

Editorial: Of low dividend yields and high interest rates

A cursory look at current market data suggests an apparent paradox that hasn't escaped the financial press: the dividend yield of many exchange-traded corporations is significantly below the yield-to-maturity on government bonds, even before taxes. For instance, at the end of July, the following yields were reported in the press:

Bankgesellschaft I	3.9%
Bank Vontobel I	2.4
Hilti P	3.4
Ciba-Geigy N	2.0
Sandoz N	1.2
Merkur I	2.1
Ascom I	3.8
Nestlé N	2.3
Feldschlösschen I	1.7
Sulzer N	2.3
BBC N	2.2

At the same time, the yields-to-maturity on fixed-income securities were:

Government bonds	7.02%
Domestic Swiss franc bonds	7.18
Fixed-rate notes (3-year maturity)	7.50
Fixed-rate notes (8-year maturity)	7.00

The seemingly inescapable conclusion from these numbers is that equity capital is much cheaper than debt. Take Sandoz. The annual cash payments to holders of registered (N) stock are 1.2% per franc of equity, whereas they would probably exceed 7%

per franc of long-term debt. Under these circumstances, it seems obvious to wonder why firms would raise funds by issuing debt when it costs much less to use internally generated funds or to issue new equity.

Granted, dividend payments are not tax-deductible and interest payments are. But even allowing for a generous tax deduction, the cash outlay per franc of funds employed appears to be much smaller for equity. Some financial analysts have even suggested issuing equity capital and investing the proceeds in high-grade fixed-income securities. Taking this tack of borrowing low and investing high would seem to be extremely profitable. Nestlé, for instance, would pay 2.3% and earn a cool 7.5% before taxes just by buying fixed-rate notes from a major bank. Why care about Perrier when you can make a bundle without any risk by placing a few phone calls? Why aren't firms jumping at this opportunity? And why are investors so foolish as to leave their money in stocks rather than switching it into fixed-income securities?

Clearly, there is something wrong with the argument. Just take it to the extreme, where the cost of equity is zero for firms that pay no dividends. Few people would seriously suggest that Oerlikon Bühler should get out of shoe manufacturing and into financial intermediation. But proving that the argument is wrong is no trivial task. The bottom line is that it fails to take into account how market participants value the cash flows promised by financial securities.

The argument fails to recognize that the dividend yield is not the only return to shareholders. Shareholders also expect a capital gain. Ignoring risk and taxes for simplicity, they require the same return from holding debt as from holding equity, say 7%. Consequently, if dividend yields are about 2-3% while the returns on debt are 7%, shareholders must expect a capital gain of 4-5%. Otherwise, no one would hold stock. All right, you will say, this explains why investors do not switch to fixed-income securities, but what has that to do with the costs of financing? The only relevant financing cost to firms is the cash they have to lay on the table to pay for the money they use. So why should they care about investors' capital-gains expectations? How can investors' expected capital gains be a cash drain on the firm?

To see the fallacy in this retort, suppose a firm needs Fr. 1 million for the very long term, say forever. That money can be raised either by issuing long-term debt (and rolling it over when it comes due) or by using internally generated funds (or issuing common stock). What would be the periodic, end-of-year interest payments if the firm chose to sell 7% debt? An issue at par would imply annual interest payments of Fr 70'000. By comparison, what would be the periodic, end-of-year dividend outlays on equity capital? If a 3% dividend yield were maintained, dividend payments would total Fr 30'000. So, direct outlays would indeed seem to be lower with equity than with debt financing. The problem is that current dividend payments are not the only cash outflows the firm incurs with equity financing. The firm is committed to future dividends as well. And while in our example the value of future interest payments is constant (Fr 70'000 every year), the value of future dividends increases. If investors expect a 4% capital gain, the stock price at the end of the period is expected to be 4% higher. And since stock prices represent the capitalized value of future dividends, this means the market expects the value of all remaining future dividends, i.e., the future outlays to stockholders, to be 4% higher at the end of the period than it is now. Consequently, the all-in costs of equity financing

are Fr 30'000 of direct dividend payments plus a year-end "invoice" of Fr 40'000 to provide for higher future dividends, for a total of Fr 70'000, just as with debt financing.

You might argue that investors' expectations are in the minds of investors, rather than commitments the firm has made. But this reply also ignores basic principles of valuation. Although it's true that the firm has not entered into any commitments, investors' expectations are what determines the current value of the stock. If the firm does not live up to those expectations, share prices will fall. To illustrate, suppose that in one year, having issued new stock, managers decide to keep dividends unchanged to lower their costs of capital. Suppose they announce that dividends will remain constant from then on. What will happen? Market participants will realize they made a mistake in anticipating higher dividends and will lower their estimates of stock value, share prices will fall, and the dividend yield will increase to 7%, the return necessary in our example to convince anyone to hold a stock with no dividend growth. And the irony is that the amount of money the firm will have to put on the table will now be exactly 7%.

As it turns out, regardless of what the firm does, its cost of equity is 7%. If the firm meets investors' expectations of higher dividends, the cost will be 3% in the form of current dividends and 4% in the form of a "bill" for higher future dividends. If it does not meet those expectations, its cost of equity will be 7% in the form of a higher dividend yield and lower dividend growth. Of course, by failing to increase dividends as expected the firm will have fooled the buyers of any equity it may have issued. But you can fool investors only once.

In sum, dividend yields cannot be chosen arbitrarily. It is therefore wrong to argue about them as if firms had them fully under their control. The only thing a firm can choose as it likes is the current dividend per share. The denominator in the dividend-yield definition, i.e., the share price, cannot be chosen equally freely, since it is set by the market on the basis of the future dividend payments the firm is expected to make with its investment (and

liquidation) program. Thus it is the market that decides how much of a given cost of equity it is willing to take as current dividends and how much it is willing to take as higher future dividends. The cost of equity for any firm is set by the market and, abstracting risk and tax considerations, it equals the cost of debt financing.