

*Investing in athletic shoes with Mac, Aisha, and Reggie*  
**Part 2: What dividends and capital tell  
you about a company**

Aisha and Mac have read studies showing that over the long-term—10 years or more—people who invest in stocks have earned more than people who either invest in bonds or keep their money in the bank. Since they're investing their \$3,800 for 10 years, they're in the "long-term" category. Now Reggie is helping them learn how to select stocks.

The last time we checked with Aisha and Mac, they were learning where they could find information about companies and stocks. Today, Reggie introduces his friends to another popular source of information about stocks—the Value Line Investment Survey.

Aisha and Mac look at the Value Line Web site and learn that Value Line produces an "Investment Rating and Report" for more than 1,700 stocks in more than 90 different industries. Each "Investment Rating and Reports" is a one-page summary containing a lot of information about a company. Mac finds a sample report on the company's Web site.

*Note: Only a sample "Investment Rating and Report" is currently available for free on the Internet. However, many public libraries subscribe to Value Line's "Investment Survey," which contains the "Investment Rating and Reports."*

**A company's capital structure is key**

Reggie tells Aisha and Mac that each company has a capital structure. He adds that it's very important for them to understand what this is, and to understand the capital structure for each company they're considering investing in. He adds that the Value Line is a good place to get this information.

**What does "cap size" mean?**

"Large-cap" companies are those with a market capitalization of \$1 billion or more, "small-cap" companies are those with a market capitalization of \$500 million or less, and "mid-cap" companies are those in between.

To find a company's market capitalization, just multiply the number of shares the company has issued by the price per share. For example, if Largeco, Inc. has issued 25 million shares of stock and the stock is trading for \$45 per share, Largeco, Inc.'s market capitalization is \$ 1.13 billion, and it would be considered a "large-cap" company.

Companies with different capitalizations appeal to different kinds of investors, depending on the investor's goals and tolerance for risk. The stock of small-cap companies tends to be more volatile since those companies are less well-established, but those companies sometimes grow more quickly than large-caps. This means that small-cap stocks tend to be riskier, but sometimes produce higher returns over time. The stock of large-cap companies (sometimes referred to as blue chips), are usually less volatile—for this reason, they're considered less risky than small caps.

"Almost all companies try to make their sales and profits grow so the price of their stock goes up," explains Reggie. "Before selling more products and increasing profits, a company usually needs to invest in itself by building new factories and offices, hiring more salespeople, buying more equipment to produce its products, and the like. All this takes capital—another word for cash."

Reggie suggests using Nike as an example, since Aisha and Mac have already started to learn about that company. "Let's say that Nike

is planning to start making a brand new soccer shoe," he suggests.

"We'll call it MacShoe!" claims Mac.

Nike hopes to sell a lot of MacShoes and increase its profits. Nike managers believe that if they increase the company's profits, its stock price will rise.

To get people to buy the MacShoes, Nike will spend a lot of money advertising it. It also needs to build a new factory to make the shoe after buying the land on which the factory will sit and must hire the people to work in the factory. Aisha and Mac realize that the new MacShoe will cost Nike a lot of money before people start buying it, and Nike starts making money on the shoe.

How can Nike pay for all these expenses? Broadly speaking, Nike, like other companies, can generate the cash it needs in two ways—either from using the money it already makes by selling its shoes and other products—called "retained earnings"—or by getting outside financing.

First, let's talk about retained earnings. Retained earnings are what's left over after a company pays all the expenses it already has—like worker salaries, rent, taxes, and the cost of the raw materials it uses to make its products.

### **Dividends reduce retained earnings**

But Nike won't use all of its earnings to pay for the new MacShoe. Why? Because Nike uses some of that money to pay a dividend to its stockholders.

Aisha finds a recent Value Line report on Nike in the library (the May 29, 2007 report). She notices a box in the top right-hand corner section of the page that says "Div'd Yld 1.40%" and learns that this refers to a "dividend yield."

"Dividends are payments that some companies make to their shareholders—usually every quarter," Reggie says. "Corporations are *not*

*required* to pay dividends; some do and others don't. A company that pays dividends may decide to increase or decrease the dividend, or may decide to eliminate it altogether. Dividends are *not* guaranteed."

Dividends are one way that investors earn a return on their investments. Some corporations feel that it is important to "share the wealth" with their stockholders as they go.

### **What's a typical dividend yield?**

Different kinds of companies tend to have different dividend policies, so there is no easy answer to this question. In general, older and more established industrial corporations such as the car manufacturers (General Motors and Ford) tend to pay dividends in the 2% to 4% range, again, depending on the current price of their stock. Newer firms, technology companies in particular, tend not to pay any dividends at all, preferring to hold onto as much cash as possible to expand their businesses.

Even corporations in the same industry can have dividend policies that are very different. According to Yahoo Finance, the average annual dividend yield for the shoe industry is 1.79%. So, Nike was less than average when Aisha checked. But some shoe companies don't pay any dividend—like Skechers.

"Dividends are only one part of a company's capital structure," Reggie explains. "There are many other factors that investors should look at when deciding whether to invest in a company's stock."

### **"Outside" financing**

If Nike doesn't have enough cash in its retained earnings to pay its expenses for the new MacShoe, after paying the dividend, it will have to look elsewhere—for "outside" financing. There are several sources of

financing that may be available to Nike: it could raise the money by taking out loans from banks or by selling stocks and bonds.

Nike's capital structure will reflect where it gets this money, along with all financing it already has "on the books." Broadly speaking, a corporation's capital structure measures how much money it has borrowed from banks and the money it's gained from selling stocks and bonds.

The Value Line reports give a snapshot of each company's capital structure. Look on the left-hand side of the report in the "Capital Structure" box. You'll see the following:

- **Total debt.** This includes the money the company has borrowed from banks as well as the money it's made from selling bonds.
- **Preferred stock.** Preferred stock is a cross between stock and bonds. Not all companies issue preferred stock.
- **Common Stock.** Value Line lists the number of shares each company has issued to investors.
- **Market cap.** This stands for its market capitalization, and is just the number you get by multiplying the number of shares of Common Stock the company has issued by the price per share. It's one way investors measure the size of a company.

### **Why is a company's capital structure important?**

Reggie tells his friends that there are many answers to this question. One of the most important reasons relates to the amount of debt a company has.

"Remember that companies have to repay debt—whether it's money the company has borrowed from a bank or has borrowed from investors by selling bonds. If a company borrows too much, and starts making less money from selling its products than it expected, it may have trouble paying back its

debt. Investors generally don't like to buy stock in a company that has trouble repaying its debts because there is a risk that company may go bankrupt. So, they pay close attention to a company's financial structure and the amount of debt it has," Reggie cautions.

Companies with little debt usually have some "room" to take on debt by borrowing money. This is an advantage. If the company sees an opportunity for growth but has to spend some money to pursue the opportunity, it might be able to do so more easily than another company that's already incurred a lot of debt.

### **Should investors prefer companies that pay dividends?**

It's really a matter of individual preference—there is no rule that says corporations that pay dividends are better or worse investments than corporations that don't.

Some investors like getting dividends; they're a "bird in the hand" since the investor is earning a return on his or her investment every quarter. Other investors would prefer that company keep that money and use it to try to make its sales and earnings grow, figuring that they'll be rewarded eventually with a higher stock price.

For more information, see:  
*Part 1: How to find information about stocks*  
*Part 3: Understanding the price-to-earnings ratio*  
*Part 4: How debt ratio and industry structure help you pick stocks*

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