Musings on Dividends: Part 2

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In March 2017, I wrote the article *Musings on Dividends*.

This article expands my views.

Many public companies struggle with capital allocation. One reason is that of the background of the CFOs. Many CFOs come to the position because they started out as accountants or as the company's auditor. As a result, they tend to think more in terms of accounting profits rather than shareholder value. This problem is reinforced if they are evaluated based on maximizing reported profits or earnings per share (EPS) accretion rather than value creation.

The other big problem is the so-called "agency problem". For most senior executives, their annual compensation package is more important to them than the appreciation of the equity they already hold. This misalignment in incentives between the shareholders and the managers can lead to perverse outcomes.

Assume the following scenario:

A CFO correctly believes that his company's stock is significantly undervalued and he has no material high-return uses for his surplus cash.

What should he do?

Most CFOs would choose to pay a special dividend or gradually repurchase shares over the years. By gradually repurchasing shares, the company can enjoy a long-term EPS growth tailwind and have the flexibility to repurchase more shares in quarters where he's concerned about hitting his EPS target.

But this is not what a value-maximizing manager would do.

A value maximizing manager would promptly repurchase a substantial percentage of the company. This increases the ownership of existing shareholders without them having to lay out a dime. However, this is a difficult strategy to follow as most managers are beholden to shareholders who want a smooth EPS trajectory.

Teledyne

Dr. Henry Singleton was an MIT trained mathematician and engineer who became the CEO of Teledyne, one of America's most successful conglomerates.

During the 1960s Go-Go era for conglomerates, Teledyne's stock traded at a premium multiple. Singleton exploited this p/e differential by using his inflated stock as currency to acquire businesses selling at 12x earnings. This boosted Teledyne's earnings and elevated its stock multiple even more.

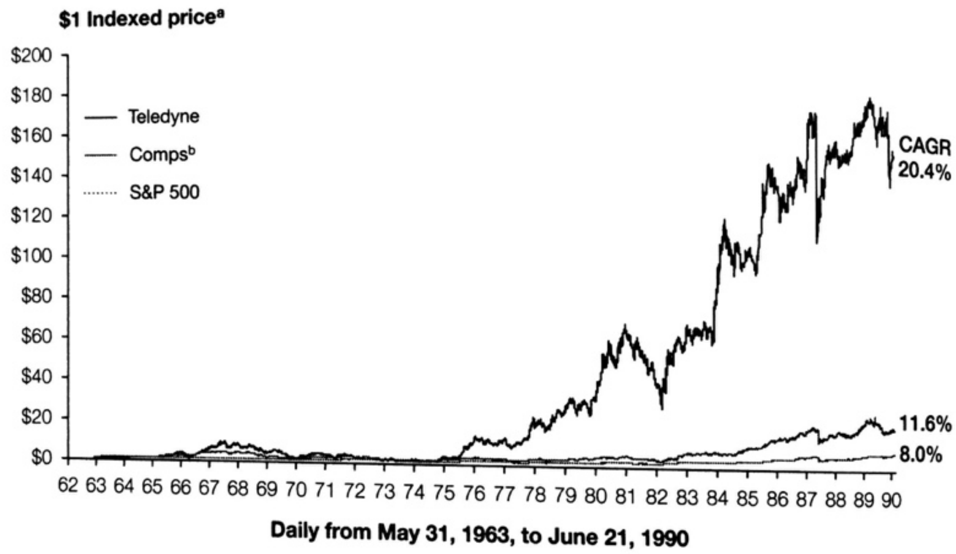
Then in mid-1969, with the multiple on his stock falling and acquisition prices rising, he abruptly stopped acquiring companies. During the bear market of the early 1970s, Teledyne fell from about $40 to a low of $6.

Singleton realized that his stock was undervalued and aggressively bought back shares ("Operation Shrink"). Between 1972-1984, across 8 separate tender offers, he bought back 90% of Teledyne's outstanding shares.

The results speak for itself.

Results produced by Teledyne's stock repurchase program ($ in millions)			
	1971	**1984**	**Change**
Sales	$1,101.9	$3,494.3	2.2 times
Net income	$32.3	$260.7	7.1 times
Earnings per share	$8.55	$353.34	40.3 times
Shares outstanding	6.6	0.9	(0.9 times)
Debt	$151.0	$1,072.7	6.1 times
Source: The Outsiders by William N. Thorndike, Jr.			

Teledyne stock price during the Singleton era versus S&P 500 and peers



a. Adjusted for stock splits, stock dividends, and cash dividends (assumed to be reinvested and taxed at 40 percent).
b. Comparable conglomerates include Litton Industries, ITT, Gulf & Western, and Textron.

Source: The Outsiders by William N. Thorndike, Jr.

A dollar invested with Singleton in 1963 would have been worth an astonishing $180 by 1990.

Teledyne is a classic example of how management can create substantial shareholder value by repurchasing shares rather than by paying generous dividends.

My take on dividends

Investors must understand how a company is funding its dividend. Potential warning signs include:

- Regular boosts in dividends in the face of irregular earnings
- Refusal to lower dividends when earnings fall and/or CapEx rise
- Dividend per share > Earnings per share
- Rising dividends and rising debt (watch out for companies that are borrowing money to pay shareholders)
- Rapidly growing interest charges as a percent of pre-tax income

I have noticed that CEOs try very hard to avoid cutting dividends – even during downturns. They are also pretty reluctant to cut CapEx. So, with dividends and CapEx pretty much fixed, that makes share repurchases a "residual."

Furthermore, if a company has a big dividend and their stock happens to be unusually undervalued at the moment, they can't opportunistically repurchase shares because they have to fund this big dividend.

As a result, I believe that a company is better off, in the long run, paying minimal or no dividends because:

1. When they start paying dividends, it is extremely difficult and unpleasant to cut or end them
2. Opportunistically repurchasing shares is more tax efficient

As an investor, I prefer that companies pay no regular dividends, but rely instead on opportunistic share repurchases and special dividends.