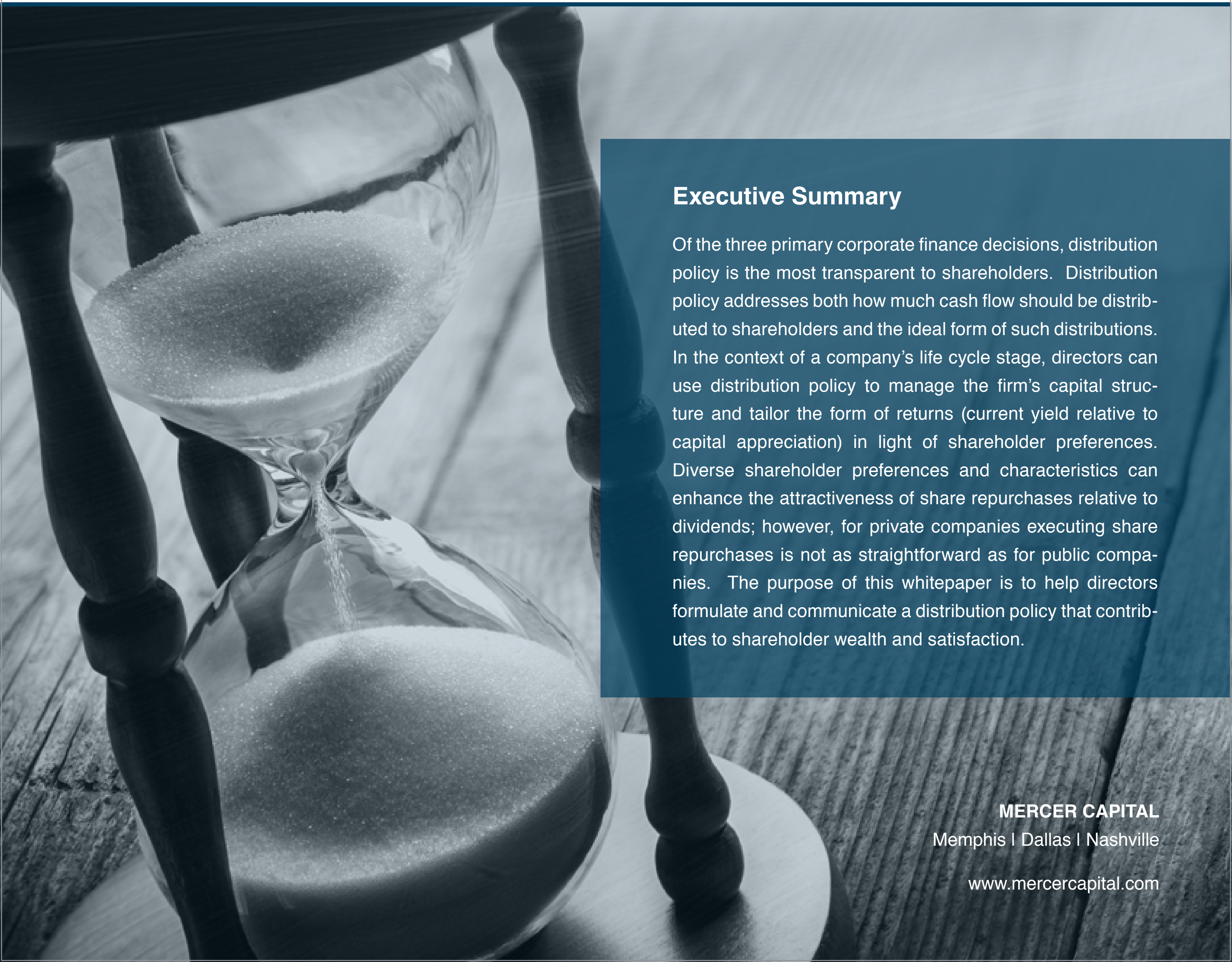
Distribution Policy in 30 Minutes

A Guide for Directors and Shareholders

by Travis W. Harms, CFA, CPA/ABV



Executive Summary

Of the three primary corporate finance decisions, distribution policy is the most transparent to shareholders. Distribution policy addresses both how much cash flow should be distributed to shareholders and the ideal form of such distributions. In the context of a company's life cycle stage, directors can use distribution policy to manage the firm's capital structure and tailor the form of returns (current yield relative to capital appreciation) in light of shareholder preferences. Diverse shareholder preferences and characteristics can enhance the attractiveness of share repurchases relative to dividends; however, for private companies executing share repurchases is not as straightforward as for public companies. The purpose of this whitepaper is to help directors formulate and communicate a distribution policy that contributes to shareholder wealth and satisfaction.

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This whitepaper concludes our series designed to provide corporate directors and shareholders confidence discussing and evaluating corporate finance decisions. The three principal corporate finance decisions are:

1. **Capital Structure:** What is the appropriate mix of debt and equity financing for the Company?
2. **Capital Budgeting:** What is the appropriate mix of capital projects for the Company to invest in?
3. **Distribution Policy:** What is the appropriate mix of current income and capital appreciation for the Company's shareholders?

In this final installment, we address distribution policy.

The Objective of Distribution Policy Decisions

Distribution policy encompasses how much cash flow should be distributed to shareholders, and what form such distributions should take. The first dimension interacts with the capital budgeting process, and the second is intertwined with the capital structure question, as illustrated in Exhibit 1.

As noted in Exhibit 1, we take a broad view with regard to what constitutes a distribution.

1. **Repay debt.** Using capital to repay debt benefits the shareholders indirectly by increasing capital appreciation.
2. **Repurchase shares.** By repurchasing shares, the company provides current cash returns on a non-pro rata basis to shareholders electing to tender shares in the repurchase. For shareholders electing not to sell shares, the repurchase program provides an indirect benefit through enhanced capital appreciation (because of the reduced number of shares outstanding).

Exhibit 1

Distribution policy encompasses both “How Much?” and “What Form?”

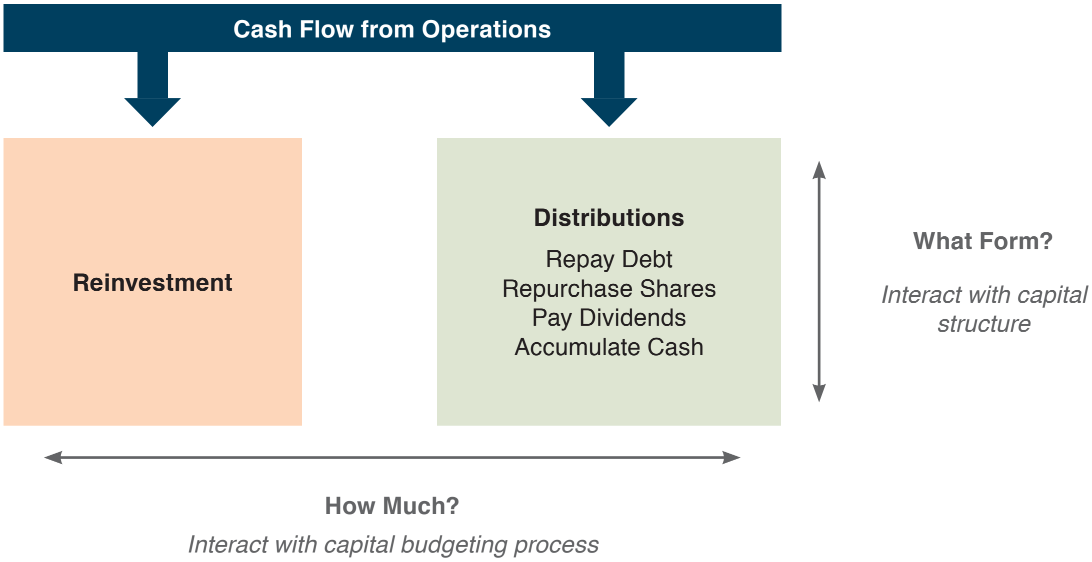
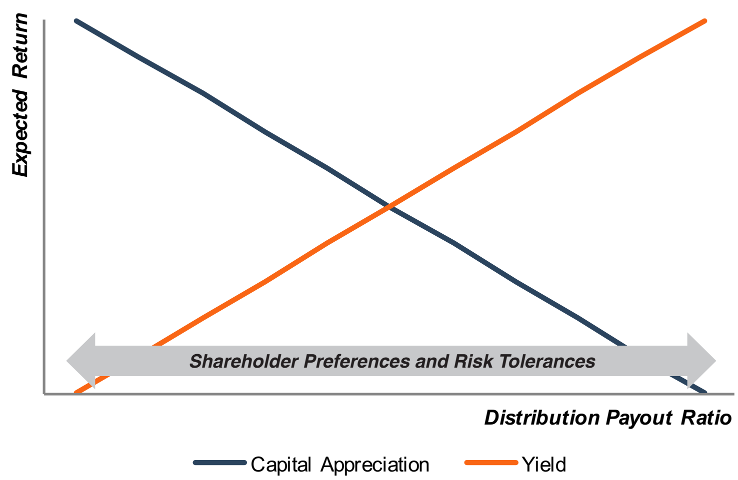


Exhibit 2

Through distribution policy, the board can calibrate return components (yield vs capital appreciation) to address shareholder preferences and risk tolerances



3. **Pay dividends.** Dividends provide current cash returns to all shareholders on a pro rata basis.

4. **Accumulate cash.** Cash accumulation can be considered either reinvestment (in one sense, holding cash is a capital project) or distribution (the value of the accumulated cash indirectly contributes to the capital appreciation realized by the shareholders and is available for distribution in subsequent periods).

The aggregate pool of returns available to provide shareholder returns is determined by the returns on the portfolio of projects to which the company has allocated capital. In isolation, distribution policy does not influence the returns generated by the company's operations. However, through distribution policy, the board can calibrate the mix of return components to address shareholder preferences and risk tolerances.

In the remainder of this whitepaper, we consider a number of factors the board should evaluate in making shareholder distributions.

Where Is the Company in its Life Cycle?

The board's discretion to calibrate the form of shareholder returns is subject to a range of natural constraints related to the stage of the company's development. For example, less mature companies that need capital to develop the scale required to achieve profitability and optimal margins are not natural dividend payers. As companies mature, the board's discretion to tailor returns to address shareholder preferences and risk tolerances broadens.

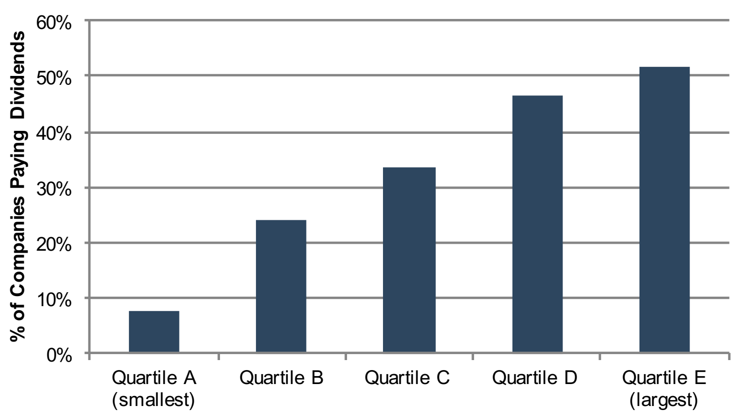
As summarized on Exhibit 3, we analyzed data for the small-cap and mid-cap companies in the Russell 2000 (excluding financials). Sorting the firms in the sample by revenue, we constructed five size deciles. Within the deciles, the propensity to pay dividends was positively related to size, with fewer than 8% of the smallest firms paying dividends in 2015, compared to more than half of the larger firms.

In this context, size is simply a proxy for life cycle stage. The critical assessment point for the board is not mere size, but the availability of attractive capital investments. In our sample, the smallest companies were least likely to pay a dividend because they had the most attractive investment opportunities, not simply because they were small. For example, the median 3-year compound annual revenue growth rate of firms in Quartile A was 14.8%, compared to 3.8% for Quartile E. Within Quartile E, the median growth rate for dividend payers was 3.1%, compared to 4.9% for non-dividend payers; as a result, the life cycle effect was evident even among the largest firms in the sample.

In other words, life cycle is not simply a matter of firm age or size, but rather the availability of attractive capital projects. Assessment of available capital investment opportunities is inextricably linked to the company's strategy. Strategy sets the boundaries for potential capital investment opportunities. In

Exhibit 3

Among the non-financial firms in the Russell 2000 index, the propensity to pay regular dividends increases with firm size (as measured by revenue)



determining the breadth of the company's strategy (and therefore the set of capital investment opportunities to be considered) the board should evaluate company's competencies and competitive advantages.

How Does the Company's Current Capital Structure Compare to the Target?

Distribution policy can be used by the board to migrate from an existing to a target capital structure over time. Since the transaction costs for shareholder distributions are minimal, distribution policy can be a cost-effective tool for fine-tuning capital structure.

As shown on Exhibit 4, there are numerous potential strategies for migrating the company's current capital structure to its target structure.

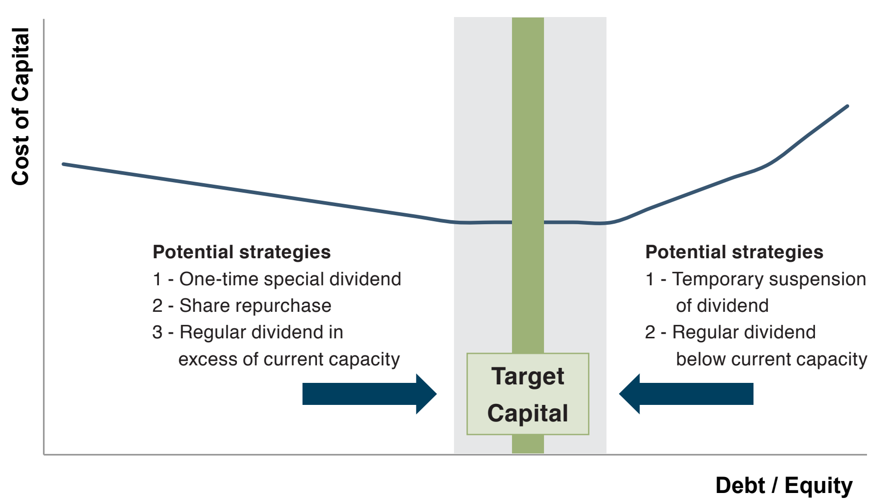
Not surprisingly, under-leveraged companies have more flexibility than over-leveraged firms. Distribution strategies to increase leverage include:

1. **Pay a one-time special dividend.** If the company is truly under-leveraged, borrowing to fund a special dividend should be available. As a dividend, the amount borrowed will be distributed to all shareholders on a pro rata basis. Under this strategy, the board must carefully communicate to shareholders the rationale for the dividend, tax consequences, and the non-recurring nature of the dividend payment.

2. **Repurchase shares.** In contrast to a special dividend, share repurchases do not have to be executed on a pro rata basis. However, whereas dividends are not dependent upon valuation, share repurchases require that the board establish an offer price. For private companies, different views regarding the value of the company's shares (including whether discounts for lack of control or lack of marketability are appropriate) can complicate execution of a share repurchase program.

Exhibit 4

Distribution policy can be a cost-effective tool for managing capital structure



3. **Set regular dividend in excess of current capacity.** For a more incremental approach, the board can adjust the regular dividend to a level in excess of current capacity. This strategy provides greater predictability for the company's shareholders and does not require the board to establish a value for the company's shares. However, unless the company is able to grow into the dividend, a reduction may be required as the target capital structure is reached. Executing this approach requires that the company have an existing store of excess liquidity or access to a flexible debt facility that can be used to fund the excess dividends.

The options available to an over-leveraged firm are more limited.

1. **Temporarily suspend dividend payments.** For a company that has historically paid dividends, suspending dividends entirely requires careful shareholder communication. Shareholders should understand the reason for the suspension, the target amount of debt reduction and/or asset accumulation, and the date at which dividends can be expected to resume.

2. **Set regular dividend below current capacity.** This is essentially a more incremental approach than an outright suspension of dividends, but the shareholder communication requirements are the same. While less painful, this approach will only be feasible if the distance between the existing and target capital structures is modest.

Once a company's board has identified a target capital structure that deviates from the company's existing structure, the board should assess whether, and how, to use distribution policy to migrate toward the target structure.

What Type of Dividend Policy Fits Best?

From the perspective of shareholders, predictability is the most important attribute of dividends. Predictability does not mean that the company pays a static dollar dividend each period (though it may). Rather, predictability means that shareholders understand the framework within which directors will evaluate the dividend to be paid each period.

Exhibit 5 on the following page summarizes the four principal dividend policies that boards can adopt.

The various policies exist along a continuum ranging from that of greatest shareholder certainty (paying a fixed annual dollar dividend) to that of greatest board discretion (paying dividends equal to the residual, if any, of operating cash flow over attractive investment opportunities). When clearly communicated to the shareholders, however, each of the policies provides predictability, which enhances the perceived value of a given dividend stream to shareholders.

Given the desire for dividend predictability, companies can use other forms of shareholder distribution in conjunction with one of the policies noted above to achieve other corporate and shareholder objectives. Recall from Exhibit 1 that we view distributions broadly, to include not only dividend payments, but also debt reduction, share repurchases, and cash accumulation.

Exhibit 6 summarizes the results of our analysis of dividend payments and share repurchases among non-financial companies in the Russell 2000 index during 2015.

Exhibit 5

A clearly communicated dividend policy enhances predictability for shareholders

Greater Shareholder Certainty

Policy	Description
Fixed Payment	The board declares a fixed annual dollar dividend, and the Company can reinvest the residual
Fixed Payout	The board sets the dividend relative to earnings during the period
Fixed Yield	The board sets the dividend relative to the value of the Company
Residual	The board assesses how much can be reinvested in financially attractive projects and sets the dividend equal to the residual

Greater Board Discretion

Exhibit 6

During 2015, approximately one-third of the public companies in our sample paid dividends, while nearly half repurchased shares

Paid Dividend	Repurchased Shares	Companies		Dividends Paid	Share Repurchases
No	No	585	40%	$0.0	$0.0
Yes	No	170	12%	5.8	0.0
Yes	Yes	306	21%	8.4	12.5
	Dividends > Share Repurchases	*154*	*11%*	*5.4*	*1.6*
	Share Repurchases > Dividends	*152*	*10%*	*3.1*	*10.9*
No	Yes	396	27%	0.0	13.8
Total		**1,457**	**100%**	**$14.3**	**$26.3**

Among the companies in this sample, aggregate share repurchases exceeded dividends on a nearly 2-to-1 basis ($26.3 billion, compared to $14.3 billion).

- Approximately 40% (585) of the companies in the sample neither paid dividends nor repurchased shares during 2015.
- Only 12% (170) of companies paid dividends without repurchasing shares.

- Nearly two-thirds (306) of dividend payers also repurchased shares during the year. That sub-group was split evenly between companies for which share repurchases or dividend payments predominated. In aggregate, share repurchases for this group ($12.5 billion) exceeded the amount paid as dividends ($8.4 billion).

- Approximately 27% of the companies in the sample repurchased shares without paying any dividends.

Companies pay dividends with greater consistency than they repurchase shares. Of the 853 companies that repurchased shares in at least one of the three years ending with fiscal 2015, only 454 (53%) did so ever year. Among companies repurchasing shares in a given year, approximately 15% did not repurchase any shares in the subsequent year; the comparable attrition rate for dividend payers was less than 5%.

What Are Shareholder Preferences for Return Composition?

The investors that populate corporate finance textbooks are blithely indifferent to the composition or form of shareholder returns. Such hypothetical investors are indifferent between current yield and capital appreciation – in our experience, real shareholders are not. Directors are responsible for managing the company for the actual shareholders, not some hypothetical phantoms. Private company directors should evaluate the degree to which the company's existing distribution policy aligns with the shareholders' return preferences and risk tolerances.

Exhibit 7 on the following page summarizes shareholder characteristics that correspond to different shareholder distribution preferences.

As the number of shareholders increases, the likelihood that shareholders will have different return preferences increases. The presence of different shareholder groups with different return preferences and risk tolerances is referred to as the "clientele effect." For liquid assets, the clientele effect is manifest in the fact that different types of assets are owned by different types of investors. The most obvious example of the clientele effect is observed in the market for non-taxable municipal bonds, which are eschewed by non-taxable investors. For illiquid interests in private companies, however, investors do not have the ability to gravitate toward assets that fit their risk and return preferences. As a result, private company directors' deliberations regarding distribution policy become more complex.

For private companies, non-pro rata forms of distribution can be used to mitigate the clientele effect.

- If the company is mature, with limited reinvestment needs, a share repurchase program allows shareholders to select their preferred return profile. Shareholders with a preference for greater current income can simulate a higher dividend yield by selling a portion of their shares to the company. Conversely, shareholders preferring capital appreciation can hold their shares and realize greater capital appreciation as the repurchases reduce the number of shares outstanding.

- If the company needs capital to fund attractive investment opportunities, a dividend reinvestment program allows shareholders desiring current income to forego the reinvestment option, while those desiring greater capital appreciation can reinvest a portion or all of the dividends received.

Exhibit 7

Lower Current Yield Higher Capital Appreciation	Higher Current Yield Lower Capital Appreciation
Shareholders have sufficient income from other sources to fund desired current consumption	Shareholders have limited income from other sources
Shareholders' other income sources have no or low correlation with the company's financial performance	Shareholders' other income sources correlated with performance of subject company
Shareholders have limited alternative investment options with comparable risk-adjusted returns (i.e., high reinvestment risk)	Shareholders have abundant alternative investment options
Shareholders have reliable mechanisms for achieving liquidity on a predictable basis	Shareholders face uncertainty regarding when/if liquidity event will occur
Shareholders enjoy favorable tax treatment on capital gains	Shareholders enjoy favorable tax treatment on dividend income
Shareholders have limited near-term cash needs	Shareholders have significant near-term cash needs
Shareholders have broadly diversified investment portfolios	Shareholders have concentrated investment portfolios

With either option, the board will need to establish the value at which the company is willing to purchase or issue its own shares. Value is a notoriously slippery term, and can refer to a variety of different prices for a particular business, depending on the "level" contemplated. For example, the price at which at competitor would be willing to acquire the entire business is likely greater than the price at which an investor would contemplate purchasing an illiquid minority interest in the same business. When purchasing or issuing shares, directors will need to determine what price along that spectrum is relevant to the purpose of the transaction, understanding that such transactions have the potential to shift wealth from one group of shareholders to another.

How can directors discern the return preferences and risk tolerances of the shareholders? There is really no substitute for asking. If the shareholder base is small, informal discussions will probably suffice, but for a larger, more fragmented group of shareholders, a more formal survey mechanism may be appropriate. The purpose of such a survey is not to outsource distribution policy to the shareholders, but rather to solicit data that the board can use to inform deliberations regarding distribution policy. Identifying what clienteles, if any, exist within the shareholder base allows the board to weigh potential strategies and understand how those strategies would affect the various clienteles. No distribution policy can accommodate the unique preferences of each shareholder, but the board's credibility with the shareholders can be enhanced by taking proactive steps to understand the shareholders' preferences and risk tolerances.

Does the Company Have Sufficient Financial Flexibility to Accommodate Shareholder Preferences?

Money is fungible: if issuing debt and new shares were easy for private companies, directors would be able to accommodate nearly any shareholder return preference. For example, even a high growth company with ample attractive investment opportunities could fund dividends to current shareholders through issuance of new debt or new equity. In practice, however, the board's discretion to tailor the form of returns to accommodate shareholder preferences is broadly constrained by life cycle factors and the company's current capital structure.

We assess flexibility with regard to both cash flow and access to capital.

- **Cash Flow.** Companies for which attractive investment opportunities exceed current operating cash flow can provide interim distributions to shareholders only to the extent the company has accumulated liquid assets or has the ability to borrow incremental funds or issue new shares.

- **Access to Capital.** Material share repurchases and special dividends require access to new capital. If the company's financial leverage is at or above the target level, incremental capital would need to be in the form of new equity. For private companies, issuing new equity is

Exhibit 8

Companies that are net cash generators are more likely to distribute cash to shareholders in the form of dividends and share repurchases

Paid Dividend	Repurchased Shares	Companies		Dividends Paid	Share Repurchases
Cash Generators					
No	No	165	22%	$0.0	$0.0
Yes	No	114	15%	3.5	0.0
Yes	Yes	238	32%	6.3	10.7
No	Yes	221	30%	0.0	9.9
Total		**738**	**100%**	**$9.8**	**$20.5**
Cash Users					
No	No	420	58%	$0.0	$0.0
Yes	No	56	8%	2.4	0.0
Yes	Yes	68	9%	2.2	1.9
No	Yes	175	24%	0.0	3.9
Total		**719**	**100%**	**$4.5**	**$5.8**
Grand Total		**1,457**		**$14.3**	**$26.3**

often expensive: existing investors may not have sufficient available liquidity to inject into the business, and new investors are often hesitant to contribute capital in exchange for minority interests in the company absent potentially onerous terms and protections.

Exhibit 8 on the preceding page summarizes the dividend characteristics of the cash generators and cash users in our sample, respectively.

For purposes of the analysis in Exhibit 8, companies were classified as cash generators or cash users on the basis of financial results for 2015 only, not the three-year cumulative totals for 2013 through 2015. The total population included roughly equal numbers of cash generators and cash users.

- During 2015, 78% of cash generators distributed cash to shareholders in the form of either dividends, share repurchases, or both. Share repurchases exceeded dividends paid both in aggregate dollars ($20.5 billion compared to $9.8 billion) and number of companies (459 compared to 352).
- In contrast, only 42% of cash users made shareholder distributions. By number of companies, the preference for share repurchases was more pronounced for this group (243 compared to 124 dividend payers), although the aggregate dollars were more balanced.
- Cash generators accounted for 69% of all dividends paid and 78% of share repurchases.

In summary, the form of shareholder returns is shaped by whether the subject company is a net generator or user of cash. The ability of directors to tailor returns to shareholder preferences is limited by these natural constraints. Cash generators have the most latitude, as directors can elect to pay dividends (providing current income) or repurchase shares (enhancing capital appreciation for those electing not to sell). Cash users are more constrained, but can pay dividends or repurchase shares if they are able borrow money or issue shares in excess of the amount needed to fund capital projects. Approximately 17% of cash users in our sample paid shareholder dividends in 2015.

Is a Share Repurchase Program Feasible?

Share repurchases are well-suited to addressing the complications associated with the clientele effect within a shareholder base. Public companies are especially enamored of the technique, as the firms in our sample returned $26.3 billion to investors through share repurchases in 2015, compared to just $14.3 billion in dividends. For private company directors, executing a share repurchase program involves evaluating both the company's financial capacity to engage in the transaction and determining the offering price per share.

There are four potential sources of funding for share repurchases:

1. **Existing liquidity.** Previously accumulated excess liquidity may be used to pay for share repurchases.
2. **Internally-generated funds.** Net cash flow from the current year (cash flow from operating activities in excess of cash flow used for investment) is available for share repurchase.

3. **Borrowed funds.** If the magnitude of the share repurchase exceeds existing balance sheet liquidity and internally generated funds, the company may borrow money to repurchase shares. If the company is under-leveraged, using borrowed funds will move the company's capital structure toward its target. If the company is currently at its target capital structure, a leveraged share repurchase may push the company past its optimal range, resulting in a higher weighted average cost of capital.

4. **New equity.** Alternatively, the company may sell new shares to fund the share repurchase. In such a case, the company is effectively replacing one set of shareholders with another.

Aggregate funding sources for public companies in our sample that repurchased shares in 2015 are summarized in Exhibit 9. For cash generators, internally-generated funds were sufficient to pay for share repurchases and shareholder dividends. Cash users returned $7.9 billion to shareholders despite a $30.1 billion deficit of operating cash flow relative to investments. Across the entire population, distributions were principally funded by new borrowing (46% of total) and equity (54% of total, consisting of new equity, internally-generated funds, and existing liquidity).

Private companies are less likely to issue new equity to fund shareholder distributions, since investors are generally hesitant to acquire minority interests in private companies. As a result, internally-generated funds and incremental borrowings are the most common sources of shareholder distributions for private companies.

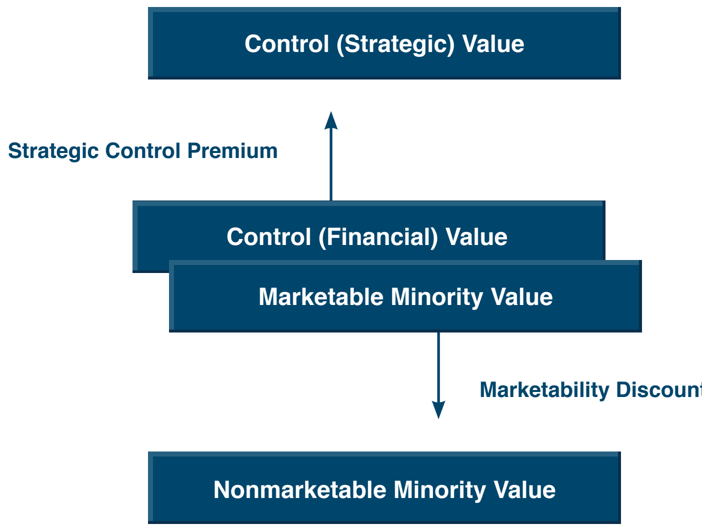
Public companies repurchase shares at the prevailing market price. For private companies, the market price of shares to be repurchased is not directly observable. For directors contemplating a share

Exhibit 9

Cash users fund shareholder distributions through existing liquidity and new capital

	Cash Generators	Cash Users	Total
Number of Companies	459	243	702
Sources of Funds			
Existing liquidity	(4.9)	8.1	3.2
Internally-generated funds	34.7	(30.1)	4.6
Borrowed funds	(6.8)	22.8	16.0
New equity	3.8	7.1	10.9
Total Sources	**$26.8**	**$7.9**	**$34.7**
Shareholder Distributions			
Share Repurchases	20.5	5.8	26.3
Dividends	6.3	2.2	8.4
Total Distributions	**$26.8**	**$7.9**	**$34.7**

Exhibit 10



repurchase program, the question of value has two dimensions. First, what are the appropriate corporate fundamentals to use in the valuation: cash flow forecasts, cost of capital, comparable public companies, comparable transactions, non-operating assets, etc.? Second, what is the appropriate "level" of value at which to execute the redemption?

Apart from the underlying corporate valuation fundamentals, the value of an ownership interest in a private company depends on the appropriate "level" as summarized on Exhibit 10.

Under the assumption that the company continues to operate under current stewardship, the results of fundamental corporate valuation techniques (discounted cash flow analysis, market comparables analysis) correspond to the financial control/marketable minority level of value from Exhibit 10. This level is analogous to the market for shares in public companies; in other words, if the subject private company were publicly traded, the share price would approximate value at the financial control/marketable minority level.

However, the shares of private companies do not trade publicly, and owners of such shares do not have ready liquidity for their interests. Since such liquidity, or marketability, is a desirable trait, investors generally demand a discount of some magnitude from the financial control/marketable minority level to compensate for the lack of marketability. As a result, the nonmarketable minority value is most representative of what (minority) shares in a private company are worth to current or prospective investors.

On the other hand, the assumption that the company continues to operate under current stewardship is not always valid or appropriate. If the company is sold in its entirety, the new controlling owner may be able to generate greater cash flow through combination with other businesses, access to more advantageous financing, or other factors. If there are competing bidders, the ultimate sales price may reflect a portion of such strategic benefits, resulting in a premium to the financial control/marketable minority level, referred to as the strategic control level of value.

Unlike paying dividends, repurchasing shares has the potential to provide disproportionate economic benefit to the company's various shareholders. Consider the implications of setting the repurchase price at each of the levels of value:

- **Nonmarketable minority level of value.** This level is most representative of the value of the shares tendered by selling shareholders. However, since the marketability discount is primarily attributable to the illiquidity which is being remedied by the share repurchase, should the price at which the share repurchase is executed reflect a marketability discount? If so, the shareholders electing not to participate in the redemption will benefit from accretion in the value of their remaining shares because the corporate treasurer (for whom illiquidity is not a concern) was able to acquire shares for less than the financial control/marketable minority value.

- **Financial control/marketable minority level of value.** This level is most representative of the value of the shares from the perspective of the corporate treasury. However, since it does not include any discount for lack of marketability (which is an inherent attribute of the private company's shares), offering to repurchase shares at this level might be perceived to provide a windfall for the selling shareholders. Executing a share repurchase at this price could create an excess supply of shares that exceed the company's financial capacity to redeem. On the other hand, if the company were sold to a strategic acquirer for a materially higher strategic control value in the succeeding two, three, or five years (memories can be long), the selling shareholders may perceive themselves to have been jilted. Add in potential family dynamics, and relationships could become combustible.

- **Strategic control level of value.** If the company repurchases shares on a strategic control basis and such a transaction does not materialize, the value of the remaining shares will be diluted. Furthermore, since the strategic control value assumes cash flows in excess of what the company currently generates, it may be difficult to finance the repurchase at that level.

There is no uniform right choice for the level of value at which a private company should repurchase shares. Directors will need to weigh the considerations noted above with the particular facts and circumstances surrounding the company and its shareholders. Above all, directors should be intentional about the level selected, and aware of the implications of that selection.

Conclusion

Distributions are the most direct signal private company shareholders receive regarding the management and performance of the company. Through distribution policy, directors of private companies determine the relative proportion of current yield and capital appreciation comprising total shareholder returns.

- Distribution policy interacts with both capital budgeting (in regard to the amount available for distribution to shareholders) and capital structure (in regard to the form of distributions).
- The range of distribution options available to a private company is constrained by the company's life cycle stage. Directors of more mature companies have greater flexibility with regard to distribution policy.
- Distribution policy can be a cost-effective means of adjusting the company's capital structure over time.
- Private company directors should be attuned to shareholder preferences for current yield and capital appreciation. In a large shareholder base, there are likely to be multiple clienteles with diverse preferences.
- With regard to dividends, shareholders desire predictability. Predictability means that the board pursues a consistent (and transparent) policy, not necessarily that the dollar amount of dividends is known in advance. In selecting a distribution policy, there is an inevitable tradeoff between shareholder certainty and board discretion.
- A company's ability to accommodate shareholder preferences will depend on its cash flow characteristics and access to incremental capital.
- Share repurchases are very popular among public companies due, in part, to their flexibility. Potential funding sources for share repurchases include existing liquidity, internally-generated funds, borrowed funds, and new equity.
- For private companies, share repurchase programs are complicated by the lack of readily observable market values for the company's shares. Depending on the level of value selected, a share repurchase can provide disproportionate economic benefits to one group of shareholders at the expense of another.

Of the three primary corporate finance decisions, distribution policy is the most transparent to the company's shareholders. Evaluating the questions raised in this whitepaper will help directors make informed distribution policy decisions that can be communicated to the shareholders.

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