

# Dividend Policy

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### THE WESTERN COMPANY

#### Directed

Tina Clark, Chief Financial Officer of The Western Company, an electric utility holding company, recently hired your consulting firm to study Western's dividend policy. Western owns two utility companies plus Western Enterprises, Inc. (WEI), whose main business is building and operating generating plants in conjunction with large industrial companies. Western's utility subsidiaries are regulated by the public utility commissions of their respective states. Although its operations are not subject to regulation, WEI faces intense business competition.

Western's executives have been debating dividend policy, but no consensus has emerged. Like most utilities, Western pays a relatively high percentage of its earnings out as dividends. Some executives think the high payout should be continued, because stockholders seem to prefer this policy. However, others disagree, pointing out that deregulation and the breakdown of the utility industry's monopoly structure is leading to increased competition, and in this new environment a lower payout ratio is appropriate.

Tina sees merits in both positions. Surveys of Western's stockholders show a strong preference for dividends—they want the company to maintain if not increase the payout ratio. If the dividend were cut, a number of stockholders would be forced to sell their stock and switch to another stock with a higher payout, and those sales would depress Western's stock price. On the other hand, Western is facing increased competition, most competitive firms have payout ratios that are less than half that of Western, and Tina thinks Western should generate more capital internally and use it to reduce debt.

Currently, Western is still the sole supplier of power in its service area to all except a few industrial firms. Moreover, Western is relatively efficient, and its low costs will help it ward off competition. Still, it does have some plants that are relatively inefficient, and the possibility exists for some new producer to move in and take away business.

One executive who advocates a high payout sent Tina Table 1, along with some news clippings describing recent dividend actions taken by companies and groups of companies. Industrial companies typically pay out about 40 percent of earnings, though the ratio rises in recessionary years when dividends are maintained even though earnings decline. Telephone companies, which are about 10 years ahead of the electrics in terms of exposure to competition, have reduced their target payout ratios as competition has increased.

Tina had employed an intern from the local university during the fall, and the intern produced a report on utilities' dividend policy. Here are her conclusions:

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1. Until the 1970s, utilities provided safe, dependable dividends. Their stocks were called “widow and orphan stocks” and were bought by retirees and others seeking safe cash income. Utilities were growing more rapidly than most other companies, but they could finance growth by issuing stocks and bonds.<sup>1</sup> This led them to pay high dividends and thus to attract stockholder clienteles who wanted high dividends.
2. The situation changed during the 1970s. Inflation accelerated, driving up utilities’ costs, but regulators, under intense political pressure, did not allow adequate cost pass-throughs. This eroded profits and stock prices.
3. Many utilities recognized that their payout ratios were too high, but they felt compelled to maintain or even increase their dividends. Partially completed plants were in the pipeline, and capital was needed to finish those plants. Debt was being used to the max, and equity was required to support the rising debt. Most companies discussed with their investment bankers the pros and cons of obtaining equity by cutting dividends versus issuing new stock. The investment bankers argued as follows:
  - a. A dividend cut would lower the stock price, increase the number of shares needed to raise a given amount of money, and thus lead to a dilution of future earnings. Those lower earnings would lead to still lower stock prices, and a downward spiral could set in. The fear of this spiral kept utilities from cutting their dividends.
  - b. The amount of new equity generated by cutting dividends would not be adequate to meet the company’s needs, so new stock would still have to be issued. Selling stock after a dividend cut is especially difficult and expensive.
  - c. Investors expected annual dividend increases, and a failure to meet those expectations would lead to disappointment and a lower stock price. However, if the dividend were increased, this would benefit the stock price and make it easier to issue stock. Some Western executives noted that the investment bankers’ recommendations were self-serving, because the higher the payout, the more stock companies would have to sell, hence the more the bankers would earn. Nevertheless, Western followed the bankers’ advice and kept its payout ratio high.
4. The typical utility entered the 1990s with a payout ratio which exceeded that of most competitive companies, even as utility competition increased. Many utility executives wanted to better align their financial policies with the new market realities, but they were afraid of what might happen to stock prices if they cut the dividend or even increased it by less than investors expected.
5. The telephone companies had experienced similar developments, but about 10 years earlier. Table 1 shows that telco payout ratios have been declining in recent years, and that decline is continuing and will probably accelerate.

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<sup>1</sup>A major drawback to issuing stock is the fact that the announcement of a stock offering is generally taken by investors to be a negative signal regarding management’s outlook for the future. If future prospects looked brighter to management than to investors, hence the stock was in management’s view undervalued, then the company would want to finance with debt rather than stock so as to avoid unnecessary dilution. On the other hand, if management was more pessimistic than the average investor, it would regard the stock as being overvalued, and in this situation existing stockholders would be better off financing with stock than with debt. Investors know that this is the way management can be expected to act, so the announcement of a stock offering is taken by investors as a negative signal, hence stock prices tend to decline when stock offerings are announced.

The strength of the effects of a stock offering announcement depends on the extent of information asymmetry between management and investors. If investors know a great deal about a company and its operations, then the announcement (and the reasons for it) will have been anticipated, and there will be relatively little pressure on the stock price. Because of regulation, investors know more about utilities than about most other companies, so the price pressure when utilities issue stock is relatively small. Therefore, other things held constant, utilities are better able to provide stockholders with cash dividends and then raise equity by issuing stock.

6. A number of utilities reduced or omitted their dividends in recent years, but all the cuts were by companies that had taken write-offs associated with high-cost nuclear plants or had severe operating problems. Thus, dividend reductions resulted from earnings reductions, and dividend cuts always led to large stock price declines. Note, though, that it was not clear if the stock price declines were caused by the dividend cuts or the operating problems—the “effect” of a stock price decline might be “caused” by either operating problems or by lower dividends. Still, utilities never cut their dividends except under extreme circumstances.
7. However, on May 9, 1994, FPL Group, the holding company which owns Florida Power & Light, dropped a bombshell on the financial community—it reduced its annual dividend by 32 percent, from \$2.48 to \$1.68 per share. In its announcement, FPL stressed that it had studied the situation carefully and had concluded that maintaining a high payout rate (over 90%) in an increasingly competitive environment was not in shareholders’ best interests. The company needed flexibility to deal with the volatile competitive environment, and trying to maintain a dividend as high as it was then paying would not provide much flexibility. FPL knew that a dividend reduction would probably be viewed as a negative signal by stockholders, at least initially, so management tried to ease the blow by simultaneously announcing (1) that the cut was motivated by a desire to establish a more fundamentally sound financial position, not by financial difficulties, (2) that a major stock repurchase program would be undertaken, and (3) that the actions taken would lead to accelerated growth in earnings and dividends.

It is worth noting that, in the 1980s and under a former management team, FPL decided to diversify into a number of unregulated businesses that had nothing to do with its core electricity business. Pursuant to its diversification program, FPL acquired a major insurance company, a cable TV company, a citrus-growing company, an information services company, a real estate development company, and a company which builds power plants for others. This diversification effort was not successful, and by 1995 most of the non-energy businesses had been disposed of at a loss of almost \$1 billion, which lowered the company’s earnings base, hence its earnings per share. Since it had continued to increase the dividend annually, even though earnings were depressed by the write-offs, FPL’s payout ratio had climbed to over 90 percent.

Prior to the dividend announcement, FPL’s management had dropped hints that it might reduce the dividend, but the hints had been picked up by few analysts. However, on May 5, four days before the company’s announcement, Merrill Lynch’s utility analyst did release a report stating that FPL might cut the dividend, and the stock fell by \$2 (5.9%) that day. Here are some data related to the cut:

- April 29, 1994 closing price: \$35.375.
- May 5 Merrill Lynch suggests that the dividend might be cut. The stock price declined by \$2.
- May 9 FPL announces a 32 percent dividend reduction, a new target payout ratio of 60 to 65 percent, and a large stock repurchase program.  
Management also suggested that the dividend would grow faster in the future and that capital gains would replace some of the old dividend yield. Still, the announcement led to another drop of \$4.375 (13.7%), to \$27.50, down 22.3 percent in just 10 days.  
Investor reactions were initially negative. Here is a typical comment: “The company should have warned us this was coming. I bought the stock expecting to receive a good dividend, and for them to cut it even though the cash is available is just not fair.”

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- Analysts' recommendations on FPL:

	On April 29, 1994 (10 days prior)	On June 29, 1994 (2 months after)	On April 29, 1995 (1 year after)	
Number recommending each action:				
Buy		3	15	21
Hold		28	18	10
Sell		2	0	0
Buy as % of total:		9%	45%	68%
- FPL's stock price has mirrored the trend in analysts' recommendations:

	FPL	Average Utility	FPL Price/Avg. Util. Price
December 1993	\$36	\$36	100%
May 9, 1994	27	32	84
December 1994	35	31	113
December 1995	46	38	121

Thus, FPL's stock dropped relative to the industry average from the end of 1993 until just after the dividend cut, but its performance was significantly better than that of the average electric after the cut.

- Even though FPL's payout ratio hit 91 percent in 1993, projections at the time indicated that the payout would decline to the industry average (79%) by 1998 or 1999 if the company (1) held the dividend growth rate to 1 percent per year and (2) experienced its then-projected earnings growth rate. However, it would have taken well into the 21st Century to "grow into" the target payout of 60 to 65 percent.
- After FPL reduced its dividend and experienced its stock price bounce-back, security analysts expected several other large, healthy utilities to follow FPL's lead and reduce their dividends. However, more than a year later, none had done so. There are rumors that several companies' managements wanted to reduce their dividends, but their boards of directors had vetoed their plans.
- Table 1 provides some information on dividend policy among electrics, telephone, and industrial companies. Two points are worth noting: (1) The utilities have historically had high payout ratios relative to unregulated, competitive firms, and (2) the telephone companies, which in recent years have been subjected to competition much like that the electrics are now facing, have been lowering their payout ratios.
- Table 2 gives selected financial information on Western. Note that Western's payout is about equal to the industry average. It is well below that of FPL at the time FPL cut its dividend, but it is well above the level FPL achieved after its cut. It is not shown in the table, but Western's payout will remain above 75 percent on into the foreseeable future if its earnings and dividends grow at their predicted rates, because earnings and dividends are projected to grow at the same rate.
- Table 3 gives some information on who currently owns Western's stock plus relevant results from questionnaires which Western sent to its stockholders in 1985 and 1995.
- Table 4 provides information on Western's earnings, cash flows, capital expenditures, and dividends from 1990 through 1995, with projected data from 1996 through 2000. The projected data were calculated with a spreadsheet model. The projections are obviously subject to a lot of uncertainty, because new investment opportunities could appear, projects that currently appear promising could be reappraised downward, profits could be higher or lower than forecasted, and so on. Indeed, the increasingly competitive environment makes the forecasts of both profits and investment opportunities far less certain than was true in the past. Assume that Western's weighted average cost of capital (WACC) for evaluating

average-risk capital expenditures is currently estimated to be 10 percent. That figure is based on the use of retained earnings; it would be somewhat higher if it were necessary to issue new common stock. Obviously, though, the WACC could change over the next 5 years, and it would be higher if the company were required to raise a substantial amount of new equity by issuing stock. (Some stock will be sold through the firm's dividend reinvestment plan and issued to employees through Western's stock purchase plan. Those funds were taken into account in the 10 percent WACC estimate.)

The data on capital expenditures for the period 1996-2000 as shown in Table 4 represents the financial staff's estimate at this time of the dollar amounts of projects that will have positive risk-adjusted NPVs, assuming a corporate WACC of 10 percent.

14. Table 5 gives data on price/earnings ratios, market/book ratios, returns on equity, and other financial information for Western, FPL, the S&P electric utilities, and the S&P 400 industrial companies. This material might be useful when considering Western's dividend policy.
15. FPL stated that it was replacing some of its cash dividends with stock repurchases, and it gave two reasons for this action: (1) The company would have more flexibility as to when and if it carried out the repurchase program versus payment of cash dividends. If funds were needed internally, or if cash flows were reduced for any reason, the repurchases could be delayed. Cash dividends, on the other hand, cannot be omitted or reduced without causing serious upset. FPL reasoned that one reduction was bad enough, but going into an increasingly competitive environment with a high payout ratio could lead to frequent dividend reductions unless the payout ratio was lowered significantly. (2) Stockholders who pay taxes would be better off having the company distribute excess cash through repurchases rather than through cash dividends.

After reviewing the information in the intern's report, Tina was not sure what step to take next. She could see some merit in following FPL's lead and lowering the payout ratio down toward the range competitive, unregulated companies generally use. However, she knew that Western's board was proud of the fact that the company had never reduced the dividend over its entire life. She also knew (from Table 3 as well as from discussions with and letters from stockholders) that stockholders would be upset if the dividend were cut. Indeed, Tina's own mother had invested a high percentage of her retirement savings in Western's stock, and she needed the quarterly dividend check. If that check were reduced, it would create a real financial hardship for her.

At that point, Tina decided to ask your consulting firm to help her analyze the situation and to decide what recommendation to make to the board. The choice, really, seemed to be either to maintain the current dividend of \$1.18 per share, to increase the dividend by a relatively small percentage such as 2 percent, or to cut it as FPL had done. At any rate, your task is to study the situation and help Tina decide what to recommend to the board. She wants you to prepare a report discussing all the issues, and, possibly, to make a presentation to the board. To help you get started, she provided you with the following set of questions.

## QUESTIONS

1. What has happened to the electric utilities' dividend payout ratios over time? Is this development consistent with growing competition in the industry?
2. Do investors in general prefer dividends to retained earnings? What about Western's investors?

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3. Do Western's investors appear to approve of its dividend policy? If it changed the dividend policy, would the new policy appeal to more or fewer investors than the current policy?
4. How should investment opportunities influence dividend policy? As a part of your answer, construct a hypothetical graph that can be used to show the relationship between a firm's cost of capital, its investment opportunities, the size of its capital budget, and its optimal dividend policy. Show dollars on the horizontal axis and percent on the vertical axis, using reasonable but hypothetical data as opposed to company-specific numbers, but relate your graph to Western.
5. What "signals" do companies send investors through dividend actions? Should Western be concerned about signaling effects if it plans to alter its dividend policy? If so, how should signaling be taken into account? Would the FPL situation have any effect on the signaling effect of a dividend cut by Western, i.e., would the signaling effect on Western be different given that FPL recently cut its dividend versus the signaling effect if FPL had not cut its dividend?
6. How should a firm's "stockholder clientele" affect its dividend policy? Is it possible that it would be in the best interests of its current stockholders if Western cut its dividend?
7. Can dividend policy reduce "agency costs," and what effect would that have on firms' stock prices in general and for Western in particular? Are agency costs more likely to be an issue for companies if officers and directors own a large or a small percentage of the shares? If a large or small percentage of its officers' and directors' wealth and income is dependent on the company's stock price performance?
8. When establishing a firm's dividend policy, in general and for Western in particular,
  - a. how should the target payout ratio be set?
  - b. how stable should dividends be, and what does "stability" mean?
  - c. should the dividend policy be formally announced?
9. If a company's current dividend policy is not appropriate, how should it make the transition to a new policy? Would it ever be appropriate to conclude that the desires of the current stockholders are inconsistent with the dividend policy that would maximize the firm's value in the long run, and then set a policy that would lead to a change in the composition of the firm's stockholders? If the conclusion is reached that a change in composition is warranted, but that the stock price will be below the "equilibrium" price during some transition period, should the company make an effort (and incur costs) to minimize the price decline? What actions might the company take in this regard?
10. Is repurchasing stock a good alternative to cash dividends (a) on a regular basis and (b) under special conditions? (Note: No large, publicly owned company has ever been challenged by tax authorities on its repurchase program, and no challenge is likely to occur.)
11. What are the pros and cons of dividend reinvestment plans, in general and for Western in particular? If Western reduces its dividend, would this increase or decrease the importance of a dividend reinvestment plan?
12. What are the pros and cons of stock dividends and stock splits, and how are those actions related to cash dividends? Should Western pay a stock dividend or split its stock? Would a dividend reduction increase or decrease the probability, or the timing, of a split for Western?

13. Should dividend policy (or the cash distribution policy) and capital structure be established jointly or independently? If Western decided to change its capital structure, how would that change feed back into its dividend policy? Might a change in dividend policy lead to a change in capital structure policy? Specifically, if Western reduced its cash dividend, would this be more likely to lead to an increase or a decrease in the use of debt. Also, if Western wants to avoid reducing its dividend, or at least minimize any reduction, might a change in capital structure policy be desirable?

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**TABLE 1**  
**Dividend Payout Ratios of Different Companies**

<b>Year</b>	<b>Western</b>	<b>FP&amp;L</b>	<b>Electric Utilities</b>	<b>Selected Telephone Companies</b>	<b>S&amp;P 400 Industrials</b>
1965	60%	50%	66%	59%	51%
1970	63	52	71	66	59
1975	65	41	69	64	43
1980	69	67	75	68	40
1985	72	62	66	62	52
1990	75	88	80	58	51
1995	78	58	79	55	36
1999E	79	59	75	48	35

Notes: 1. Western compares itself with 10 electric utilities that are generally comparable in terms of size and operating characteristics. Estimated 1999 data were obtained from Value Line and other investment advisory services.

2. FP&L hit a high of 91% in 1993.

**TABLE 2**  
**Selected Financial Information on The Western Company**

<b>Year</b>	<b>Year-End</b>						
	<b>EPS</b>	<b>BVPS</b>	<b>Price</b>	<b>P/E</b>	<b>M/B</b>	<b>Payout</b>	<b>ROE</b>
1965	\$0.59	\$ 4.55	\$10.0	17.1x	2.2x	60%	12.9%
1970	0.58	4.06	7.3	12.6	1.8	63	14.3
1975	0.62	5.60	5.6	9.1	1.0	65	11.0
1980	0.77	6.50	5.2	6.8	0.8	69	11.8
1985	1.28	8.83	10.6	8.3	1.2	72	14.5
1990	1.18	9.53	14.3	12.1	1.5	75	12.4
1995	1.52	12.69	20.0	13.2	1.6	78	12.0



**TABLE 3**  
**Results of Western Stockholder Questionnaire**

I. Current Classification of Stockholders:

Individuals	56.1%
Institutions	
Pension funds	20.2%
Mutual funds, money managers	14.3
Other financial institutions	5.0
Money managers	4.3
Total	<u>43.8</u>
Officers and directors	0.1
	<u>100.0%</u>

II. Individual stockholders' responses to questionnaire:

	<b>Responses:</b>	
	<b>1995</b>	<b>1985</b>
<b>Question:</b> Which statement best describes your position:		
I hold the stock primarily for the cash dividends it provides.	72.8%	78.6%
I give equal weight to dividends and capital gains.	27.2	21.4
<b>Question:</b> Would you prefer to have the company use income to increase the dividend or reinvest in the business and thus provide capital gains?		
a. Pay higher dividends.	70.6%	79.3%
b. Reinvest earnings to provide capital gains.	29.4	20.7
<b>Question:</b> Is your taxable income:		
a. \$20,000 or less	15.1%	18.7%
b. Over \$20,000 but below \$50,000	61.5	62.8
c. \$50,000 to \$100,000	20.2	16.2
d. Over \$100,000	3.2	2.3

**TABLE 3 (Continued)**  
**Results of Western Stockholder Questionnaire**

	Responses:	
	1995	1985
<b>Question:</b> What percentage of your total portfolio does Western's stock represent?		
a. 100 percent	9%	11%
b. Over 75 but less than 100 percent	3	7
c. Over 50 but less than 75 percent	4	6
d. Over 25 but less than 50 percent	17	18
e. Over 20 but less than 25 percent	18	16
f. Over 15 but less than 20 percent	19	17
g. Over 10 but less than 15 percent	13	11
h. Over 5 but less than 10 percent	12	10
i. 5% or less	5	4

Notes: 1. The questionnaire was administered by a polling company, and only data on individual investors are reflected in the table. Informal telephone surveys of other types of investors suggested dividends and capital gains were given equal weight, except that money managers showed a slight preference for dividends because their clients wanted dividends.

2. 1985 income data were adjusted upward to reflect inflation and to make them comparable to 1995 data.

3. The questionnaire had been sent out before Tina joined the company, but she wondered how the results would be changed if the responses had been based on number of shares held rather than stockholders regardless of the number of shares they held. While the questionnaire did not ask for number of shares, Tina had asked the polling company to conduct some telephone surveys, and her intern had gone over the responses. The intern concluded that the results would have been quite different had the responses been based on shares held. In particular, stockholders with more shares seem to put greater weight on capital gains than those with fewer shares, hence larger stockholders would be more willing to see the company retain more of its earnings. Also, stockholders with more shares tend to have higher incomes, hence are in higher tax brackets. The intern also estimated that if the results had been weighted by number of shares held, over 80 percent of the stock held by individuals would have been held by investors whose Western shares represent 10 percent or less of their total portfolios, and less than 1 percent of the shares were held by undiversified investors. Considering that 44 percent of the stock is held by institutional investors, the intern concluded that the vast majority of the stock (but not the individual stockholders) is held in reasonably diversified portfolios.

**TABLE 4**

**Selected Information on Western,  
Historical 1990–1995 and Projected 1996–2000  
Dollars in Millions**

	Net Assets (1)	Common Equity (2)	ROE (3)	Net Income (4)	Dep'n (5)	Internal Funds (4) + (5)	Capital Expenditures			Free CF (10) = (6) - (9)	Common Divs (11)	Payout Ratio (12) = (11)/(4)
							Utility (7)	WEI (8)	Total (9) = (7) + (8)			
1990	\$14,462	\$3,876	12.4%	\$481	\$370	\$ 851	\$652	\$ 46	\$ 697	\$153	\$360	75.0%
1991	14,896	3,954	11.7%	463	390	853	618	31	648	205	413	89.2%
1992	15,343	4,103	10.5%	431	419	850	608	56	664	186	413	95.9%
1993	15,803	4,346	10.4%	452	471	923	793	112	904	19	413	91.4%
1994	16,277	4,612	11.0%	507	497	1,004	845	174	1,019	(14)	439	86.5%
1995	16,766	5,075	12.0%	608	509	1,117	850	319	1,169	(52)	472	77.6%

Part I. Payout Ratio Calculations

Assumptions:

Capital Structure Targets

Debt 45%

Preferred 5

Common 50

Dividend growth, 1996 2.0%

Dividend growth, After 1996 2.0

Capital expenditure growth, Utility 5.0

Capital expenditure growth, WEI 15.0

**TABLE 4 (Continued)**  
**Selected Information on Western,**  
**Historical 1990-1995 and Projected 1996-2000**  
**Dollars in Millions**

	Net Assets (1)	Common Equity (2)	ROE (3)	Net Income (4)	Dep'n (5)	Internal Funds (6) = (4) + (5)	Capital Expenditures			Free CF (10) = (6) - (9)	Common Divs (11)	Payout Ratio (12) = (11)/(4)
							Utility (7)	WEI (8)	Total (9) = (7) + (8)			
1996	17,426	5,364	12.0%	644	553	1,197	893	367	(62)	481	74.8%	
1997	18,132	5,642	12.0%	677	584	1,261	937	422	(98)	491	72.5%	
1998	18,908	6,069	12.0%	728	614	1,342	984	485	(127)	501	68.7%	
1999	19,763	6,198	12.0%	744	645	1,388	1,033	558	(203)	511	68.7%	
2000	20,709	6,411	12.0%	769	675	1,444	1,085	642	(282)	521	67.7%	
										Average Forecasted Payout:		<u>70.5%</u>

Note: In Part I, historical data are given for 1990-1995, along with projections for 1996-2000. These data are inputs. Internal funds = Net Income + Depreciation. Capital expenditures for 1990-1995 are given for both the utility and WEI, and the 1996-2000 data are calculated by the model based on the growth rates given in the Input Section. Free cash flow is defined as internal funds less the capital expenditures required to maintain the core business. Common dividends for 1990-1995 are given, and dividends for 1996-2000 are calculated based on the dividend growth rates specified in the input data section. The payout ratio is calculated within the model. Note that growth rates for capital expenditures and dividends can be varied to see the effects on the payout ratio, i.e., to see the payout ratio that results from different growth rate assumptions. Data in the top section of the table are used in the lower section.

**TABLE 4 (Continued)**

Selected Information on Western,  
Historical 1990–1995 and Projected 1996–2000  
Dollars in Millions

	Cap Exp + Divs (1)	Internal Funds (2)	External Reqmt (3)	Req'd Com Eq (4)	Req'd Debt+Pf (5)	Ret'nd Earn's (6)	Extra RE (7)	Stk Sold (8)	% Com Eq Sold to Outstanding (9)
			(1)-(2)	(3)-(4)	(3)-(4)				
1996	\$1,741	\$1,197	\$544	\$272	\$272	\$162	\$0	\$109	2.04%
1997	1,850	1,261	589	295	295	186	0	108	1.92%
1998	1,970	1,342	627	314	314	228	0	86	1.42%
1999	2,102	1,388	714	357	357	233	0	124	2.00%
2000	2,247	1,444	803	401	401	248	0	153	2.39%
						Total Extra R.E. or stk sold:	\$0	\$581	1.95%

Extra retained earnings are retentions in excess of what is needed to keep the capital structure in balance. As the model is programmed, there could never be a year when extra retained earnings are generated and stock is issued. Part II of the table uses information developed in Part I, along with the model inputs, to see if stock must be sold or whether funds will be available after capital expenditures and dividends. Column 1 is the sum of capital expenditures and dividends from above, and Column 2 also comes from above. Column 3 is the difference between Columns 1 and 2. Columns 4 and 5 show the allocation of Column 3 between common equity and debt-plus-preferred stock. Column 6 is Net Income less Dividends, from above. We then subtract Column 4 from Column 6. If this difference is negative, we show 0 in Column 7 and the difference in Column 8, as that amount must be raised by issuing stock. If (6)-(4) is positive, then the company has retained earnings in excess of the amount needed to support capital expenditures, or "extra retained earnings," which could be used to repurchase stock, for acquisitions, to increase the dividend, etc.

One goal of the firm might be to have no extra RE and also to avoid having to issue stock. Then, dividend growth could be adjusted in the Input Data section until those conditions were (approximately) met. The payout ratio in the top section of the table that results would be the target payout ratio. Of course, changes in the capital expenditure growth rate and the capital structure could also lead to changes. There is no "right answer," but the model can be used to get an idea of what would happen under different dividend policies.

FPL employed a large, realistic model, and they built into it the use of "extra retained earnings" to retire debt, repurchase stock, and make investments in regulated and unregulated businesses, and they examined the effects on EPS and the stock price under different dividend payouts. Of course, such modeling relies on assumptions as to such things as the price of the stock, the price that will have to be paid for repurchased shares, the rate of return on existing and new assets, and so forth. Actual outcomes will almost never agree with predicted outcomes, and for this reason, companies never release their model runs and forecasts. Managers don't like to get sued!

**TABLE 5**  
**Financial Ratios for Western, FP&L, S&P Electrics,**  
**and S&P400 Industrials**

P/E Ratio				
Year	Western	FP&L	S&P Electrics	S&P 400 Industrials
1965	17.1x	13.2x	20.4x	6.8x
1970	12.6	16.6	11.9	16.5
1975	9.1	6.5	7.4	10.8
1980	6.8	6.5	6.5	8.4
1985	8.3	7.8	7.3	13.7
1990	12.1	11.5	13.1	15.8
1995	13.2	12.8	12.0	18.4

  

M/B Ratio				
Year	Western	FP&L	S&P Electrics	S&P 400 Industrials
1965	2.2x	1.7x	2.4x	2.1x
1970	1.8	2.1	1.5	1.7
1975	1.0	1.0	0.9	1.3
1980	0.8	0.7	0.7	1.3
1985	1.2	1.3	1.1	1.7
1990	1.5	1.6	1.3	2.6
1995	1.6	1.7	1.5	4.7

  

ROE Ratio				
Year	Western	FP&L	S&P Electrics	S&P 400 Industrials
1965	12.9%	12.6%	12.3%	12.6%
1970	14.3	11.9	11.8	10.3
1975	14.0	13.3	11.2	12.1
1980	11.8	11.1	11.5	14.9
1985	14.5	15.0	12.4	12.1
1990	12.4	13.5	11.5	16.2
1995	12.0	13.0	11.5	25.4

**TABLE 5 (Continued)****Financial Ratios for Western, FP&L, S&P Electrics, and S&P400 Industrials**

Year	Indexed Price*, 1965=10			
	Western	FP&L	S&P Electrics	S&P 400 Industrials
1965	\$10.0	\$10.0	\$10.0	\$10.0
1970	7.3	8.6	6.9	9.6
1975	5.6	5.9	4.6	10.0
1980	5.2	6.7	4.7	14.7
1985	10.6	12.8	7.8	22.6
1990	14.3	16.0	10.4	42.4
1995	20.0	20.5	14.9	76.0

\*Value to which a \$10 investment would have grown, ignoring dividends.

Year	Annual Growth Rate in Price			
	Western	FP&L	S&P Electrics	S&P 400 Industrials
1965				
1970	-6.1%	-2.9%	-7.2%	-0.7%
1975	-5.2	-7.2	-7.4	0.7
1980	-1.5	2.5	0.3	8.0
1985	15.3	13.6	10.4	9.0
1990	6.2	4.7	5.9	13.4
1995	6.9	5.1	7.5	12.4

TABLE 5 (Continued)

## Financial Ratios for Western, FP&amp;L, S&amp;P Electrics, and S&amp;P400 Industrials

Year	Dividend Yield			
	Western	FP&L	S&P Electrics	S&P 400 Industrials
1965	3.5%	3.8%	3.2%	3.1%
1970	5.0	3.1	6.0	3.7
1975	7.1	6.4	9.4	4.1
1980	10.2	10.3	11.6	4.9
1985	8.7	8.0	9.1	3.8
1990	6.2	7.7	7.3	3.3
1995	5.9	4.5	6.8	2.0

## Approx. Total Return: Dividend Yield + Avg. Annual Growth Rate

Year	Western	FP&L	S&P Electrics	S&P 400 Industrials	L.T Treasury Bonds
1965					4.5%
1970	-1.1%	0.2%	-1.2%	3.0%	8.2
1975	1.9	-0.8	2.0	4.8	8.5
1980	8.7	12.8	11.9	12.9	12.5
1985	24.0	21.6	19.5	12.8	11.5
1990	12.4	12.4	13.2	16.7	8.6
1995	12.8	9.6	14.3	14.4	6.5

## Common Equity/Capitalization Ratio

Year	Western	FP&L	S&P Electrics	S&P 400 Industrials
1965	36.5%	39.1%	34.1%	77.9%
1970	34.1	39.0	33.4	64.0
1975	33.2	33.9	33.0	63.8
1980	35.8	36.6	35.4	65.1
1985	40.0	40.0	40.1	69.3
1990	42.1	41.9	42.5	60.8
1995	47.6	48.0	46.0	61.5