STUDY SESSION

6

Corporate Issuers (1)

This study session covers the capital budgeting process with emphasis on its principles and investment decision criteria. Project evaluation through the use of spreadsheet modeling is presented. Other income and valuation model approaches are compared. The subject of capital structure is introduced with the classic Modigliani–Miller irrelevance theory, which proposes that capital structure decisions should have no effect on company value. Additional considerations of taxes, agency costs, and financial distress are introduced. The session concludes with discussion on dividend policies, factors affecting distribution or reinvestment, and dividend payout or share repurchase decisions.

READING ASSIGNMENTS

Reading 15	Capital Structure by Raj Aggarwal, PhD, CFA, Pamela Peterson Drake, PhD, CFA, Adam Kobor, PhD, CFA, and Gregory Noronha, PhD, CFA
Reading 16	Analysis of Dividends and Share Repurchases by Gregory Noronha, PhD, CFA, and George H. Troughton, PhD, CFA

LEARNING OUTCOMES

READING 15. CAPITAL STRUCTURE

The candidate should be able to:

a explain the Modigliani–Miller propositions regarding capital structure;

b explain the effects on costs of capital and capital structure decisions of taxes, financial distress, agency costs, and asymmetric information;

c explain factors an analyst should consider in evaluating the effect of capital structure policy on valuation;

d describe international differences in the use of financial leverage, factors that explain these differences, and implications of these differences for investment analysis.

READING 16. ANALYSIS OF DIVIDENDS AND SHARE REPURCHASES

The candidate should be able to:

a describe the expected effect of regular cash dividends, extra dividends, liquidating dividends, stock dividends, stock splits, and reverse stock splits on shareholders' wealth and a company's financial ratios;

b compare theories of dividend policy and explain implications of each for share value given a description of a corporate dividend action;

c describe types of information (signals) that dividend initiations, increases, decreases, and omissions may convey;

d explain how agency costs may affect a company's payout policy;

e explain factors that affect dividend policy in practice;

f calculate and interpret the effective tax rate on a given currency unit of corporate earnings under double taxation, dividend imputation, and split-rate tax systems;

g compare stable dividend with constant dividend payout ratio, and calculate the dividend under each policy;

h compare share repurchase methods;

i calculate and compare the effect of a share repurchase on earnings per share when 1) the repurchase is financed with the company's surplus cash and 2) the company uses debt to finance the repurchase;

j calculate the effect of a share repurchase on book value per share;

k explain the choice between paying cash dividends and repurchasing shares;

l describe broad trends in corporate payout policies;

m calculate and interpret dividend coverage ratios based on 1) net income and 2) free cash flow;

n identify characteristics of companies that may not be able to sustain their cash dividend.