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Mounting Debts, Less Dividend Payouts? The More Loans Companies Have, The More Dividends They Pay

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ABSTRACT

It has been a long-held principle in corporate finance that a company's dividend payments must come from its net profits. Also, that the dividends paid to a company's shareholders, whether holders of common or preferred stock, are entitled to some of those net profits in the form of dividends as a reward for investing and the risk involved. These concepts have been used in countless textbooks dealing with finance, accounting, and investments and has served as a basis for investors to purchase common or preferred stock throughout the decades. A company's performance is often measured by how much dividends have increased over the years and whether it is a good long-term investment for individual investors, pension funds, mutual funds, and hedge funds. However, in recent years, the trend is changing in that corporations issuing common or preferred stock are paying dividends, not based on the amount of net profits they have made but based on the amount of financial capital that can be borrowed. A corporation may not necessarily make shareholders aware of this tactic as long as it adheres to its long-stated dividend policy and that they are receiving regular dividend payments whether they are increasing over time or remaining the same. The corporation could, in theory, maintain this method of paying dividends as long as the shareholders are satisfied and content with their cashflow from their equity investment in the company. But, in the long run, the corporation may actually be misleading shareholders as well as damaging the company's financial situation by overextending itself with too much debt.

Keywords: Common stock, Covid-19, Debt, Dividends, Pandemic, Preferred stock, Standard & Poor's 500 Index (S&P 500)

INTRODUCTION

In most investment classes, the financial text books that are used often teach that if a company's debt is going up dramatically, it might be in a struggling financial position, and that cutting all possible expenses sounds logical and fiscally prudent. In the year 2020, the Covid-19 pandemic has swept across the globe resulting in millions of people having died from the coronavirus. Most of

the countries around the world have been under travel restriction or quarantine, and as a result, businesses and economies around the globe have been hit hard. Over the first two quarters of 2020, we have witnessed that the total liabilities of most large companies listed on stock exchanges in the United States have surged because of economic downturn.

By using logical thinking, one will not be surprised that there are many companies reducing or suspending their dividends. However, so far until now, there are in total only 37 out of 414 (excluding 91 companies which never pay dividends, such as Facebook) large-cap companies that are listed in the Standard & Poor's 500 Index (S&P 500) that have suspended or reduced their dividends. Meanwhile, we find this number of companies reducing or suspending dividends is actually decreasing despite the fact that Covid-19 has not yet been cured, vaccines are still under trial, and the global economy continues to struggle as the fall and winter seasons could highly possibly bring a second Covid-19 wave. If you are an investor or fund manager who seeks stable quarterly dividend cash flows or even wants to obtain more dividend payouts from companies under this kind of economic circumstance, or think that an increase in debt obligations can lead to dividends falling in most scenarios, then the aim and purpose of this article is to prove why this long-held logical thinking of mounting debts will result in less dividends is wrong.

METHOD

Based on our quantitative research, we find that a large number of companies listed in the S&P 500 Index have highly positively correlation between total liabilities and dividends. This means that mounting debts bring more dividend payouts in most case scenarios.

We have taken out a correlation coefficient test over 7 years, from 2013 to 2020, between total debts and dividends from 41 randomly chosen large companies. These companies cover various industries, but excluding 37 companies which have suspended or reduced their dividends in 2020 (the test result is shown in the third paragraph) and 91 companies which have never paid dividends. According to Figure 1, only 2 out of 41 companies show a negative relationship between dividends and total liabilities. Thirty companies reflect a highly positive correlation (correlation coefficient results are from 0.5 to 1) between the two factors, while only one company has a highly negative correlation (correlation coefficient results are from -0.5 to -1) between them. Some firms, as seen in Figure 2, such as American Tower Corporation clearly demonstrate that their dividends rise while so do their liabilities. Figure 3 illustrates that AT&T Inc. changes in its dividend payouts closely correlates according to its total liabilities. A similar situation happens to UnitedHealth Group, Inc. as seen in Figure 4.

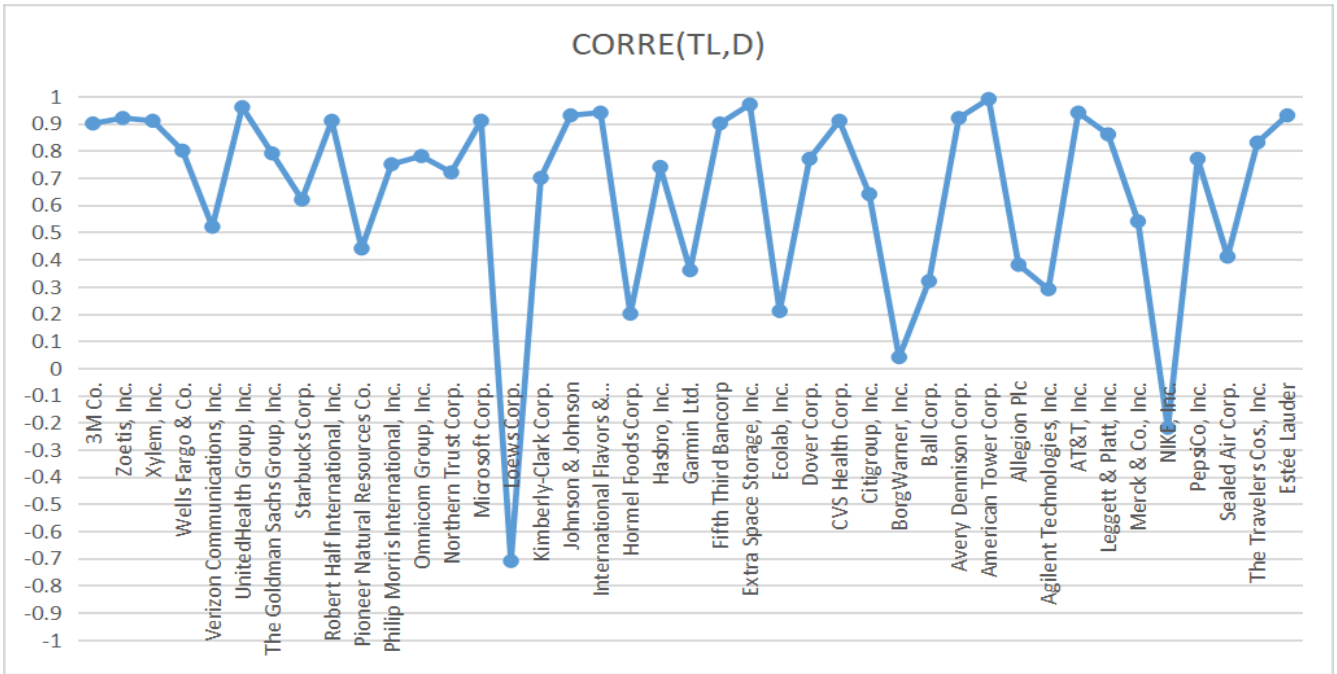

Figure 1: Correlation coefficient test result between total liabilities and dividends

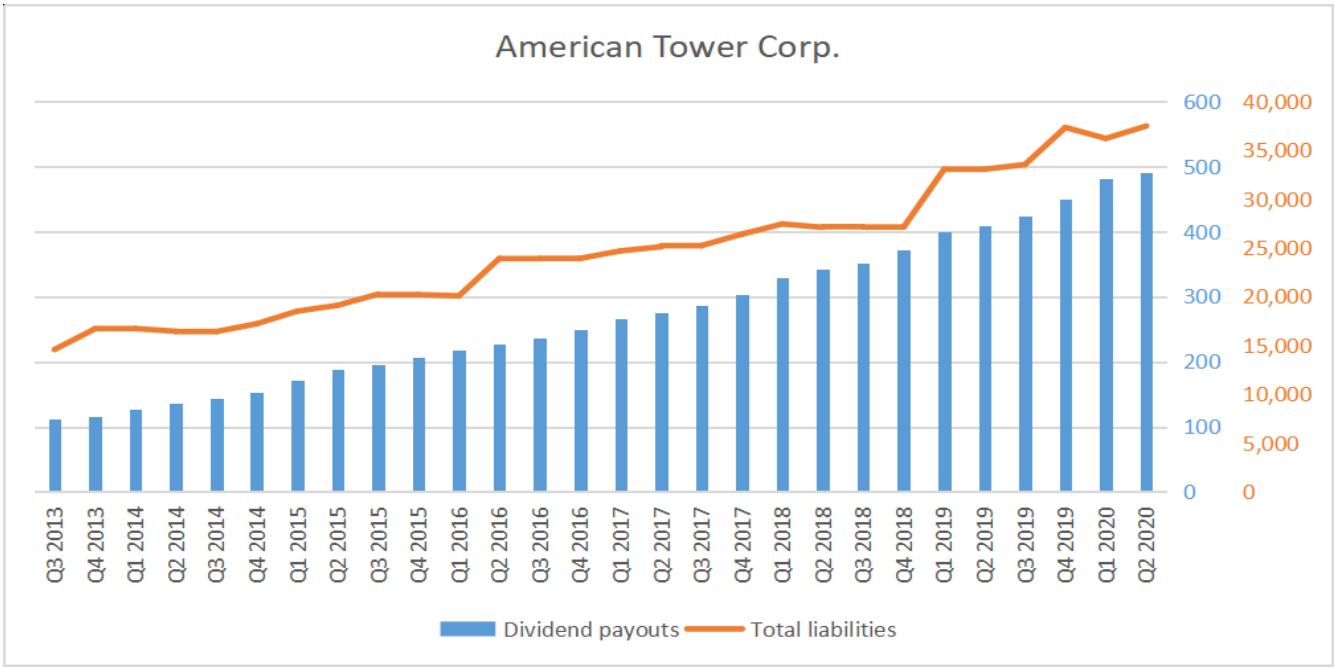

Figure 2: Dividend payouts and Total liabilities of American Tower Corp. from the third quarter of 2013 to the second quarter of 2020, all figures in Y Axis are in millions

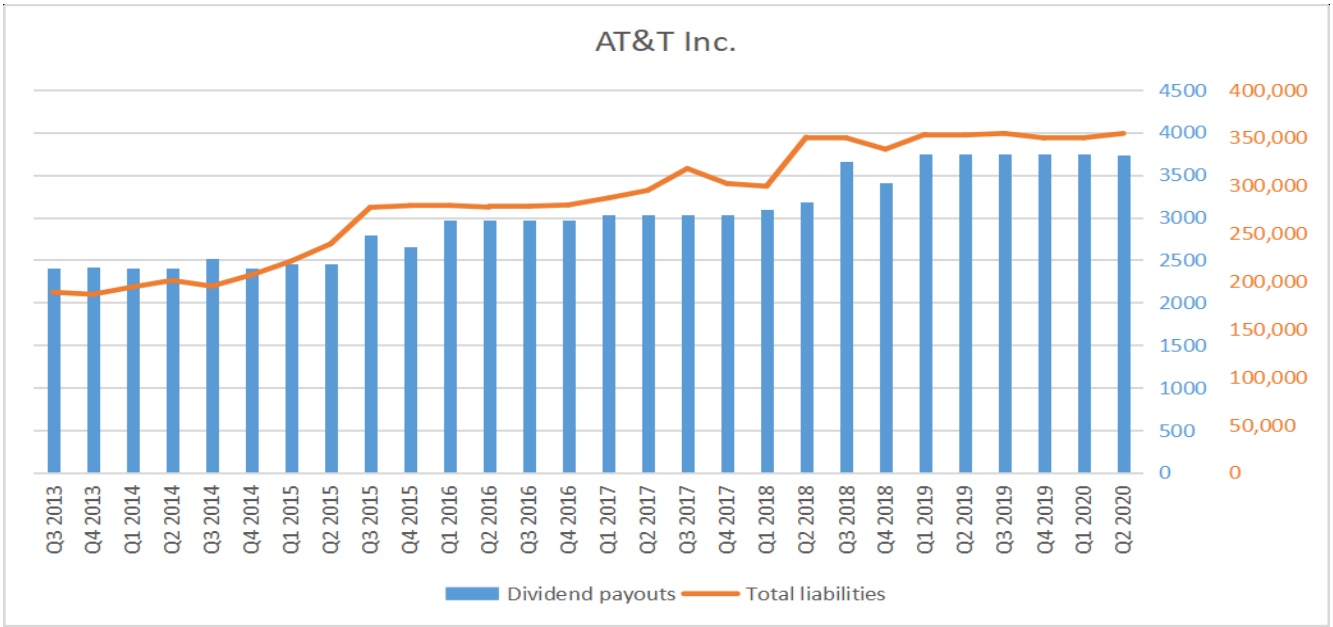

Figure 3: Dividend payouts and Total liabilities of AT&T Inc. from the third quarter of 2013 to the second quarter of 2020, all figures in Y Axis are in millions

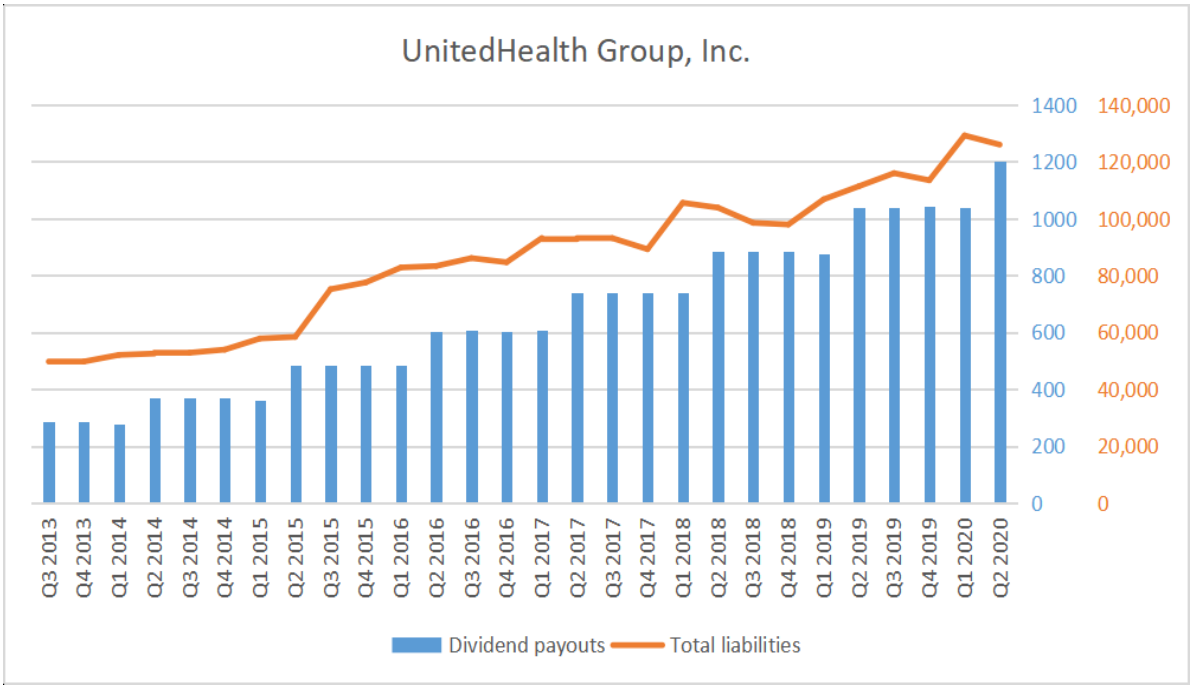

Figure 4: Dividend payouts and Total liabilities of UnitedHealth Group, Inc. from the third quarter of 2013 to the second quarter of 2020, all figures in Y Axis are in millions

As we mentioned in the beginning, there are 37 companies which have suspended or reduced their dividends over the first two quarters in 2020. The relevance between those companies' dividend payouts and liabilities draws our attention to implement correlation coefficient tests, also. We might guess that among these 37 companies, they must have more negative reliance of the two factors, because they have reduced or suspended their dividends when the debts are increasing. However, we find that there are 8 more positive correlations than negative ones, and 2 more highly

positively correlated ones than highly negative ones (see Figure 5). This test result interprets two facts: First, there does exist some companies which pay less dividends because of increasingly issuing debts, such as American Airlines and Nordstrom. However, compared to most of the firms in the S&P 500 Index, they are not mainstream. Secondly, there are still far more companies who pay dividends that highly correlated to how much debt they are issuing, even among those 37 companies, such as National Oilwell Varco and Marathon Oil. According to Figure 6, over the years, National Oilwell Varco tried to reduce its liabilities, and its dividend payouts dropped accordingly.

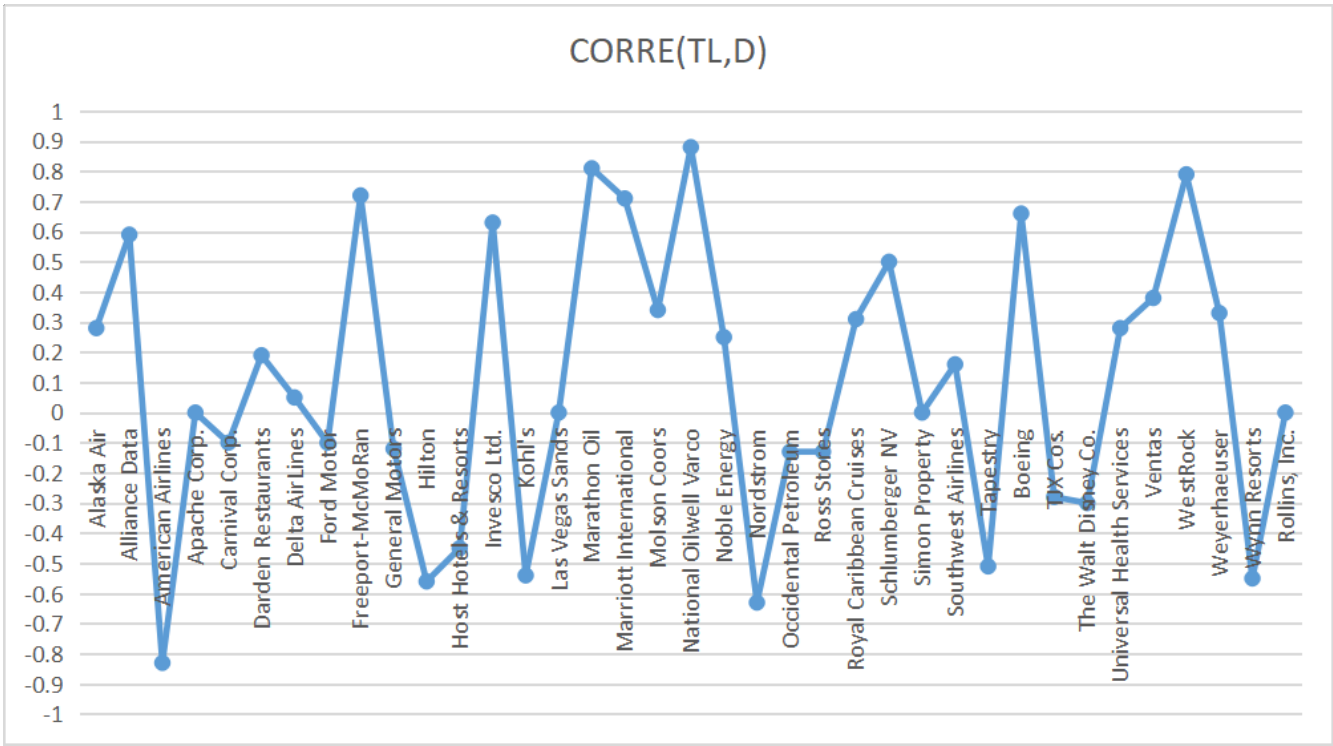

Figure 5: Correlation coefficient test result between total liabilities and dividends

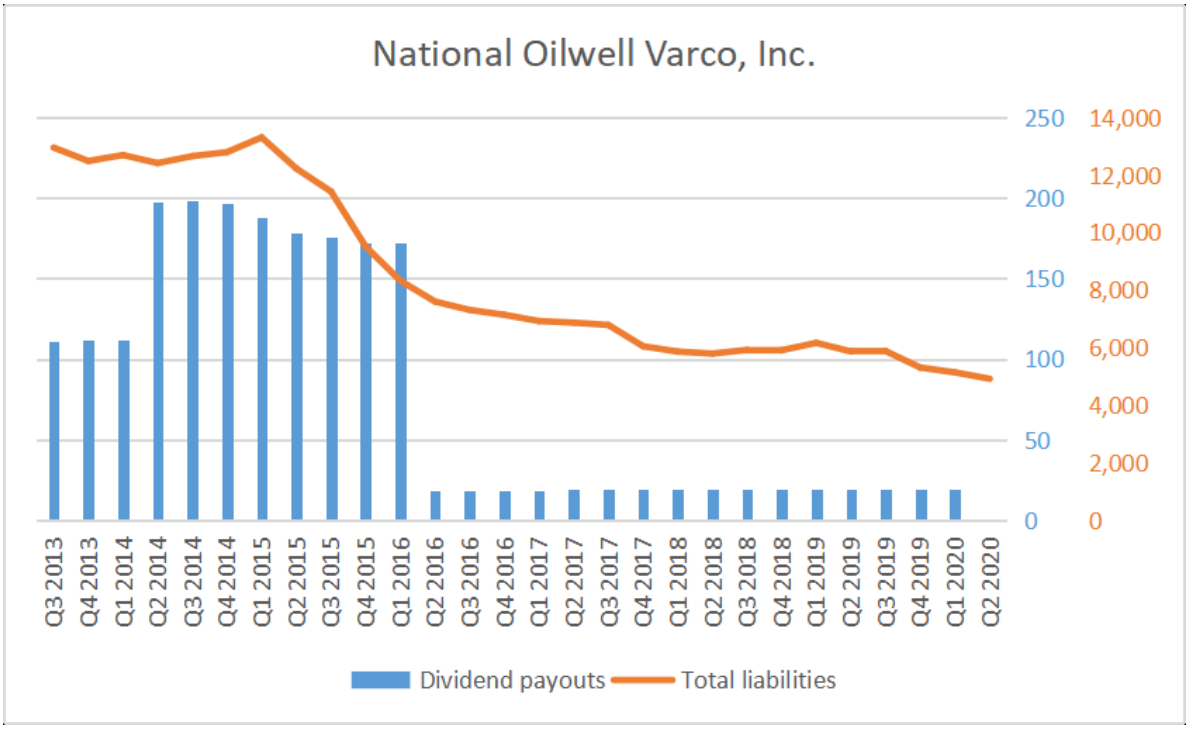

Figure 6: Dividend payouts and Total liabilities of National Oilwell Varco, Inc. from the third quarter of 2013 to the second quarter of 2020, all figures in Y Axis are in millions

DISCUSSION

Different companies may have different strategies towards their debt management, thus impacting their dividend payouts. From our research, we observed that some companies are trying to decrease their debts over the years, while a majority are actually increasing issuing debt over time. Debt can be an important financial tool for a large or small business that can help it expand its operations in the long-term and keep it functioning in the short-term. Debt, whether it is in the form of mortgages, notes, bonds or money market instruments, can be regarded as playing an integral role in a company's financial situation as an alternative source of capital. But like any other financial instruments, debt has its advantages and disadvantages.

Among the advantages of debt is that the interest is tax deductible to the issuing firm.

The interest that a borrowing firm must pay back as part of the loan obligation is a tax write-off. The business may deduct that interest from its operating income, which for many is regarded as an incentive and huge benefit in borrowing for expansion and growth. These businesses, especially those in the growth stage or that need cash to help it through a down period, could use that tax deduction as a key benefit. Without this tax deduction, many businesses would not be able to survive. While there is controversy that governmental involvement in business should be minimal or eliminated altogether, the tax deduction of interest on a debt obligation is perhaps one of the best ways for a firm to survive or grow.

Another key benefit of issuing debt is that it allows a publicly or even privately-owned corporation to retain control over its operations.

Corporations could issue new common stock to existing or new shareholders in order to raise more financial capital, whether it is for expansion or shore up its cash needs. But the risk in this case is

that the new shares of common stock could be purchased by one or two parties whose ultimate goal is to take over the company, whether by a friendly or hostile takeover. This could create a serious divide among the shareholders as to whether they should back the existing management team and help them retain control of the company, or go with the new shareholders who could offer a high premium for the outstanding shares.

The problem here is that substantial amounts of money, such as increased amounts of debt, fees for investment bankers, attorneys, and financial consultants, could be wasted rather than helping to grow the corporation. The parties initiating the hostile takeover could be doing everything they can to artificially raise the market price of the common stock even if it means diverting financial capital away from the corporation's future. Debt allows the managers to retain control over the firm and keep to the long-term strategic plan management may have enacted some time earlier. Debt issuance also allows for a company not to dilute its share value and help the existing shareholders maintain their investment at a price that actually reflects the true worth of the common stock.

Issuing debt also has a mixed advantage for a corporation in being able to experience increased earnings per share over time.

Rather than a company issuing new shares of common stock in order to raise financial capital, it could borrow money and maintain the number of shares outstanding. As stated previously, not only would this prevent dilution of the shares outstanding, but possibly maintain a steady market price for the common stock. But this also means that even if the net earnings remain stable or increase, and the shares outstanding either stay the same or decrease, then the earnings per share could see an increase over time. If the company is publicly traded, then the stock market could possibly reward the company with a higher market price. Also, stock analysts and dealers could regard this as a positive sign for the firm's long-term growth in the market price. The issuance of more debt could actually help increase the stock's market price in the long run by avoiding the possibility of selling too many shares to the buying public and actually driving the stock price down.

Issuing debt could also be regarded as a cheaper method of raising financial capital as opposed to common stock.

With issuing common stock there are various fees involved such as for investment bankers, accountants, attorneys, financial consultants, auditors and audit fees, and any fees that must be paid to the stock exchange that will list the issuing company's shares. This is considered as part of the floatation cost that a company must incur when going public. There is also the risk that the stock issue may need to be withdrawn if the stock market or the nation's macroeconomy takes a downward spiral. Also, the dividends that the company plans on eventually paying on the issued stock is not tax deductible and should, ideally, only come from any net profits the company makes. And, if there are no profits, then, generally, there are no dividends. But, as stated earlier, interest is tax deductible to the borrowing firm and, in essence, there is a lower after-tax cost of issuing debt for the company. If market interest rates are low and due to the firm's credit and bond rating, then the issuance cost of debt for the corporation is even lower as compared to common stock.

A key disadvantage of debt is that a business may over extend itself in the long-term.
*T*he problem is that a firm may take on too much debt and eventually face the possibility of bankruptcy or liquidation. Even if a company is able to avoid bankruptcy, too much debt could hurt its credit rating and raise the interest rate on any new loans. Too much debt could also reduce, suspend, or eliminate dividends payable to common and preferred stockholders. But the key problem with too much debt is that a business may find itself in a financial abyss for a long time.

In essence, debt can allow a company to achieve various goals and help keep its costs for acquiring capital down.
If certain factors align themselves properly, then a business can see itself expand beyond its own expectations.

CONCLUSION

In an economic downturn year, such as 2020, most nations are trying their best to save their economy by quantitative easing, implementing almost 0 percent interest rate, as well as issuing various stimulus packages to enterprises and businesses, both large and small. Investors or fund managers who seek for quarterly dividend payouts that have experienced suspended or reduced dividends should adjust their investment strategies, therefore, to be financially stable or to achieve a higher return.

Our suggestion to investors is as follows: Look for companies whose dividend payouts are more predictable. For instance, seek companies whose dividends are highly correlated to some inter-related factors such as total liabilities and gross profits.
In our research, we also found that dividends are more correlated to gross profits rather than net income which we will address in another article. However, sometimes it is harder to predict companies' gross profits than total liabilities. Therefore, at this stage, while America's economy is still not clear, and under aggressive financial aid programs, we suggest that investors who seek dividends look for the companies whose dividend payouts have higher reliance on total liabilities and the financial strategy of these companies is that total debt is increasing rather than decreasing over the years, for example, companies such as Microsoft Corp., Johnson & Johnson, and International Flavors & Fragrances, Inc.