ATLANTIS PRESS

Advances in Economics, Business and Management Research, volume 155

Proceedings of the 2020 2nd International Conference on Economic Management and Cultural Industry (ICEMCl 2020)

The Introduction and Comparison of Share Repurchase and Dividend

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ABSTRACT

Share Repurchase and Dividend are the two most popular strategies for company to requite their shareholders and investors. Both of them have significance on a company's cash flow and future growth. What is the definition of Share Repurchase and Dividend and their advantages and disadvantages become the common lesson of investors and shareholders. However, as the growing of numbers of shareholders and companies, these two strategies might be strangeness for them. Knowing of the impacts and difference of Share Repurchase and dividend will support them for a period of time. Through discussing and comparing the Share Repurchase and Dividend. This article provides an understanding of which strategy should be used in which situation for readers.

Keywords: S*hare Repurchase, Dividend, invest strategy, EPS, ROA, ROE*

1. INTRODUCTION

The relationship between the shareholder and corporations can be resembled as the feeder and the animal. A feeder gives fodder to their animal and the animal will use a way to requite what their feeder likes. From the paper posted in 2018 by the U.S Securities and Exchange Commission, Kara
M. Stein, the relationship between a company and its shareholders is similar to the form of mutualism[1]. Shareholders invest their capitals in a company, and the company will use these capitals ti fund its operations, which causes the growth of investment on both of the shareholder and the company. Corporations generally uses two strategies as their way to requite their shareholders, Share Repurchase and Dividend. Also, using these two strategies to maximum their profits under the assumption of satisfaction of their shareholders. Since the fierce competition between each Corporations in order to hold their shareholders, the significance of choosing of stock sharing strategy is increasingly apparent. In this paper, it is going to introduce the readers about the definitions, ascendancies and disadvantages of Share Repurchase and Dividend. Furthermore, comparing these two strategies for comparative analysis. The purposes of this paper are not only to establish readers a basic and explicit insights into Share Repurchase and Dividend, but also to assist readers to comprehend under which situation which strategy is the best choice they ought to choose.

1.1 The Function of Share Repurchase

Share Repurchase, also known as stock buybacks or share buybacks, definite as way to pay cash to shareholders through a buyback — the corporation use money to buyback their outstanding stocks— which is a more flexible way of returning cash to their shareholders. Based on U.S. corporate law, open market, private negotiations, repurchase put rights, two variants of self-tender repurchase, fixed price tender offer, Dutch auction and accelerated repurchase were the Share Repurchase's six significance way. According to the page which wrote by the Full professor of Finance, Nuno Fernandes, entitled as Finance for executives; a practical guide for managers. More than 95% of the buyback programs are through the open market method[2].
Through data analysis, it can be found that share repurchase is of great significance to the development of capital market. According to the federal reserve official statistics, in 2009 by the end of 2017, the U.S. non-financial companies has bought $3.37 trillion of shares, predominantly ETF index in mutual fund bought $1.64 trillion of shares, the American family and brokerage agencies are net sales of $655.7 billion and $1.14 trillion respectively, long-short market camp distribution be clear at a glance. The Fed's data also show that another man is the biggest bull in the U.S. stock market, with s&p 500 companies buying back $4.23 trillion of their own stock between the first quarter of 2009 and the first quarter of 2018[3]. Nevertheless, According to the Journal of Corporate Finance wrote by Sang-Gyung, Mookwon Jung, and Ralph
A. Walking "Share repurchase, executive options and wealth changes to stockholders and bondholders". Share repurchase is an excellent choice and plays a big role in Shareholders' side[4]. Also, according to U.S Securities and Exchange Commission (SEC) rule, 10b-18 sets requirements for stock repurchase in the United States.
There are numerous reasons for a cooperation to buy back their outstanding shares. The most generous explanation for a company to buyback their stock is that the company's

finance might is doing quite excellent and no longer need ongoing equity funding from their shareholders[5]. Therefore Share Repurchase support a business to release more profits and fund growth.

Moreover, companies are able to repurchase the outstanding stocks at the deflated price when they suspects their stocks are undervalued. When the stock prices moves up again or even higher, companies can reissue the number of shares that they bought from their shareholders with higher price in order to increase their total equity capital. Share Repurchase also supports corporations to consolidate their ownership. "Shareholder dividends are paid out of a company's net profit. If there are fewer shareholders, the proverbial pie is divided in to fewer pieces[5].The earnings per share (EPS) is increasing when its denominator is reducing. The return on equity(ROE) works in the similarly way. When the shareholder's equity is minimized and the company's net profit preserves the same, the ROE will automatically rise. Thus, the company can use bonus to stimulate the enthusiasm of the employees or raise executives' salaries in order to make them feel the company is profitable. When the share price is below net asset value. Assuming the share price is 1.50 yuan, in this case, assuming the buyback of 30%, namely 30 million outstanding shares, the company's net asset value after the buyback is 155 million yuan, the total share capital after the buyback is 70 million yuan, then the net asset value per share rises to 2.21 yuan, will cause the share price to rise. The share price is higher than the net asset value, but the cost of equity financing is still higher than the bank interest rate. In this case, the company's buyback is still profitable, which can reduce the financing cost and increase the after-tax profit per share. Let's say the previous company makes an annual profit of 30 million yuan, pays all dividends, the bank pays a one-year loan rate of 10%, and the stock price is 2.50 yuan. The company's equity financing cost is 12%, higher than the bank's 10% interest rate [6].

However, there are also some factors which cause some companies to choose other strategies rather than Share Repurchase. Share Repurchase is an unrealistic picture through ratios. Although Share Repurchase raise some ratios such as EPS, ROA and ROE, etc, the increasing of such ratios is because of the decrease in outstanding stocks rather than the increase of profitability. This is not an organic growth in profit. In addition, Share Repurchase does not show a company's economic reality. Companies expect that they can buy back their outstanding stocks when stocks are cheap. On the contrast, because of the stock market is unpredictable, the company might end up with buying their stocks which turns out to be high prices, and this makes Share Repurchase become a bad use of capital for the company. Also, Share Repurchase means the company is in a situation of lacing of future growth, because when they buy back they stocks, it is likely send a signal to their shareholders who believe that the company has potential future in company's revenue that the company does not have many profitable opportunities to grow business — the company does not choose to expand itself through acquisitions of smaller competitors — thus, it might cause the shareholders to invest capitals in alternative company.

$$\text{Payout ratio} = \frac{\text{dividends per share}}{\text{earnings per share}} \times 100$$

Figure 1. Payout ration based on dividends per share and earnings per share

$$\text{Payout ratio} = \frac{\text{dividends per share}}{\text{free cash flow per share}} \times 100$$

Figure 2. Payout ration based on dividends per share and free cash flow per share

1.2 The Function of Dividend

According to John D. Rockefeller, "The only thing that gives me pleasure is to see my dividend coming in". Dividend plays a big role in Shareholders' side as well. In the financial history of the world, the first company that recorded to pay regular dividends is the Dutch East India Company (VOC)[7]. VOC paid annual dividends worth about 18 percent of the shares from 1602 to 1800[8].

Dividend can be understand as a way of the company share the profits to its shareholders. In another way, when the company earns profits, the company is required to pay a dividend—portion of its profits— to shareholders. The remaining profits that does not distributed is called retained earnings and retained earnings will be invested in company's business again. There are various forms of dividend such as cash dividend, bonus share, property dividend and scrip dividend, etc. Dividend may pay in cash or it can be paid by Share Repurchase as well. A dividend is distributed as a fixed amount per share, while shareholders receive dividends in proportion to their shareholding. Thus, there are two specific formula to calculate the payout ratio. Normally a company pays dividends at a fixed schedule, but some non-mainstreams declare dividends at anytime(special dividend).

When a company consistently pays dividend, it demonstrates a stability to its shareholders who are looking for solid returns over the long term. Thus it implicitly can be understand as the shareholders can be gain long-term and stable benefits from the company. Dividend has a form of predictability. If shareholders choose dividend-paying stocks, they will get a certain degree of predictable returns. Despite the difficult times in the stock market, shareholders can still receive some form of dividends in return. Moreover, Dividend-paying stocks significantly improve the stock price and the company will turn to a tremendous attractive force for shareholders. Also, since the company's interest increased build demand, the stock value will increase as well. Furthermore, Dividends play a significant role in Equity evaluation. Shareholders and investors usually overlook the importance of impacts of dividends, same as dividends impact of providing analysis in equity evaluation and stock selection. In fact, using dividends to

evaluate stocks is a more intelligent way than using other commonly metrics (price-to-earnings, P/E ratio)[9]. Apparently, most of analysts use these metrics on the figures which obtained from companies' financial statement. However, the financial statement sometimes might be misleading in order to improve the company's appearance. On the contrast, a company pays dividend means it has real cash flow to afford the dividend payment. Thus, using dividend is a more effective and reliable way and provide a solid indication for analysts to analysis in equity evaluation.

Undoubtedly and obviously, dividend is not the peak of perfection. Dividend has clientele effect. If a dividend-paying company is facing a dilemma on its cash problem, it might be unable to pay dividends to its shareholders for a certain time, and this might cause shareholders who expect a long-term regular dividend to give up the corporation. Thus the company will loss its old clientele and reputation. Also, dividends will limit the company's future growth, if the company does not decrease its retained earning and pays dividend, it might cause some unexpected expenses for the company. Furthermore, the debt obligation of the company will rise because it does not have enough cash. Also, paying dividends get the company into the dilemma — lack of usable cash— which limits the future growth of the company. This is due to the company will have less usable cash to spend on its project or invest on its business. In addition, dividends-paying need abundant work of recording, because it has to be ensure that the right shareholders receive their dividends. Thus the company needs to hire workers for recording job and this will subjoin the company's workload and economic burden.

1.3 Comparison

Although Share Repurchase can be understand as a form of Dividend, the relationship between them is still like a transparent wall. Like this paper mentioned in the Introduction, feeder and the animal. Different ways of the animals choose will have different effects. Similarly, Share Repurchase and Dividend are different. Figure 3, compiled by S&P Dow Hones Indices, sheds lights on how buybacks have truly accelerated over the last decade[10].

Apparently, the acceleration of buybacks is rapidly, but the percentage of dividends was higher than buybacks' for more than 50% of time. Share Repurchase is a better way to satisfy the company and have more flexibility, while Dividend can be more resembled as a way to make Shareholders to be delighted but has less flexibility. From the company's side, they can buy back their outstanding stocks when they are cheap and resell them when they are high in order to minimize their losses. However, aside from special dividend, dividend-pay companies are lack or choice, because they ought to pay dividend to their shareholders at a fixed schedule. Moreover, Share Repurchase-companies can buy back their shares when they think the capitals are enough and thus reduce the number of shareholders. Most importantly, its EPS and ROE will rise as the decline of the number of shareholders. On the contrast, dividend does not have the flexibility and the ability of consolidate ownership as Share Repurchase. However, dividend is more stability and attractive to investors and shareholders. Because of the stability and the high stock price of the dividend-pay companies. Who does not like a long-term and stability cash source? Thus, dividend-pay companies obviously are more

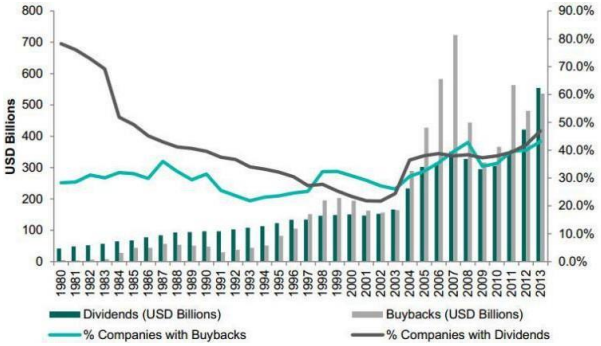

Figure 3. aggregate Dividends and Buybacks Paid by U.S Firms and the Percentage of Firms with positive Dividends and Buybacks in the U.S

attractive than Share Repurchase-companies for shareholders to spend their capitals on which means they have more money to invest on their business. Also, it means these companies have longer future growth. From Shareholders and Investors' side, Share Repurchase-companies might be a better choice than dividend-pay companies for them to earn more cash, but this can also be a potential problem, the stock market is unpredictable. Aside from the stability of dividend-pay companies. They are more reliable than Share Repurchase-companies for shareholders and investors because paying dividend means they have real cash flow to afford dividends.

2. CONCLUSION

In general, this paper introduce the basic introduction of Share Repurchase and Dividend to readers, focusing on the advantages and defects of the Share Repurchase and Dividend. Based on the comparative analysis of Share Repurchase and Dividend, it demonstrates each strategy has their own strong and weak points. Dividends versus share buybacks is something of a false dichotomy. There is no strategy which is better than the other. It is all about how to choose a strategy that is suitable for your company in order to maximize profits. On the contrast, choosing which company to invest will bring you what you expect to obtain.

ACKNOWLEDGMENT

First and foremost, I would like to show my deepest gratitude and respect to my teachers

who provided me numerous valuable guidance of writing this paper. Furthermore, I would like to thank all my friends and my brother who give me the most encouragement and supports. Without their enlightening guidance and kindness encouragement, I could not complete this thesis.

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