Dividend Decision

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Financial Management

University Elective

Topics

- Overview
- Why firms pay dividend?
- Factors affecting dividend policy
- Walter and Gordon model
- Guidelines
- Bonus shares
- Stock split
- Buy back
- Numericals

Overview

+ Dividend policy of a firm determines what proportion of earnings is paid to shareholders by way of dividends and what proportion is ploughed back in the firm
+ What is the relationship between dividend policy and market price of equity shares?
+ Carefully evaluate its circumstances and environment to frame dividend policy

Why Firms Pay Dividends?

<u>Plausible Reasons</u>

- Investor preference for dividends – self control and aversion for regret
- Information signaling – convey prospects using dividend
- Clientele effect – dividend policy and investor preferences
- Agency costs – reduce propensity to waste resources

<u>Dubious Reasons for Paying Dividends</u>

- Bird-in-hand fallacy
- Temporary excess cash

Factors Affecting Dividend Policy

The considerations relevant for determining the dividend payout ratio are:

- Funds requirement
- Liquidity
- Access to external sources of financing
- Shareholder preferences
- Difference in the cost of external equity and retained earnings
- Control
- Taxes

Walter Model

+ Share valuation model
+ Dividend policy has a bearing on share valuation
+ Assumptions:
+ All equity financed. Rely on retained earnings to finance future investments.
+ Rate of return on investment is constant.
+ The firm has an infinite life.

Walter Model

$$P = \left(\frac{D + (E - D)\, r / k}{k} \right)$$

- P – price per equity share
- D – dividend per share
- E – earnings per share
- r – rate of return on investment
- k – cost of capital

Walter Model

- When the rate of return is greater than the cost of capital (r>k), the price per share increases as the dividend payout decreases
- When the rate of return is equal to the cost of capital (r=k), the price per share does not vary with changes in dividend payout ratio
- When the rate of return is less than the cost of capital (r<k), the price per share increases as the dividend payout ratio increases

Gordon Model

- Stock valuation
- Dividend capitalisation approach
- Assumptions:
- Only source of financing is retained earnings.
- Rate of return on investments is constant.
- Growth rate is the product of its retention ratio and its rate of return.
- Cost of capital for the firm remains constant and it is greater than the growth rate.
- Firm has perpetual life.
- Tax does not exist.

Gordon Model

- $P_0 = \left(\dfrac{E_1 (1 - b)}{k - br} \right)$
- P0 – price per share at the end of the year
- E1 – earnings per share at the end of year 1
- 1 – b – fraction of earnings the firm distributes as dividends
- b - retention
- K – is the rate of return required by the shareholders
- r – rate of return earned on investments
- br – growth rate (earnings and dividends)

Gordon Model

- When the rate of return is the greater than the discount rate, price per share increases as the dividend payout ratio decreases
- When the rate of return is equal to the discount rate, the price per share remains unchanged in response to variations in the dividend payout ratio
- When the rate of return is less than the discount rate, the price per share increases as the dividend payout ratio increases.

Guidelines –Dividend Policy Formulation

- Investment decisions have the greatest impact on value creation.
- External equity is more expensive than internal equity (retained earnings) because of issue costs.
- Most promoters are averse to dilute their stake in equity and hence are reluctant to issue external equity.
- There is a limit beyond which a firm would have real difficulty in raising debt financing.
- The dividend decision of the firm is an important means by which the management conveys information about the prospects of the firm.

Guidelines –Dividend Policy Formulation

- Don't pay dividends at the expense of positive NPV projects.
- Minimise the need to sell external equity.
- Define a target dividend payout ratio along with a target debt-equity ratio, taking into account the investment needs, managerial preferences, capital market norms, and tax code.
- Accept temporary departures from the target dividend payout ratio and the target debt-equity ratio.
- Avoid dividend cuts.
- In essence, the above guidelines imply that a firm should pursue a smoothed residual dividend policy.

Guidelines –Dividend Policy Formulation

A survey of dividend policies and practice, conducted by the Conference Board in the U.S., revealed that five considerations or guidelines were dominant in the minds of dividend decision makers:

- The company's earnings record and its future prospects.
- The company's record of continuity or regularity of dividend payments.
- The need to maintain a stable rate of dividends per share of stock.
- The company's cash flow, present cash position, and the anticipated need for funds.
- The needs and expectation of the owners of the common stock.

Bonus Shares

+ A bonus issue represents capitalisation of free reserves built out of the genuine profits or share premium collected in cash only

+ In the wake of a bonus issue:

  (a) The shareholders' proportional ownership remains unchanged.

  (b) The book value per share, the earnings per share, and the market price per share decrease, but the number of shares increases.

Stock Split

- In a stock split the par value per share is reduced and the number of shares is increased proportionately

Comparison – Bonus Shares and Stock Split

Bonus Issue	*Stock Split*
• The par value of the share is unchanged	• The par value of the share is reduced
• A part of reserves is capitalised	• There is no capitalisation of reserves
• The shareholders' proportional ownership remains unchanged	• The shareholders' proportional ownership remains unchanged
• The book value per share, the earnings per share, and the market price per share decline	• The book value per share, the earnings per share, and the market price per share decline
• The market price per share is brought within a popular trading range.	• The market price per share is brought within a more popular trading range.

Buy Back of Shares

- Share buybacks, referred to as equity repurchases or stock repurchases in the US, have become possible since 1998 in India.
- In India, corporates generally choose the open market purchase method. Under this method, a company buys shares from the secondary market over a period of one year subject to a maximum price fixed by the board/shareholders