When is it better for a company to distribute cash back instead of investing it?

Large cash positions are generally considered a plus, from an investment perspective, because they allow companies to pay dividends, buy back shares, acquire other companies, or otherwise use the cash strategically to improve shareholder value. In troubled markets with tight liquidity like today's, cash does turn out to be king; however its abundance per se does not guarantee it will be utilized in the most value-efficient way. In this sense, making the right choice between distributing free cash to shareholders and retaining control over the investment decision is of crucial importance for a company. But that is easier said than done – what actually determines the outcome of this choice?

Basically, there are two forms of cash distributions to shareholders: dividend payments and stock buybacks. Both of them turn out to be the most viable option for a company's cash in several cases, which I will highlight below:

1) The smartest thing mature companies can do with their free cash (…is not very smart!).

Normally, "cash cow" companies that operate in mature sectors such as the retail (Wal-Mart), food and beverage (Nestle, Coca-Cola), oil (Exxon) and tobacco (Philip Morris), and/or which have entered the mature stage of their own development (Microsoft, Walt Disney), are facing the problem of generating substantial cash flows without having many investment opportunities to achieve profitable generic growth. Many researchers have pointed out that in those cases there is the danger of managers being inclined to use free cash flow to sustain growth at the expense of profitability for agency reasons to be further discussed. In those cases, the estimated return of any new potential investment project is smaller than the market capitalization rate. It naturally comes to mind that a more rational decision would be to distribute free cash to stockholders in the form of dividends or stock repurchases. That way, investors will be given the discretion to invest their money presumably more profitably in the financial markets.

A good example is probably the most famous one-time payout of cash in 2004 by **Microsoft**, which at the time had $56 billion in hoarded cash, of which it distributed a $33 billion present to shareholders in the form of a $3 per share payout, plus a $30 billion share buyback. This surprising move definitely had a multi-faceted explanation. However, the most obvious one looks at the fact that the software giant reached a stage in its development where there were no profitable investments on the horizon. It had established itself as the undisputed market leader yet there seemed to be no real opportunities for further expansion. If we look at the market environment at that time, we will find supporting evidence. The bursting of the technology bubble from late 1999 to mid-2001—when dividend payout ratios reached unprecedented lows—led to a slow-down in the whole economy, not to mention the technology sector. While the market value of most tech companies dropped sharply, it was yet too risky even for Microsoft to engage in risky acquisitions.

2) To play safe and gain new investors in times of market slowdown (…you have to show them the money!) .

A stable stream of cash dividends is among the best indicators of a company's profitability and positive financial outlook, particularly in volatile and bearish financial markets like today's. That is why, many market watchers use dividend history statistics as a screening tool for producing a pool of low-risk companies with market-beating potential. That is also one reason why many cautious investors would rather go for dividend-paying stocks as opposed to shares of fledgling high-growth companies that retain all their earnings for reinvesting in the company. Market studies have shown that dividend cash distribution policies are normally reflected in the perceived quality of a company's stock. Purchasing treasury stock, on the other hand, is a proven tool for supporting the price of the outstanding shares of the company, while also being a good strategic choice for power concentration when a company is threatened by a hostile takeover.

3) To prevent managerial entrenchment, or, in other words, to minimize the agency costs for shareholders in mature companies with limited capital requirements (… you should keep them poor!).

Whenever a company has a weak board of directors and strong anti-takeover provisions in its corporate charter, senior managers feel that their positions with the company are less contingent on their ability to generate returns for shareholders: management is entrenched. Because managerial compensation is a reflection, among other things, of a company's size and growth, entrenched managers might end up making overpriced acquisitions and accepting projects with negative market value added. When combined with maximized leverage of the company's capital structure, dividend payments and stock buybacks produce an effective mechanism for keeping managerial investment disciplined and responsible. Managers would have a higher incentive to make prudent investment decisions if they are facing the constraints of having to allocate a good portion of corporate earnings to debt holders in the form of interest payments, and to shareholders in the form of dividends. Skipping the interest payments is out of the question, while not distributing cash to shareholders in most cases would be taken by the market as a bad signal and would yield a negative effect on stock prices. Buying back shares of the company is another good instrument for that purpose, because essentially, it has a concentrating effect on ownership, giving each existing shareholder's stock higher weight in the company's capital structure and decision-making process in terms of investors having their voices heard by the Board of Directors.

So, do you still think that the dividends you get from the companies in your portfolio are good enough?