Payout Policy

- Successful projects generate cash
  - firms reinvest this in NPV > 0 projects
    - as additional capital investment and working capital
  - or hold it as cash reserves
    - surplus cash over NWC requirement is like negative debt
- however at some point, some of this cash should be returned to shareholders
  - the payout policy of the firm is the result of its decision of how and how much free cash flow to return to the equity holders
  - common choices:
    - dividend - cash payment out of FCF to shareholders
    - share repurchase – buying share from SHs with FCF
- much like capital structure, we will see that payout policy is determined by market imperfections
  - taxes, agency costs, transaction costs and info asymmetry
What are Dividends

- Dividends are cash payments by a firm to its SHs
- besides the amount per share, there are 4 important dates related to a dividend announcement:
  - announcement date
  - the date the firm declares that it has decided to pay a dividend
  - record date
  - date at which owners of stock are recorded for purposes of receiving the dividend
  - implies an ex-dividend date
    - date on and after which buyer of stock no longer receive dividend
      - investor must purchase stock before this date to be a registered owner of stock by the record date and receive the dividend
    - with stock transaction settlement time of transaction plus 3 days (T+3), the ex-dividend date is 2 days prior to the record date
      - the shares trade with dividend or cum-dividend until ex-dividend date
      - when the stock goes ex-dividend, its prices drops by PV of dividend
  - payment date
    - the date the owners of record are sent the dividend checks

Recent Del Monte Dividend

- Most recent dividend for DLM
  - dividend announcement date: 09/26/08
    - dividend amount: $0.04/share (regular – quarterly)
    - at current rate equivalent to $0.16 per share annually
      - at current price of $7.51 on announcement day this is a dividend yield (annual dividend / price) = 2.13%
  - dividend record date: 10/16/08
    - to receive the dividend you must be a registered owner of stock on this date
    - with T+3 settlement on stocks, since 10/16 is a Thursday, so owners must be purchase share by end of trading on Monday 10/13/08, so ex-dividend date is Tuesday 10/14/08
      - anyone buying the stock on or after 10/14/08 will not receive the dividend
    - this implies that with no other information release, the price of DLM stock should fall between the close of trading on 10/13/08 and the open of trading on 10/14/08 by $0.04 per share (ignoring taxes)
      - this is because the firm shares will have lost $0.04/share worth of cash
        - the value of the firm on a per share basis should be $0.04 lower
  - dividend payment date: 10/30/08 – checks are mailed
Kinds of Dividends

- Firms typically pay regular dividends
  - stable but (growing) amounts at regular intervals (i.e. quarterly or annually)
    - DLM has been paying a regular quarterly dividend since only Jan 2006
      - became public company in 1999
  - firms can also pay special one-time dividends
    - result of special situations or desire to distribute a large amount of cash
      - in Nov 2004 Microsoft paid a $3.08/share dividend (~10% yield) to return some it is over $50b in surplus cash to investors
        - on ex dividend date, stock price fell from closing price of $30.97 cum dividend to open price of $27.34 ex-dividend
        - Microsoft paid out $30.18b in cash

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Share Repurchases

- Typically firms distributions dividends to all shareholders
  - the average dividend in the US market is around 2% of price
    - this ratio, D/P, is the dividend ratio
      - it used to be much higher, in the early 1900s it was 6-8%
  - alternatively the firm can repurchase their own shares and pay out the cash to only shareholders who sell shares
    - these repurchased shares become treasury stock
      - can be re-issued if the firm needs new equity later
    - SHs who want to cash in will sell some shares and take cash, the remaining share holders benefit from having claim on a larger future dividend per share in the future
      - fewer shares mean more income per share in the future
  - currently, far more money is return to SH in the US via share repurchases than via dividends
Repurchase Methods

Three ways to repurchase shares

1. open market repurchase
   - firm announces plan to buy back shares in open market
   - most common practice (~95% of all repurchases)

2. tender offer to buy shares at pre-specified price (~10 -20% premium) above market for short period of time
   - often requires SH tendering a sufficient number of shares
   - if too many want to sell, offer is pro-rated across demand

3. direct negotiation with a major shareholder
   - offer to buyback specific SH shares at attractive price
   - this is referred to as greenmail

- stock repurchases are very common
  - over 100 firms announced buybacks in past 30 days (3/23)
  - see http://www.theonlineinvestor.com
  - total value is in the hundreds of billions of dollar range

Impact of Payouts on Firm Value

The impact of payouts (dividends or repurchases) on firm value involves several issues

- the payment or non payout of cash affects the potential growth of the future cash flows of the firm
  - paying out cash today means less re-investment and lower future income

- market imperfections such as taxes, transaction costs and information asymmetry can have affect
  - difference in taxes can affect after-tax value of payouts or retaining cash
  - transaction costs for investors of converting shares into cash can give rise to preference for dividends
  - information asymmetry means that investors use payout decisions as signals of managers view of the future

- net impact is mixed and generally assumed that payout policy does not significantly affect current firm value
Dividends vs Share Repurchase: Impacts on SH wealth and Stock Price

- Start with perfect capital markets (M&M world)

*Example:* A firm has $5M in surplus cash, no debt, and $E(\text{future FCF}) = $10M

- Enterprise value, \( EV = PV(\text{FCF}) = $10M / 10\% = $100M \) (Firm's CoC = 10%)
- Total MV of firm = \( EV + \text{Surplus cash} = $105M \)
- with 5M shares, share price = \( P_{\text{cum}} = (\frac{$105M}{5M}) = $21 \)

**Payout cash dividend:**
- if firm pays out $5M cash dividend to all SH, on ex-dividend date share price falls by $1/share ($5M/5M) to $20/share and each shareholder receives $1 in cash and holds share worth $20 for total value of $21

**Share repurchase (open market):**
- if firm used $5M to buy back shares they will buy $5M / $21 = 238,095
- this leaves 4,761,904M shares as claims on \( EV = $100M \) and share price after repurchase, \( P_{\text{exr}} \) would be $100M / 4.762M = $21/share, so whether SH sell to firm or hold shares the value of their position is $21 per share

**Implication:** in perfect capital markets, investors are indifferent between firms distributing funds via dividends or repurchases

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**Changes in Dividend per Share**

- In the previous example, the firm expects to generate FCF of $10M / year in future to payout as dividends
  - with cash dividend, each of the 5M SHs is expecting future dividends of $10M/5M = $2 per share
    - cum-dividend share price, \( P_{\text{cum}} = $1 \) dividend today + $2 / 10\% = $21
  - with share repurchase, each shareholder who sells gets $21 today and those that hold on to share expect higher future dividends of $10M / 4,761,904M = $2.10 per share
    - price of shares after repurchase, \( P_{\text{exr}} \) would be $2.1/10\% = $21
    - fewer shares expect larger future dividend per share

- suppose firm wants to pay $10M in dividends today
  - if firm wants to pay $10M dividend today it needs $5M more cash
  - could issue 238,095 new equity shares
    - 238,095 shares at $21/share = $5M cash
    - now has 5,238,095M shares outstanding and $10M to surplus cash
    - dividend per share today = $10M / 5,238,095 shr = $1.91 per share
      - this is now also the future dividend per share with 5,238,095 shares
      - \( P_{\text{cum}} = \text{Div}_0 + PV(\text{Future Div/shr @10\%}) = $1.91 + ($1.91/10\%) = $21 \)
Dividend Policy in Perfect Markets

- MM dividend irrelevance hypothesis
  
in perfect capital markets, with fixed investment policy, a firm’s dividend policy is irrelevant and does not affect initial share price
  
  - when argued by M&M in 1961, this view went against common wisdom that dividend policy mattered for current firm value
    
    * assumption was that paying dividends drove up equity value
  
  - MM show that choice of dividends today affect dividends that can be paid in the future in an offsetting fashion
    
    * so dividends do determine share price, but the firm’s choice of dividend policy does not
  
  - this is because value is derived from FCF of underlying assets
    
    * these FCF determine level of possible payouts
    
    * exact choice of the form of payout does not matter
  
  - but real world is not perfect, so like capital structure we must consider taxes, transaction costs, agency issues and asymmetric information as justifications for optimal payout policy

Dividends and Taxes

- Taxes generally provide a disincentive for dividends
  
  - dividends generate income to investors while share repurchases (SR) generate capital gains
    
    - dividend income is taxed when received at a dividend rate, \( \tau_d \)
      
      * $1 in cash dividend realized today yields SH only $(1-\tau_d)$ after taxes
        
        » until recently \( \tau_d \) was the investor’s personal income tax rate
    
    - capital gains are taxed only when realized at capital gains rate, \( \tau_g \)
      
      * $1 in capital gains realized today yields SH only $(1-\tau_g)$ after taxes
    
  - if \( \tau_d > \tau_g \), then investors will prefer SR over dividends
    
    * until recently in the US, \( \tau_d > \tau_g \) so there was a tax disadvantage to most SH receiving cash dividends
      
      » in some cases dividends were taxed 35% more than capital gains
      
      » now \( \tau_d = \tau_g \) so direct tax disadvantage is gone
    
    * this bias has led to an increasing reliance on share repurchases
    
    » “dividend puzzle”
      
      * why did firms pay cash dividends at all given tax disadvantage
Declining Use of Dividends

- Reduction in Total Payouts
  - over 60% of cash paid out in US is through SR
  - only 30% of US firm now pay dividends, over 60% make no equity payouts

Tax Clienteles and Dividends

- However, not all investors face tax penalty for dividends

  *Example*

  An investor buys a share with dividend right (cum dividend) and sells right after it goes ex-dividend. This entitles her to the dividend, Div, but subjects her to the capital loss of the ex-dividend price change.

  To prevent arbitrage, the after-tax capital loss on going ex-dividend must equal the after tax dividend the investor receives

\[
(P_{\text{cum}} - P_{\text{ex}}) \times (1 - \tau_g) = \text{Div} \times (1 - \tau_d) \quad \text{(note: } P_{\text{cum}} > P_{\text{ex}})\]

\[
(P_{\text{cum}} - P_{\text{ex}}) = \text{Div} \times \left(\frac{1 - \tau_d}{1 - \tau_g}\right) = \text{Div} \left(1 - \tau^*_{d}\right)
\]

Given this, the effective dividend tax rate for the marginal investor is

\[
\tau^*_{d} = \frac{\tau_d - \tau_g}{1 - \tau_g}
\]

\(\tau^*_{d}\) is the additional tax the investors pay on income received as a dividend rather than as capital gains

- this rate will vary across investor because rates are function of:
  - income level – tax rates are often a function of income level
  - investment horizon – gains from short holding periods taxed more
  - tax jurisdiction – location of tax payer affects rate
  - type of investor – some investors are tax exempt or tax preferred
Different Tax Penalty for Dividends

- Consider 4 different investors under current US taxes
  1. a “buy and hold” investor who plans to pass the assets to heirs
     - capital gains face zero tax when passed to heirs in an estate
       - $\tau_d = 15\%$  $\tau_g = 0$  $\tau^*_d = 15\%$
  2. a ST investors in taxable account with 1 year holding horizon
     - US tax rates same on dividends as LT capital gains
       - $\tau_d = 15\%$  $\tau_g = 15\%$  $\tau^*_d = 0$
  3. a pension fund/IRA investor
     - investor taxed on proceeds of investments only as income when distributed
       - $\tau_d = 0\%$  $\tau_g = 0$  $\tau^*_d = 0\%$
  4. a corporation
     - US corporations are allowed to exclude 70% of dividends from corporate taxes
       - $\tau_c = 35\%$  $\tau_d = (1-70\%) \times 35\% = 10.5\%$  $\tau_g = 35\%$  $\tau^*_d = -38\%$

- based on investor mix in market, only about half of investors face a tax disadvantage to receiving dividends

Another Clientele for Dividends

- Transaction costs for trading securities also provides a clientele for dividend paying stocks
  - certain investors rely on their portfolio for a periodic income stream
    - this income stream can be created from cash payments from the portfolio (interest and cash dividend payments) or by selling a certain number of securities each period
  - with transaction costs associated with selling securities, some investors might be willing to pay a premium to hold equity that pays periodic dividends
    - the premium would be relative to the transaction costs they would save by not having to sell some securities to generate cash flow
      - this would work to make the MV of firms that pay dividends higher than others as these investors prefer to hold these stocks and thus bid up the price above the perfectly competitive market level
Payout versus Retention

- We have seen that if firm decides to distribute cash, SR have advantages over dividends
  - what about the decision to distribute cash versus retain it within the firm?
    - we start with the proposition that to maximize firm value the firm must take all currently available NPV > 0 projects
      » this is how value is really created
    - all other projects not taken are assumed to be NPV ≤ 0
  - if there is any excess cash, the firm could hold it for next period to invest in NPV>0 projects or it could distribute it to SH
    - with perfect capital markets, M&M also showed that once a firm has taken all NPV>0 projects, the decision to retain excess cash or distribute it (as Div or SR) does not matter for firm value
  - when we allow for the market imperfections there will be a trade-off between retaining or paying out extra cash flow
    » the decision to retain cash will reduce the cost of raising capital in the future (avoid transaction costs) but it will increase taxes and agency costs

Benefits of Retaining Excess Cash

- Surplus of cash on hand has several advantages
  - income volatility insurance
    » one way to insure against financial distress is piles of extra cash
      - if volatile operating cash flows fall short, you avoid issues of distress by falling back on surplus cash to cover fixed claims
        » lowers probability of financial distress
  - avoid costs of insufficient operating cash flow to cover future NPV>0 investments
    » raising external funds to finance additional NPV>0 projects (beyond those with internal cash flow) entails transaction costs
      - debt ~1 - 3% and equity ~ 3.5 - 7 % of funds raised disappear to outsiders as financing costs
        » shareholders pay this cost in reduced cash flows to equity
      - alternatively the firm could not invest in all NPV>0 projects available in a period, but this is a opportunity cost to SHs
    » having surplus cash balance to cover this shortfall can be valuable in avoiding these potential costs
Taxes and Retaining Cash

- If a firm retains surplus cash it pays tax on any gain

**Example**

Consider a firm whose only asset is $100.

It could pay out cash \( \text{div} = $100 \) today or retain the cash and pay out interest as a dividend each year in perpetuity.

Give investors cash today, the pre-dividend share price would be

\[
P_{\text{cum}} (1 - \tau_g) = P_{\text{ex}} + \text{Div} \times (1 - \tau_d)
\]

\[
P_{\text{cum}} = 0 + 100 \times (1 - \tau_d) / (1 - \tau_g)
\]

Retain and pay after-tax interest \((100 \times r_f \times (1-\tau_c))\) as dividend forever.

\[
P_{\text{retain}} = \text{Div} \times (1 - \tau_d) / (r_f \times (1 - \tau_i)) = (100 \times r_f \times (1-\tau_c)/(r_f \times (1-\tau_i)))
\]

Comparing prices \(P_{\text{cum}}\) and \(P_{\text{retain}}\):

\[
P_{\text{retain}} = P_{\text{cum}} \times [(1 - \tau_c) \times (1 - \tau_d) / (1 - \tau_i)] = P_{\text{cum}} \times (1 - \tau_{\text{retain}})
\]

\(\tau_{\text{retain}}\) is the effective tax disadvantage to retaining cash.

\[
\tau_{\text{retain}} = \{1 - [(1 - \tau_c) \times (1 - \tau_d) / (1 - \tau_i)]\}
\]

In US, using 2005 rates \((\tau_i \text{ for highest income earners)}\) there is a tax disadvantage to firms retaining cash of

\[
\tau_{\text{retain}} = \{1 -[(1-0.35) \times (1-0.15)]/(1-0.35)]\} = 15\%
\]

Agency Costs of Surplus Cash

- As with capital structure there are potential agency costs associated with surplus cash
  
  - Managers might use funds inefficiently
  - Pet projects
  - Excessive executive perks
  - Overpaying for acquisitions
  - As surplus cash is like negative leverage, many of the incentive benefits of leverage are undone with retaining surplus cash

  In this sense, a high payout ratio is a mechanism, like leverage to incent the managers to provide optimal effort in maximizing value of the firm.

  In practice we tend to see firms that use low leverage to also be firms that retain larger amounts of cash.
Payout Policy and Info Asymmetry

- With asymmetric information, payout policy can act as a signal of managers inside knowledge
  - manager's incentive in setting payout policy
    - dividend smoothing
      - most firms adjust dividends infrequently
        - Toro has changed dividend only 4 times in 20 years
      - most changes of dividends are increases
        - between 1971-2001 only 5.4% of changes were decreases
    - Lintner's classic executive survey of dividend policy
      1) managers believe that investors prefer stable dividends with sustained growth
      2) managers target long run dividend/earnings ratio
    - firms raise dividends when management believes long run earnings support an increase and cut dividends as a last resort

Implication: firms set dividends at a level they expect to be able to maintain based upon the firm’s future earning prospects

Signaling and Payouts

- If these views are believed, then dividend changes signals management’s beliefs to investors
  - dividend increases signal management’s optimism about future earnings
    - this is a credible signal as a weak firm would not want to raise dividends as they would have to cut them later or suffer distress
      - unexpected dividend increases are met with increases in share price
  - dividends decreases signal management’s pessimism about future earning and that things are not just temporality bad
    - the dividend cut is a credible signal that the firm does not have good future earning prospects
      - unexpected dividend decreases are met with sharp declines in price
  - share repurchases are generally seen as positive signals
    - not as credible as dividends as managers are not as committed to SR in terms of size or frequency
    - but a firm would only want to repurchase its shares when it felt that they were under priced
      - announcement of a SR program increases firm value by about 3%
Leasing

Leasing is an method to gain to an assets without having to take ownership

- a lease is a contract between two parties:
  - lessee
    - signer of the lease responsible for making periods cash payments in return for use of the asset
  - lessor
    - the owner of the asset entitled to the periodic payments in exchange for lending the asset
- types of leases
  - sales-type lease – the lessor is manufacturer of asset
  - direct lease – lessor is independent company specializing in leasing
  - sales and lease back – lessee sells asset to lessor and then leases it back
  - leveraged lease – lessor provides initial capital to purchase the asset
    - lessor may be a Special Purpose Entity (SPE) set up to hold the lease

Lease Payments

- In competitive markets lease payments are set so:
  \[ PV(lease \ pmts) = Purchase \ price - PV(residual \ value) \]

  - so in perfect markets, leasing is financially equivalent to purchasing and reselling the asset
    - the cost of leasing and then purchasing the asset (at the end of the lease) is equivalent to the cost of borrowing to purchase the asset
- end of term lease options
  - fair market value lease
    - lessee has option to purchase asset at its fair market value lease will stipulate how fair market value will be determined
  - $1.00 out lease (finance lease)
    - ownership of asset transfers to the lessee for a nominal cost
      - this lease is effectively a purchase of the asset
  - fixed price lease
    - lessee can buy asset for fixed price set upfront in the lease
      - common in car leases
  - fair market value cap lease
    - lessee can buy asset at minimum of market value or pre-set price
Accounting Aspects of Leases

- From an accounting perspective, leases are broken into 2 groups based upon features of lease
  - operating leases
    - a rental contract for accounting purposes
    - entire lease payment is an operating expense
    - no deduction for depreciation
    - asset and lease liability is not reported on financial statements
      - off balance sheet financing
  - capital lease (finance lease)
    - an acquisition for accounting purposes
    - asset is listed on lessee’s balance sheet
    - lessee incurs depreciation expenses for asset
    - PV of future lease payments is listed as a liability
    - interest portion of lease payments is deducted as interest expense
    - these different accounting treatments affect the lessee’s balance sheet as well as its debt-equity ratios

Operating versus Capital Leases

- Firms typically prefer to have leases classified as operating leases
  - keeps numbers off the balance sheet
- SFAS No. 13 provides criteria to classify leases
  - a lease is treated as a capital lease if it meets any of the following
    - title to the property transfers to lessee at end of lease term
    - lease contains an option to purchase at less than fair market value
    - lease term is 75% of more of the estimated economic life of asset
    - PV of minimum lease payments at start of lease is 90% or more of asset’s fair market value
  - firms often work hard with lawyers to structure lease agreements to avoid triggering any of these categories to treat the lease as an operating lease
    - operating lease payments are simply normal expenses of doing business that are deductible from taxable income
Tax Treatment of Leases

- IRS has its own rules for classifying leases
  - since taxes affect cash flow, these rules are more important than accounting ones
  - tax lease
    - lessor received depreciation deduction
    - lessee can deduct full amount of lease payment as expense
    - lease payments are revenue for the lessor
  - non-tax lease
    - despite lessor being owner, lessee gets depreciation expense
    - lessee can deduct interest portion of lease payments as expense
    - interest portion of lease payment is interest income to lessor
  - lease is non-tax lease is any of the following pertain
    » lessee obtains equity in leased asset
    » lessee receives ownership of asset at end of lease
    » total value of ST lease is large proportion of total value of asset
    » lease payments greater than fair rental value
    » bargain price to acquire asset at end of lease
    » some portion of lease payment is specifically designated interest

Lease and Bankruptcy

- In Chpt 11 bankruptcy, firm has its assets protected from seizure by creditors
  - for leased assets this protection depends on legal classification of lease
    » if lease is a security interest
      - firm is assumed to have owner rights over asset and gets protection from seizure
        » leased asset is treated just like all other assets
    » if lease is a true lease
      - the lessor retains ownership rights over asset
      - firm is protected for 120 days, then firm must decide to assume the lease (make missed payments and make all promised payments) or reject lease and return asset to lessor
    - operating and true tax leases are generally treated as true leases for bankruptcy purposes,
    - final decision lies in bankruptcy judge’s hands
Leasing Decision

As with other financial decisions, in perfect market the decision to lease or purchase will not matter

- in making a lease decision, the lease cash flows should be compared against the cash flows of borrowing to purchase the asset and then sell it
  - examine the cash flows of the lease versus buy/sell option

Example

A firm is considering whether to buy then sell or lease an asset

- Purchase price is $1,000, depreciation expense is $200/year, and they expect to sell it in 4 years for $200; tax rate = 35%
- Lease asset for 4 years at annual lease payments (upfront) of $240 (after-tax cost of lease payments = $240 x (1-0.35) = $156)
  - Firm’s borrowing rate to purchase the asset would be 5% so after-tax rate would be 5% x (1-0.35) = 3.25%
- Consider the CFs to leasing versus buying and then selling

Leasing Decision

Consider IRR or NPV of “lease–buy” cash flows

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<tr>
<td>Lease - Buy cash flows</td>
<td>844</td>
<td>-226</td>
<td>-226</td>
<td>-226</td>
<td>-270</td>
<td></td>
</tr>
</tbody>
</table>

- think of these L-B cash flows as a loan and loan payments
  - borrow 844 today and make payments of -226, -226, -226, & -270

<table>
<thead>
<tr>
<th>Lease - Buy cash flows</th>
<th></th>
<th>-226</th>
<th>-226</th>
<th>-226</th>
<th>-270</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRR of (Lease - Buy) cash flows</td>
<td>4.68%</td>
<td>&gt;</td>
<td>3.25%</td>
<td>a-f-tax cost of loan</td>
<td></td>
</tr>
<tr>
<td>PV payments at 5% x (1-τc)</td>
<td>-219</td>
<td>-212</td>
<td>-205</td>
<td>-238</td>
<td></td>
</tr>
<tr>
<td>NPV(Lease - Buy) CFs</td>
<td>-30</td>
<td>loan equivalent of CF1 - 4 =</td>
<td>$874</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- the IRR on this loan is 4.68%
  - this is greater than the firms after tax borrowing rate (3.25%)
  - a lease equivalent loan is $874 (PV of future net cash flows of lease)
    - this loan give the firm same liabilities in years 1-4 as lease – buy but leaves firm with cost of purchase today of $1000 – 874 = $126
    - this is $30 better (less) than the lease cash flow today
  - alternatively, NPV (lease – buy) CFs is -$30
    - negative value means lease costs more
Arguments for Leasing

Valid arguments for leasing an asset:
- tax differences between lessee and lessor
  - the PV of the tax benefits differ across parties so that value is created by transferring these tax benefits to one party
- reduced resale costs
  - if reselling is costly in time or specialization, leasing preferred to buying and selling
- efficiency gains
  - special skill in maintaining assets suggests leasing might be better than owning
- reduced distress costs and increased debt capacity
  - better recovery in bankruptcy means better rates on lease than loan
- improved incentives
  - if lessor is manufacturer with residual value risk, they incentive to produce high quality product that maintains value

Arguments for Leasing

Suspect arguments for leasing:
- avoiding capital expenditure controls
  - avoids need to scrutiny of purchase decision
  - however no guarantee that lease will not be significantly more expensive that buying
- preserving capital
  - leasing is 100% financing since no down payment so it saves cash for other uses
  - large companies the amount of leverage a firm can get through a lease is unlikely to exceed what it could obtain through borrowing
  - especially for a capital lease
- reducing leverage through off balance sheet financing
  - leasing allows firm to increase effective leverage without increase D/E ratio on the books
  - sophisticated investors look for operating leases in footnotes and recognize that these are effectively leverage
Summary

- **Payout policy works a lot like capital structure**
  - no impact in perfect markets
    - tradeoff of tax issues, transaction costs, agency costs and issues of information asymmetry
    - bottom line is that even with imperfect markets dividend policy not strongly related to firm value

- **Leasing versus buy and sell a similar story**
  - alternative way for firm to obtain use of assets
  - like other financial decisions, no impact on firm value with perfect capital markets
    - different kinds of leases and difference in accounting and tax treatments
      - valid arguments for leasing related to tax issues, transaction costs / expertise in selling or maintaining assets or creating better incentives for managers