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WHY TAX POLICY CHANGES SHOULD NOT AFFECT DIVIDEND AND SHARE REPURCHASE PLANS

By Decker Walker, Jeff Kotzen, Eric Olsen, and Eric Wick

As the U.S. Congress debates changes to tax policy ahead of the December 31 expiration of the Bush-era tax cuts, executive suites and corporate boardrooms have been abuzz with urgent questions about the optimal approach to returning cash to investors through dividends and share repurchases. Timing is a particularly pressing concern for the many companies that typically announce dividend increases during the December-to-March time frame each year. Given the current intense corporate interest in tax policy, we believe it may be helpful to offer our thinking on the implications of a change in the relationship between U.S. capital gains and dividend tax rates. Briefly put, we find that while each corporation's situation is unique, these potential changes should not affect most corporations' capital-deployment decisions.

Congress is still debating the details, but it appears likely that the relationship between taxes on capital gains and dividends, which has varied dramatically over the past century, will change again in the near future. Currently, both capital gains and qualified dividends are taxed at 15 percent in the United States. If new tax policies take shape, as most experts expect, then the U.S. capital gains tax rate could increase to 23.8 percent, and taxes on qualified dividends could increase to the individual marginal tax rate, which would be in excess of 40 percent for the highest marginal tax bracket.

Whatever the next change in U.S. tax policy and tax rates happens to be, it will almost certainly not be the last change that executives see in this decade. Yet no matter where tax rates go next, many classes of investors will continue to seek U.S. stocks with a stable cash-return component and will take a positive view of regular dividends and share repurchases. To be sure, certain classes of investors will be impacted, perhaps meaningfully, by a dividend and capital gains tax-rate differential. And the right mix of dividends and repurchases will vary from one company to the next, depending on the overall tax regime, the specific tax situation of a company's shareholders, the solidity and stability of a company's finances, and other factors.

That said, we believe that potential changes in tax policy—and in the differential between dividend and capital gains tax rates—should not affect how most companies decide to distribute excess free cash to shareholders. Historically, corporate payouts and equity valuations have been far more influenced by macroeconomic conditions and the performance of individual companies than by changes in tax policy. What's more, better than half of U.S. equities are in the hands of tax-exempt or tax-deferred investors. Changing tax rates would not influence their decisions to buy, sell, or hold. For that matter, even taxable investors often prefer the more stable income that regular dividends provide, compared with the less reliable cash returns from share repurchases, which can be curtailed without notice.

We therefore see no reason, all else being equal, for management teams and boards to let the potential for increased dividend tax rates skew their decisions regarding the levels and mix of dividends and share repurchases.

Tax Rates and Dividend Payout: Minimal Correlation

In the past century, dividend tax policies have varied widely in the United States. But throughout the history of the U.S. stock market, returning cash to investors via dividends has been the rule rather than the exception. As far back as 1938, the renowned investor John Burr Williams famously remarked, "A cow for her milk, a hen for her eggs, and a stock, by heck, for her dividends. If earnings not paid out in dividends are all successfully reinvested, then these earnings should produce dividends later; if not, then they are money lost. In short, a stock is worth only what you can get out of it."

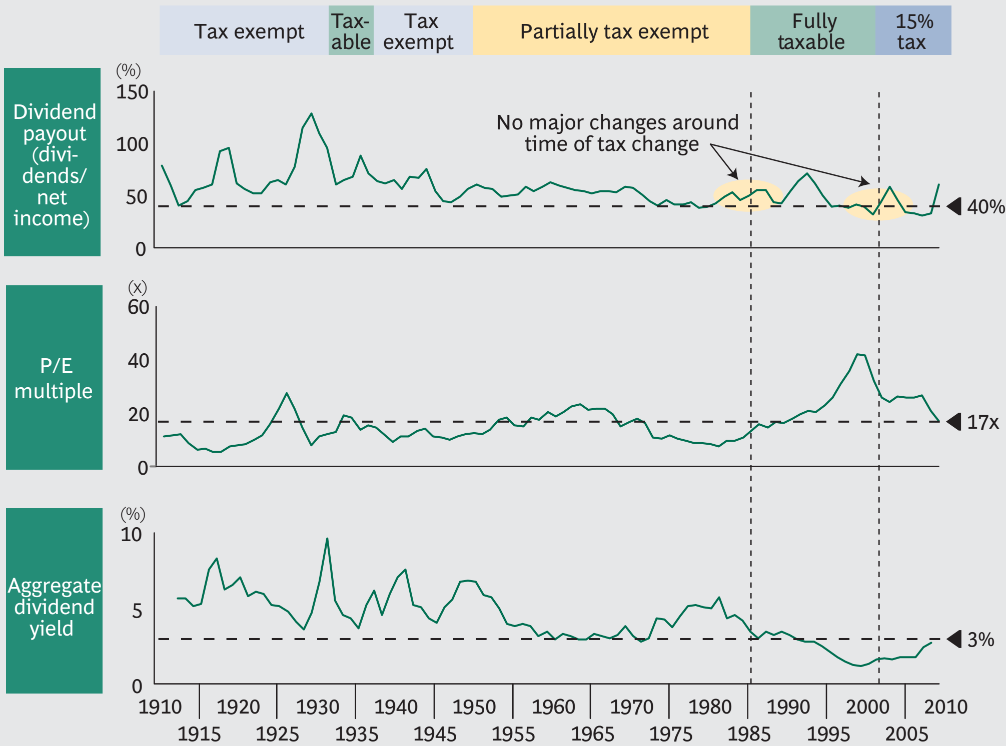
Numerous studies by analysts, policymakers, and academics suggest that changes in dividend tax rates have had only limited impact on equity valuation levels and payout ratios. Since the beginning of the twentieth century, U.S. tax policy on dividends paid to individuals has varied widely: During two distinct periods, dividends were fully tax-exempt. At other times, dividends have in turn been partially exempt, taxed at a flat rate of 15 percent, and fully taxable at marginal individual tax rates. Despite those gyrations, U.S. companies in the aggregate consistently paid out at least 40 percent—and usually more than 50 percent—of their net income as dividends. (See Exhibit 1.) When different eras of tax policy are plotted alongside contemporaneous aggregate stock-market performance data, it appears that the trend in dividend payouts is less related to dividend tax rates than to general economic and financial conditions—such as 1970s-era stagflation, fluctuations in the business cycle, and overall stock-market price-to-earnings (P/E) levels.

Tax-Indifferent Investors

Today's capital-markets environment is very different from that of the past: the widespread participation of investors in tax-deferred personal savings accounts and the rise of public-sector pension plans have changed how investors react to tax laws as they allocate capital and make investment decisions. We have reviewed public data on securities ownership and Internal Revenue Service data and conclude that 55 to 63 percent of the total value of U.S. equities is held in tax-exempt or tax-deferred accounts. While reliable data on historical trends are not available, the percentage of U.S. equity ownership held in tax-exempt or tax-deferred accounts is likely much higher today than even a decade ago.

Although tax rate differences may cause some taxable individual investors to shift out of dividend-paying stocks into capital gains-focused stocks, it does not necessarily follow that this investor migration is a one-way street or that it should affect how all companies develop their financial policies. Because a larger portion of equity investors are indifferent to tax rates, an arbitrage opportunity is created: dividend-paying corporations that are subject to a substantial selloff by their taxable investors (solely for tax reasons) will likely see

EXHIBIT 1 | Taxes Do Not Appear to Impact Dividend Payout



Sources: Compustat; BCG analysis.

their shares quickly purchased by tax-exempt or tax-deferred investors, potentially offsetting temporary valuation declines.

A Broad Preference for Dividends

When they decide how best to deploy their excess cash, corporations with a large portion of taxable or "retail" investors may worry that they must consider different factors than the typical corporation with primarily tax-deferred and tax-exempt investors. Many taxable investors, however, may actually prefer dividends over capital gains-producing share repurchases, despite the potential rise in tax rates on dividends relative to those on capital gains. Taxable individuals, after all, care about after-tax returns, not just tax rates. They also care about reliable streams of income, protection against inflation, and risk. Taking all these considerations into account, it is not clear that a cash payout policy that minimizes taxes for taxable investors would be desirable for many of those individuals.

- Taxable investors may still prefer the likely stronger internal capital-allocation discipline and lower risk that dividends promote. These investors may also seek a much more reliable (indeed, quasi-guaranteed) source of income than share repurchases. After all, even announced share repurchases are often put on hold or discontinued. In the words of one of the investors we interviewed, "Dividends are like marriage and buybacks are like dating, and I much prefer marriage in this environment."

- Taxable investors may require a source of income that also offers more inflation protection than bond payments. Moreover, the current low yields sharply diminish the attraction of debt securities as an alternative to dividend-paying equities. Indeed, in today's market there is a genuine "yield scarcity."

- Taxable investors who selected a specific stock as an attractive long-term investment may view a reduced dividend or failure to raise dividends as a signal of management's lack of confidence in the future. This signal could negatively impact the company's valuation.

A Long-Running Debate

The prospect of increased capital gains and dividend taxes is not a new development. For the past several years, there has been extensive debate over tax increases of all sorts—including those on dividends. In 2010, when the Bush tax cuts were due to expire, debate raged in Congress before the tax cuts were temporarily extended at the last moment. Increases in dividend and capital gains taxes were also topics of intense dispute during the 2012 U.S. election cycle. And the Obama administration has already presented Congress with a proposal for an updated tax policy that raises tax rates for many. As a result, many investors who would be negatively impacted by higher dividend tax rates have likely already adjusted their portfolios, and any downward pressure in pricing due to increased tax rates has likely already begun and may even be behind us.

Pretax-Returns-Based Fund Management

Taxable investors who choose to invest via mutual funds often find that the funds they invest in are not managed for tax efficiency. This is not only because fund managers are not taxed on their investment income, but also because they are evaluated based on pretax returns relative to their peers or benchmark indexes. Most mutual funds are not set up to track the changing tax mix of the individuals that move in or out of their fund—and even if they could, they couldn't anticipate how that tax mix might change or devise a sustainable after-tax investment strategy for an unknown future pool of investors. As a result, the vast majority of mutual funds focus on a pretax objective. While there are funds that specialize in tax-efficiency strategies for individuals and the tax-efficiency rating of most funds is widely available, the majority of fund managers do not consider managing tax efficiency to be fundamental to their investment strategy.

In recent interviews with institutional fund managers, BCG asked, "Will a change in dividend tax rates versus capital gains tax rates make a difference in your investment strategy and company selection decisions?" The answer was a resounding "no."

- A U.S.-based value-focused investment manager noted: "Companies that can sustain and grow dividends are going to be in demand no matter what happens to dividend taxes."

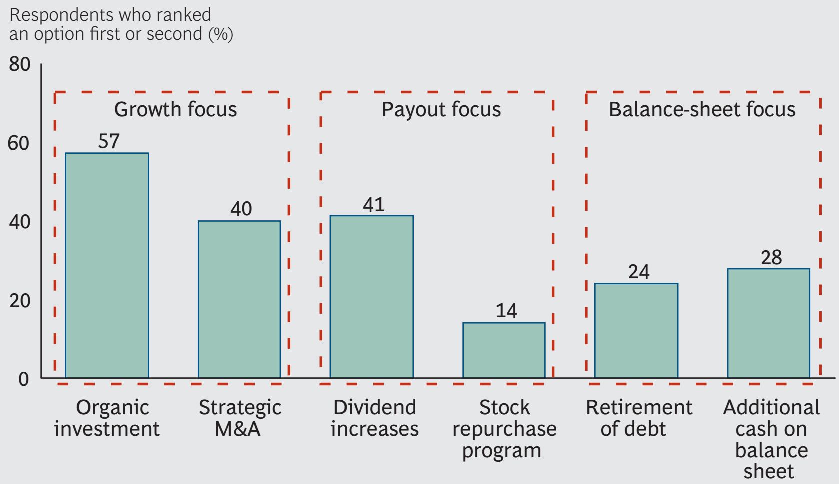
- A global GARP (growth at a reasonable price) focused equity investor told us: "I won't change how I invest because of the tax policy, and I don't think CEOs and CFOs should change their approach to dividends or share repurchases either."

- A U.S.-based equity income investor remarked: "The vast majority of investors are not going to change how they think about dividend-paying stocks if taxes increase. For the small portion of investors who will be impacted, there are plenty of yield-hungry investors ready to take those shares off their hands if they decide to sell."

These views were further reinforced in The BCG 2012 Investor Survey, in which 68 percent of respondents said that the expiration of the Bush tax cuts would have no impact or minimal impact on their views about companies' financial policies. Further, 41 percent of investors selected an increase in dividend payouts as their first or second choice among capital deployment options, preceded only by investing for organic growth. Only 14 percent of investors named increasing share repurchases as their first or second priority. (See Exhibit 2.)

Exhibit 2 | Dividends Are Still a Top Priority for Investors

How would you rank the following options based on your preference for the use of excess cash?



Source: The BCG 2012 Investor Survey, conducted in the first quarter of 2012.

The Likely Limited Impact of Tax Policy Changes

Over the past decade, BCG has observed an overall shift in fund managers' preferences for dividends over share repurchases during the course of more than 2,000 investor interviews conducted on behalf of our clients. The reasons for this shift are not related to the lower tax rates on dividends that resulted from the Bush tax-law changes.

Fund managers' views have changed in part because a surprisingly large number of share repurchases occur at peaks in stock prices, while a much smaller number occur at troughs in stock prices. That tendency has not gone unnoticed. In responding to BCG's 2012 investor survey, 69 percent of investors indicated that they felt companies they owned were doing a poor job of executing share repurchases. In addition, many investors appreciate the discipline that paying dividends represents for companies and view dividends as a commitment over the long term that is not easily reduced or stopped, unlike share repurchases. Fund managers also recognize that dividends can put a floor under a company's share price—when the P/E multiple declines, the dividend yield increases proportionately, drawing new buyers to the company's stock. Further, unlike in the period from 1982 through 2007, when U.S. fund managers' outlook for average market returns was roughly 10 percent, their outlook for the next three years is in the 6 to 7 percent range. In this type of low-return environment, a 3 percent dividend yield would account for close to half of a fund manager's target return, with very low risk. Thus, in a highly volatile, yield-scarce, and low-growth environment, many fund managers increasingly view companies with strong dividend yields as preferable to those that emphasize share repurchases as their primary method for paying out cash.

In all, there is strong evidence that the reinstatement of differential tax treatment of dividends and capital gains should not affect how the majority of fund managers prefer companies to return cash to investors. Rather, most fund managers want companies to manage their cash payout policies in a way that enables them to optimize their pretax, medium- to long-term total shareholder return.

Short of a major change in the tax treatment of retirement accounts or to the tax-exempt status of fund managers, we see nothing on the horizon that might cause investors to meaningfully change how they prefer companies to return cash to shareholders. As a result, potential changes to current capital gains and dividend tax rates should not affect capital deployment decisions for the vast majority of companies. Each company, however, should rigorously analyze its financial policies in light of its own unique circumstances and investor base.

About the Authors

Decker Walker is a principal in the Chicago office of The Boston Consulting Group and a core member of the Corporate Development practice. You may contact him by e-mail at walker.decker@bcg.com.

Jeff Kotzen is a senior partner and managing director in the firm's New York office and the global topic leader for Value Creation Strategy within the Corporate Development practice. You may contact him by e-mail at kotzen.jeffrey@bcg.com.

Eric Olsen is a senior advisor in BCG's Chicago office and a founding member of the firm's Value Creation Strategy topic within the Corporate Development practice. You may contact him by e-mail at olsen.eric@bcg.com.

Eric Wick is a partner and managing director in the firm's Chicago office and a core member of the Corporate Development practice. You may contact him by e-mail at wick.eric@bcg.com.

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