CA | BUSINESS SCHOOL
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Session 09 & 10

Dividend Policy

Programme : Postgraduate Diploma in Business, Finance & Strategy (PGDBFS 2017)
Course : Corporate Valuation (PGDBFS 203)
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Dividend Policy

- Dividend policy is an integral part of the firm's financing decision
- Dividend payout ratio determines the amount of earnings that can be retained in the firm as a source of financing
- However, retaining a greater amount of current earnings in the firm means that fewer rupees will be available for current dividend payments
- Therefore, the major aspect of the dividend policy is to determine the appropriate allocation of profits between dividend payments and additions to the firm's retained earnings

Whether shareholder wealth can be enhanced by altering the pattern of dividends not the size of dividends overall

Dividends

- Many companies pay a regular cash dividend

  - Public companies often pay semiannually

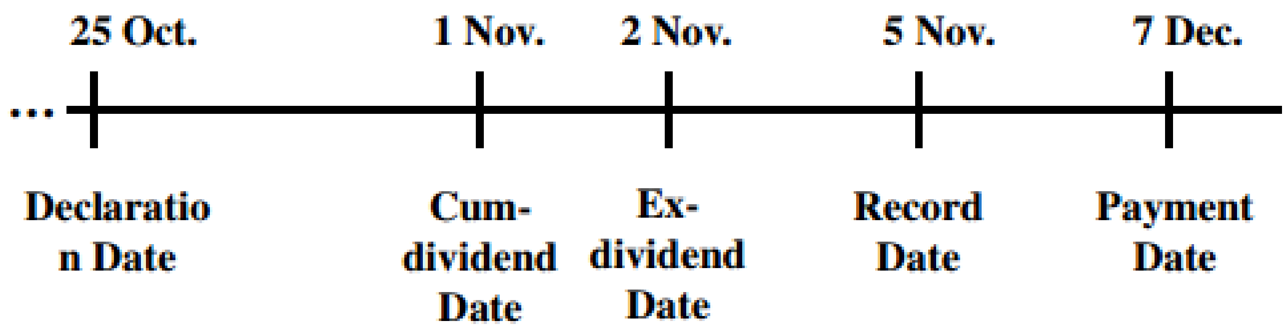
  - Sometimes firms will pay an extra cash dividend

- Companies will often declare stock/scrip dividends

  - No cash leaves the firm

  - The firm increases the number of shares outstanding

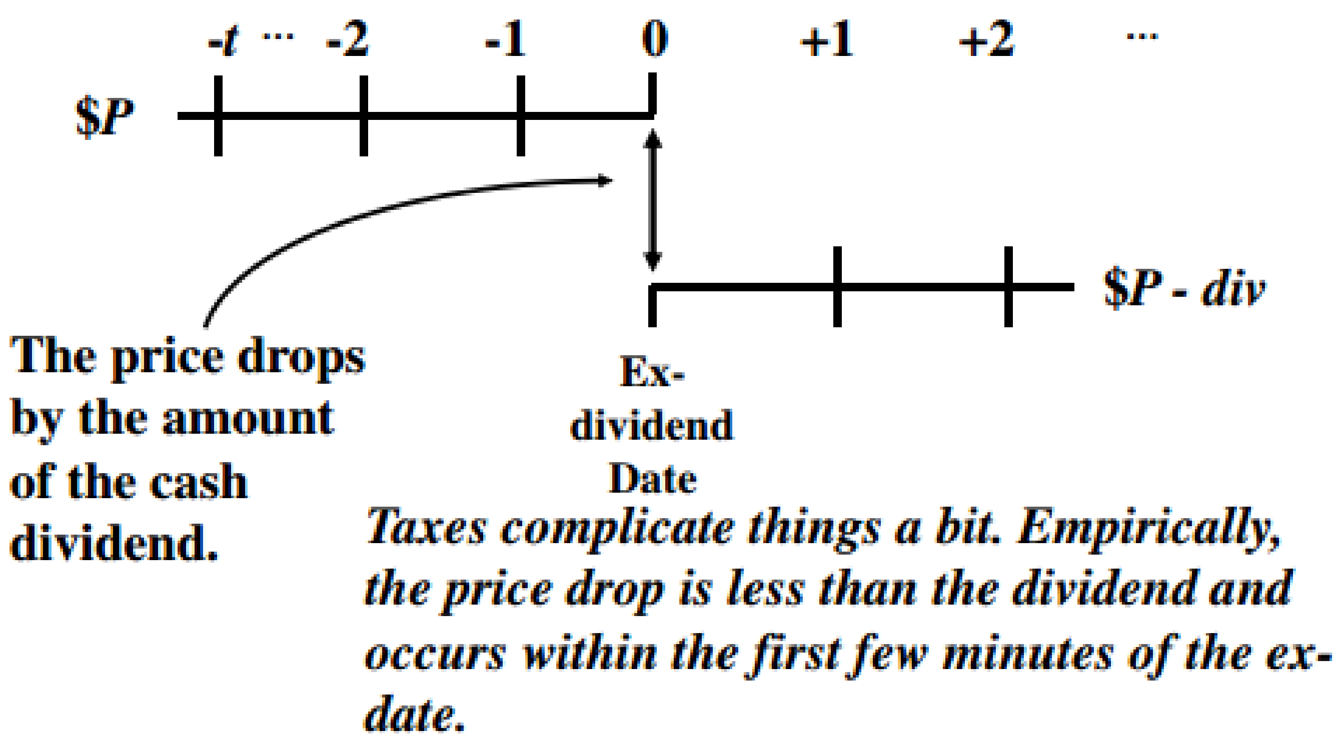
Dividends



- Declaration Date : The Board of Directors declares a payment of dividends
- Cum-Dividend Date : Buyer of stock still receives the dividend
- Ex-Dividend Date : Seller of the stock retains the dividend
- Record Date : The corporation prepares a list of all individuals believed to be stockholders as of 5 November

Price Behaviour

In a perfect world, the stock price will fall by the amount of the dividend on the ex-dividend date



The Irrelevance of Dividend Policy

- **Miller and Modigliani (MM) said dividend policy is irrelevant to share value**
- **The determinant of value is the availability of projects with positive NPVs; and the pattern of dividends makes no difference to the acceptance of these**
- **The share price would not move if the firm declared either a zero dividend policy or a policy of high near-term dividends**

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The Irrelevance of Dividend Policy

The conditions under which this was held to be true included:

1. There are no taxes
2. There are no transaction costs; for example:

a) investors face no brokerage costs when buying or selling shares;

b) companies can issue shares with no transaction costs

3. All investors can borrow and lend at the same interest rate
4. All investors have free access to all relevant information
5. Investors are indifferent between dividends and capital gains

Home Made Dividends

- Bianchi Inc. is a $42 stock about to pay a $2 cash dividend
- Bob Investor owns 80 shares and prefers a $3 dividend

Dividends as Residual

- Dividends should only be paid when the firm has financed all its positive NPV projects
- Any unused earnings are paid out in the form of dividends
- The percentage of earnings paid out as dividends will fluctuate from period to period in keeping with fluctuations in the amount of acceptable investment opportunities available to the firm

The treatment of dividend as residual policy implies that dividends are irrelevant

Dividends as Residual

In these circumstances dividend policy becomes an important determinant of shareholder wealth:

1. If cash flow is retained and invested within the firm at less than Ke shareholder wealth is destroyed; therefore it is better to raise the dividend payout rate

2. If retained earnings are insufficient to fund all positive NPV projects shareholder value is lost, and it would be beneficial to lower the dividend

Clientele Effect

- Some shareholders prefer a dividend pattern which matches their desired consumption pattern
- There may be natural clienteles for shares which pay out a high proportion of earnings, and another clientele for shares which have a low payout rate
- This may place pressure on the management to produce a stable and consistent dividend policy
- Inconsistency would result in a lack of popularity with any client group and would depress the share price

Information Content of Dividends

- An unexpected change in the dividend is regarded as a sign of how the directors view the future prospects of the firm
- An unusually large increase in the dividend is often taken to indicate an optimistic view about future profitability
- A declining dividend often signals that the directors view the future with some pessimism
- Dividend as an information-transferring device occurs because of a significant market imperfection – information asymmetry

Owners Control (Agency Theory)

Many firms seem to have a policy of paying high dividends, and then, shortly afterwards, issuing new shares to raise cash for investment. The cost of issuing shares can be burdensome and shareholders generally pay tax on the receipt of dividends

One possible answer is that it is the signalling (information) value of dividends that drives this policy

Owners Control (Agency Theory)

A second potential explanation lies with agency cost.

Managers (the agents) may not always act in the best interests of the owners. One way for the owners to regain some control over the use of their money is to insist on relatively high payout ratios Then, if managers need funds for investment they have to ask

Taxation and Dividends

- The taxation of dividends and capital gains on shares is likely to influence the preference of shareholders for receiving cash either in the form of a regular payment from the company (a dividend) or by selling shares (in the market to create homemade dividends or in a share buy-back)

- If shareholders are taxed more heavily on dividends than on capital gains they are more likely to favour shares which pay lower dividends

- In the presence of personal taxes :

1. A firm should not issue stock to pay a dividend
2. Managers have an incentive to seek alternative uses for funds to reduce dividends
3. Though personal taxes mitigate against the payment of dividends, these taxes are not sufficient to lead firms to eliminate all dividends

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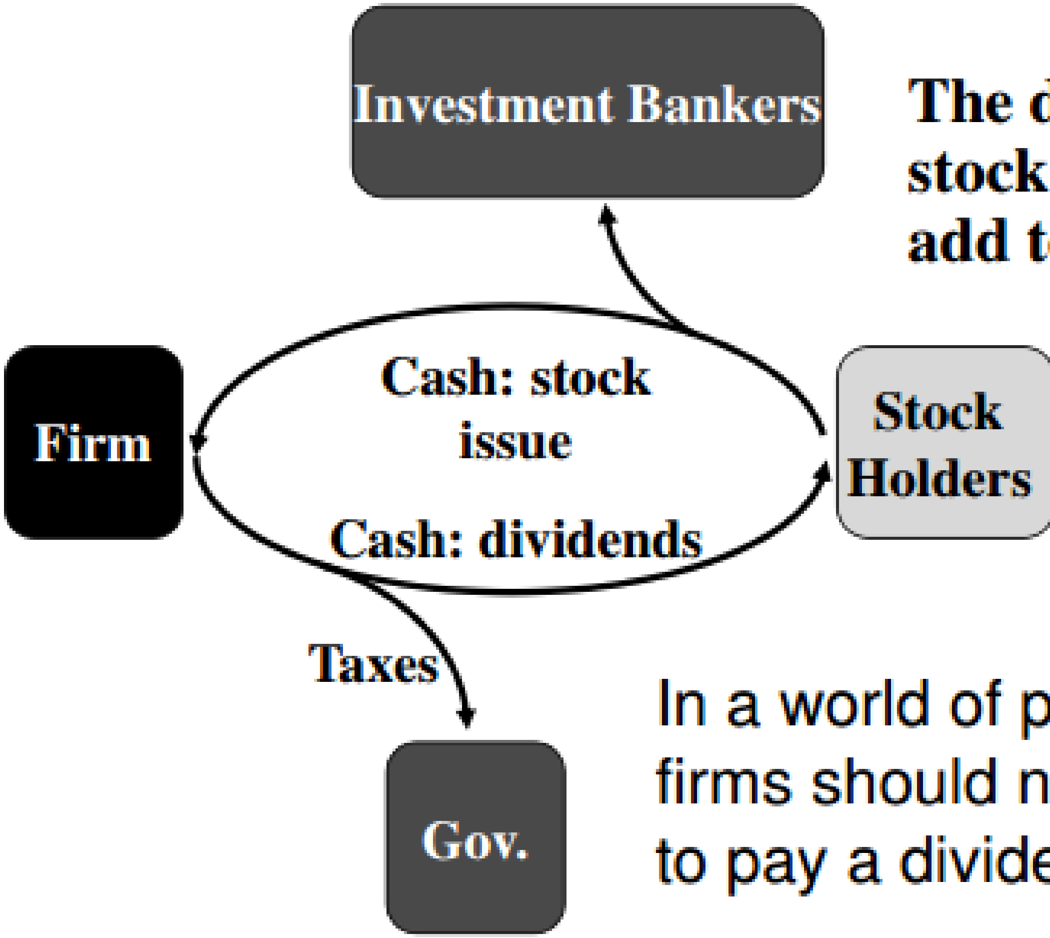
Taxation and Dividends



The direct costs of stock issuance will add to this effect.

In a world of personal taxes, firms should not issue stock to pay a dividend.

Dividend Policy in Practice

- Residual dividend policy
- Constant growth dividend policy – dividends increased at a constant rate each year
- Constant payout ratio – pay a constant percent of earnings each year
- Compromise dividend policy

Share Repurchase

- Instead of declaring cash dividends, firms can rid themselves of excess cash through buying shares of their own stock.
- Company buys back its own shares of stock
    - – Tender offer – company states a purchase price and a desired number of shares
    - – Open market – buys stock in the open market
- Stock repurchases sends a positive signal that management believes that the current price is low
- Tender offers send a more positive signal than open market repurchases because the company is stating a specific price
- The stock price often increases when repurchases are announced

Share Repurchase

Consider a firm that wishes to distribute $100,000 to its shareholders

Assets		*Liabilities & Equity*	
A.Originalbalancesheet			
Cash	**$150,000**	**Debt**	**0**
OtherAssets	**850,000**	**Equity**	**1,000,000**
Value of Firm	**1,000,000**	**Value of Firm**	**1,000,000**

Shares outstanding = 100,000

Price per share = $1,000,000/100,000 = $10

Share Repurchase

If they distribute the $100,000 as a cash dividend, the balance sheet will look like this :

If they distribute the $100,000 through a stock repurchase, the balance sheet will look like this :


ANY
QUESTIONS
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