Practice Questions – Dividend Policy

1. The Well Company belongs to a risk class for which the appropriate discount rate is 10%. Well currently has 100,000 outstanding shares selling at $100 each. The firm is contemplating the declaration of a $5 dividend at the end of the fiscal year that just began. Answer the following questions based on the Miller and Modigliani model:

   A) What will be the price of the stock on the ex-dividend date if the dividend is declared? What will be the price of the stock at the end of the year if the dividend is not declared

   B) If Well makes $2 million of new investments at the beginning of the period, earns net income of $1 million, and pays the dividend at the end of the year, how many shares of new stock must the firm issue to meet its funding needs?

   C) Is it realistic to use the MM model in the real world to value stock? Why or why not?

2. Flychucker Corporation is evaluating an extra dividend versus a share repurchase. In either case $3,000 would be spent. Current earnings are $1.50 per share, and the stock currently sells for $58 per share. There are 600 shares outstanding. Ignore taxes and other imperfections in answering parts (a) and (b).

   (i) Evaluate the two alternatives in terms of the effect on the price per share of the stock and shareholder wealth.

   (ii) What will be the effect on Flychucker's EPS and PE ratio under the two different scenarios?

   (iii) In the real world, which of these actions would you recommend? Why?

3. The net income of Novis Corporation is $45,000. The company has 20,000 outstanding shares and a 100 percent payout policy. The expected value of the firm one year from now is $1,635,000. The appropriate discount rate for Novis is 12 percent, and the dividend tax rate is zero.

   (i) What is the current value of the firm assuming the current dividend has not yet been paid?

   (ii) What is the ex-dividend price of Novis's stock if the board follows its current policy?

   (iii) At the dividend declaration meeting, several board members claimed that the dividend is too meager and is probably depressing Novis's price. They proposed that Novis sell enough new shares to finance a $4.60 dividend.

      a) Comment on the claim that the low dividend is depressing the stock price. Support your argument with calculations.

      b) If the proposal is adopted, at what price will the new shares sell? How many will be sold?

4. Gibson Co. has a current period cash flow of $1.4 million and pays no dividends. The present value of the company's future cash flows is $20 million. The company is entirely financed with equity and has 750,000 shares outstanding. Assume the dividend tax rate is zero.

   (i) What is the share price of the Gibson stock?

   (ii) Suppose the board of directors of Gibson Co. announces its plan to pay out 50 percent of its current cash flow as cash dividends to its shareholders. How can Jeff Miller, who owns 1,000 shares of Gibson stock, achieve a zero payout policy on his own?

5. The balance sheet for Levy Corp. is shown here in market value terms. There are 8,000 shares of stock outstanding.

Market Value Balance Sheet			
Cash	$ 30,000	Equity	$380,000
Fixed assets	350,000		
Total	$380,000	Total	$380,000

The company has declared a dividend of $1.60 per share. The stock goes ex dividend tomorrow. Ignoring any tax effects, what is the stock selling for today? What will it sell for tomorrow? What will the balance sheet look like after the dividends are paid?