

Class: MSc

Subject : Business Finance

Chapter: Unit 2 Chapter 2

Chapter Name: Dividend policy and decisions

Topics to be covered

1. What is Dividend?
2. Why companies pay dividend?
3. Key dividend ratios
4. Why companies have a dividend policy?
5. Fundamentals of dividend policy
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1 What is Dividend?



A **dividend** is the distribution of reward from a portion of the company's earnings and is paid to a class of its shareholders.

- Dividends are decided and managed by the company's board of directors, though they must be approved by the shareholders through their voting rights.
- Dividends can be issued as cash payments, as shares of stock, or other property, though cash dividends are the most common.
- In order to understand dividend amount that an investor receives, look at the **face value** of the company. If a company has given 1000% dividend and the face value of the shares is Rs.1, it means the company is giving 1000% of Rs. 1 as dividend to a shareholder, which is Rs. 10. In another case, a company may give just 100% dividend on face value of Rs. 10 shares which will again be 100% of Rs.10 meaning that a shareholder has received Rs. 10 as dividend.
- Companies are not allowed to pay out in dividends more than they have in their retained earnings from the current and previous years. This is to protect creditors in the event of the company being wound up.

2 Why companies pay dividends?

- Companies pay dividends for a variety of reasons. These reasons can have different implications and interpretations for investors.
- Dividends are expected by the shareholders as a reward for their trust in a company and the company management aims to honor this sentiment by delivering a robust track record of dividend payments. Dividend payments reflect positively on a company and help maintain investors' trust.
- Dividends are also preferred by shareholders as they are treated as tax-free income for shareholders in many jurisdictions, while capital gains realized through the sale of a share whose price has increased is taxable.
- Traders who look for short-term gains may also prefer getting dividend payments that offer instant tax-free gains.
- A high-value dividend declaration can indicate that the company is doing well and has generated good profits. But it can also indicate that the company does not have suitable projects to generate better returns. Therefore, it is utilizing its cash to pay shareholders instead of reinvesting it into growth.
- If a company has a long history of past dividend payments, reducing or eliminating the dividend amount may signal to investors that the company could be in trouble.

3 Key dividend ratios



$$\text{Dividend Payout Ratio} = \frac{\text{Dividends Paid}}{\text{Net Income}}$$

- The dividend payout ratio is the ratio of the total amount of dividends paid out to shareholders relative to the net income of the company.
- It is the percentage of earnings paid to shareholders in dividends.



$$\text{Dividend Yield} = \frac{\text{Annual Dividends per share}}{\text{Market Price of the Share}}$$

- The dividend yield is an estimate of the dividend-only return of a stock investment.
- Assuming the dividend is not raised or lowered, the yield will rise when the price of the stock falls, and it will fall when the price of the stock rises.
- Because the dividend yield changes with the stock's price, it often looks unusually high for stocks that are falling quickly.

4 Why companies have a dividend policy?

- Successful companies earn income. That income can be reinvested in operating assets, used to retire debt, or distributed to stockholders. If the decision is made to distribute income to stockholders, three key issues arise:

How much should be distributed?

Should the distribution be in the form of dividends, or should the cash be passed on to shareholders by buying back stock?

How stable should the distribution be?

- That is, should the funds paid out from year to year be stable and dependable, which stockholders like, or should they be varied depending on the firms' cash flows and investment requirements, which managers tend to like?
- All of these questions are answered by the dividend policies of companies. They provide a sense of certainty regarding the company's financial health.

5 Fundamentals of dividend policy

- While framing a policy, Dividends can be seen as a **Financing Decision** as the amount paid as dividends is no more available with the company for investments into business.
- Primarily for unlisted companies, dividends are more like a financing decision as:
 - the company does not have the option of raising further funds in the stock market
 - the borrowing powers of unlisted companies tend to be more restricted
- On the other hand, shareholders in unlisted companies have the opposite problem – they cannot sell some shares in the market to replace dividend income.
- In general, the choice for a company's Board (and its shareholders) is between immediate income and the prospect of higher income at some future date.
- The latter will, in a listed company, be reflected in capital appreciation as the market takes that prospect into account.

6 Factors influencing the Decision on Dividend Policy

- The following factors majorly influence dividend policies of corporations:
 - Stock Markets
 - Cash Reserves
 - Tax
 - Growth Opportunities
 - Stability and Consistency

6.1 Stock Markets

- Stock markets display significant adverse reactions to announcements of dividend cuts. Managers therefore tend to conservatism in good years, particularly in cyclical industries and for smaller companies (especially those that are new to the market).
- If the stock market is focused on the short term, it is possible that investors will reward companies that pay high dividends with a high share price.
- Companies may then return too much to shareholders, rather than focusing on the payout ratio that best suits their business, which may be bad for the company's long-term prospects.
- A change of dividend policy can have significant repercussions for a company's market rating and its capacity to raise finance.
- For example: The announcement of a 50% decrease in dividends from General Electric Co. (GE), one of the biggest American industrial companies, was accompanied by a decline of more than seven percent in GE's stock price on November 13, 2017.

6.2 Cash Reserves

- Companies with large cash reserves that fear a takeover bid may well distribute generously to both encourage shareholder loyalty and limit the size of the 'cash pile'. A cash pile is seen by investors as a sign of weakness.
- Some companies try to label it as a 'war chest' – cash held in anticipation of a large aggressive takeover bid – in the hope that the market will continue to believe that some big value-adding maneuver is imminent.
- Shareholders invest in companies to get exposure to a certain type of risk. If they wished to invest it in cash or other investments, they would choose to do it themselves through direct investment, rather than let the company do it for them.
- So, the belief is that if the company can't use the money they should give it back to shareholders. Shareholders can then find another company that has some ideas and that can use the cash!

6.3 Tax

- Companies with a large proportion of non-tax paying shareholders may feel it appropriate to distribute a large proportion of earnings.
- In general, non-taxpaying shareholders (and those who receive dividend income tax-free. E.g. because the income is below the tax-free dividend limit) will wish to receive much of their return in the form of income, rather than reinvesting the profits in the company to give a capital gain.
- This will lead to a bias towards higher payouts from companies whose shareholder base contains a higher proportion of non-taxpaying shareholders or smaller investors.

6.4 Growth Opportunities

- Companies in high-growth industries may find that the demands for capital investment to maintain competitive advantage exceed their capacity to borrow on satisfactory terms and may prefer to pay low dividends rather than making frequent rights issues.
- Many internet companies pay no dividend at all, and often have negative net cashflow. It is the promise of superior growth in the future that makes these companies attractive, not a high dividend yield. So, paying a dividend to the sort of investor who invests in such companies makes little sense.

6.5 Stability and Consistency

- Since companies with high dividend policies tend to attract investors who seek high payouts (and similarly for low dividend policies and preferences) any move from one category to the other will cause adverse market reaction as investors readjust their portfolios.
- Based on this parameter, dividend policies can broadly be classified as:
 - **Stable Dividend Policy**
 - **Constant Dividend Policy**
 - **Residual Dividend Policy**

7 Types of dividend policies

- **Stable Dividend Policy** - A stable dividend policy is the easiest and most commonly used. The goal of the policy is a steady and predictable dividend payout each year, which is what most investors seek. Whether earnings are up or down, investors receive a dividend.
- The goal is to align the dividend policy with the long-term growth of the company rather than with quarterly earnings volatility. This approach gives the shareholder more certainty concerning the amount and timing of the dividend.
- **Constant Dividend Policy** - The primary drawback of the stable dividend policy is that investors may not see a dividend increase in boom years. Under the constant dividend policy, a company pays a percentage of its earnings as dividends every year. In this way, investors experience the full volatility of company earnings.
- If earnings are up, investors get a larger dividend; if earnings are down, investors may not receive a dividend. The primary drawback to the method is the volatility of earnings and dividends. It is difficult to plan financially when dividend income is highly volatile.
- **Residual Dividend Policy** - Residual dividend policy is also highly volatile, but some investors see it as the only acceptable dividend policy. With a residual dividend policy, the company pays out what dividends remain after the company has paid for capital expenditures (CAPEX) and working capital.
- This approach is volatile, but it makes the most sense in terms of business operations. Investors do not want to invest in a company that justifies its increased debt with the need to pay dividends.

8 Alternative ways of distributing profits

- In addition to regular dividends, usually paid quarterly or half-yearly, one-off extra or special dividends may be paid occasionally. Alternatives to cash dividends include:
 - scrip, stock or share dividends – either ‘pure’, where the shareholder has no option to take cash, or as a scrip alternative to a cash dividend; and
 - share buybacks.

8.1 Scrip or Stock Dividends

Effect of Scrip Dividends on the Company:

- This method of distribution is of benefit to companies that either:
 - have no cash with which to pay a dividend because of long-term expansion
 - usually paid a dividend, but are unable to pay one at present.
- If they expect to resume paying dividends in the future, and wish the dividend yield to be continuous through these hard times, they may pay a scrip dividend.
- From the company's point of view, the scrip dividend retains funds to be used for investment or to reduce borrowings and, therefore, to improve earnings. The capital base will increase and this will improve the company's financial capacity. The shareholder base may be increased by attracting investors who prefer scrip dividends.

8.1 Scrip or Stock Dividends

Effect of Scrip Dividends on the Shareholders:

- From the shareholder's point of view there are fewer benefits
- Tax will normally be payable as if cash had been taken but, as no cash is received by the shareholder, this must be funded out of other resources.
- The scrip issue only benefits those shareholders who wish to increase their holdings, as they will avoid brokerage and other acquisition costs and may also benefit from a slightly better price.
- On the other hand, the practice complicates the computation and recording of capital gains.

8.2 Share Buybacks

- If a company has accumulated large amounts of cash which it does not need in running the business, or if it wishes to change its capital structure by replacing equity with debt, it will generally undertake a share repurchase or buyback exercise.
- Investors invest in a company with the intention of being exposed to a certain type of risk (and hopefully a certain return).
- The company is essentially forcing some investors to sell their shares and invest elsewhere. Such an announcement can also be seen as a sign of weakness by investors, who may think that the company has no ideas or innovative projects to generate returns.
- On the other hand, some might argue that it is good to reduce the stockpile of cash, since it will not have been earning a great rate of return.

8.2 Share Buybacks

- There are also Tax Issues to consider:
 - Some investors might be happy to realize a capital gain if they have not used their capital gains allowance because they will pay no tax on the capital gain.
 - However other investors may be forced into realizing capital gains at times when they would rather not, e.g. if their year's allowance is already used up.
- Share buybacks can benefit private shareholders to the extent that the tax treatment of capital gains is better than that of dividends.
- The effect on the company's earnings per share should be beneficial, since the cash held is probably only earning a deposit rate of interest – much less than its industrial assets. The value of the remaining shares should, therefore, improve.

8.2 Share Buybacks

- The company announces that it intends to buy back a certain number of its own shares. Procedure or Ways to Repurchase Shares are:
 - **Purchase of shares** in the **Open Market**, often by a gradual repurchase program over a period of time
 - **Fixed Price Offer** – If the company repurchases a stated number of shares at a fixed price (typically at a significantly higher price than the current market value), the shareholders are informed of the company's intention and are free to accept the offer or not.
 - **Tender Offer** (either a Dutch or uniform price auction) – In a Dutch auction, the company states a series of prices at which it is prepared to repurchase shares. Shareholders reply to this offer, informing the company of how many shares they are willing to sell at each price. The company then calculates the lowest price at which it can buy the required number of shares.
 - **Repurchase by Direct Negotiation** with a major Shareholder Effect of Share Buyback on Shareholders
- Often, for simple supply/demand reasons the share price rises on such an announcement. However, this is not always the case.

9 Market and Dividends

- The market value of a company is the market's valuation of future dividends (unless there are expectations of takeover or winding up and the distribution of residual assets).
- If no outside loan capital is available and the company has better investment opportunities than its shareholders, the payment of dividends will reduce the business' ability to take advantage of these situations and will be damaging to the market value of the company.
- However, provided loan capital is available to the company on tolerable terms, this restriction does not apply (and even after this is exhausted there is always the possibility of a rights issue).
- Looking at the dividend question from the point of view of the shareholder, it is a reasonable assumption that the purchaser of shares has some expectation of a dividend policy. If this expectation is not fulfilled, it will change the investor's relative valuation of the share.

9 Market and Dividends

- A consistent dividend policy is, therefore, important in building a clientele of investors, and an unexpected change can have a negative effect on perceptions of the company's worth. It follows that investors will move to shares where dividend policy is compatible with (or acceptable in) their tax position.
- The financial management of a company must, therefore, consider carefully the likely effect on investor perception of any dividend announcement – particularly if it can be construed as a change in dividend policy. If a change should be necessary, it is necessary to explain the reasons quickly and clearly – shareholders will generally accept decisions made for the long-term benefit of the shareholders.
- Any efficient market will take its cue from the statements and actions that enter the public domain, not from what a company's managers wish or think.