachai and Ranjan D'Mello, "Intra-Industry Reactions to Stock Split Announcement", *The Journal of Financial Research*, Vol. XXV, No. 1, Spring 2002.