**UNIT – 5**

**DEVIDEND DECISION AND THEORIES**

A dividend is a distribution of a portion of a company's earnings to its shareholders, typically in the form of cash payments or additional shares of stock. It represents a return on investment for shareholders and is often considered a signal of a company's financial health and profitability. Dividends are usually declared and paid by the company's board of directors.

**Types of Dividends:**

1. **Cash Dividend**:
   * This is the most common type of dividend where shareholders receive cash payments from the company's profits. Cash dividends are typically paid quarterly, semi-annually, or annually, depending on the company's dividend policy and financial performance.
2. **Stock Dividend**:
   * Instead of cash, shareholders receive additional shares of the company's stock. Stock dividends are expressed as a percentage increase in the number of shares held by each shareholder. For example, a 5% stock dividend means shareholders receive an additional 5 shares for every 100 shares held.
3. **Property Dividend**:
   * In some cases, companies may distribute assets other than cash or stock as dividends. This could include physical assets, real estate, or other investments held by the company. Property dividends are less common than cash or stock dividends.
4. **Scrip Dividend**:
   * A scrip dividend is similar to a stock dividend, where shareholders receive certificates that entitle them to additional shares instead of cash. Scrip dividends give companies flexibility in managing cash flow while still providing shareholders with a return.
5. **Special Dividend**:
   * Special dividends are one-time payments made by a company in addition to its regular dividend payments. They are usually larger than regular dividends and may be issued in response to exceptional profits, asset sales, or other extraordinary events.
6. **Dividend Reinvestment Plan (DRIP)**:
   * While not a type of dividend per se, a DRIP allows shareholders to reinvest their cash dividends into additional shares of the company's stock. DRIPs offer shareholders the option to accumulate more shares over time without incurring brokerage fees.

**Factors Influencing Dividend Decisions:**

* **Profitability**: Companies typically pay dividends out of their profits. Therefore, sustained profitability is a key factor in a company's ability to maintain or increase dividend payments.
* **Cash Flow**: The availability of cash flow is crucial for paying cash dividends. Companies must ensure they have sufficient liquidity to meet their dividend obligations while funding ongoing operations and investments.
* **Financial Health**: Dividend payments are often seen as a reflection of a company's financial stability and confidence in future earnings. Strong financial health and consistent earnings growth support regular dividend payments.
* **Capital Requirements**: Companies must balance dividend payments with their capital expenditure needs for growth, debt repayment, and other strategic investments.
* **Legal and Regulatory Considerations**: Companies must comply with legal requirements, including state corporate laws and regulations, which may impose restrictions on the payment of dividends.

**Dividend policy**

Dividend policy refers to the guidelines and decisions a company follows regarding the distribution of dividends to its shareholders. There are several types of dividend policies that companies may adopt, each reflecting different approaches to managing cash flows, retaining earnings, and rewarding shareholders. Here are the common types of dividend policies:

1. **Regular Dividend Policy**:
   * Under this policy, companies pay dividends at regular intervals, typically quarterly, semi-annually, or annually. The amount of the dividend is usually stable or grows gradually over time, reflecting the company's consistent earnings and cash flow stability.
2. **Stable Dividend Policy**:
   * A stable dividend policy aims to maintain a steady dividend payout regardless of fluctuations in earnings or economic conditions. Companies using this policy prioritize providing a predictable income stream to shareholders, even if it means smoothing dividend payments during periods of lower profitability.
3. **Constant Dividend Payout Ratio**:
   * In this policy, companies distribute a fixed percentage of their earnings as dividends. For example, if a company follows a 50% payout ratio policy, it distributes 50% of its annual earnings as dividends each year. This policy ties dividend payments directly to earnings performance.
4. **Residual Dividend Policy**:
   * Under a residual dividend policy, dividends are paid from the residual or leftover earnings after funding all positive net present value (NPV) projects and maintaining the desired level of retained earnings. This policy prioritizes investment in profitable projects before distributing dividends.
5. **Irregular Dividend Policy**:
   * Companies with irregular dividend policies do not follow a fixed schedule or pattern for dividend payments. Dividends may be paid sporadically based on specific events (e.g., one-time profits, asset sales) or when the company has excess cash that is not immediately needed for operations or investments.
6. **No Dividend Policy (Zero Dividend)**:
   * Some companies, particularly growth-oriented or newly established firms, may opt not to pay dividends at all. Instead, they reinvest all earnings back into the business to fund expansion, research and development, or debt reduction. This approach is common among technology startups and high-growth industries.
7. **Hybrid Dividend Policy**:
   * A hybrid dividend policy combines elements of different dividend policies to suit the company's financial objectives and market conditions. For example, a company may maintain a stable base dividend while also paying special dividends or adjusting payouts based on earnings performance.

**Factors Influencing Dividend Policy:**

* **Industry and Business Cycle**: Companies in stable industries with consistent cash flows may prefer stable or regular dividend policies, whereas cyclical industries may opt for more flexible or conservative approaches.
* **Profitability and Earnings Stability**: Companies with steady and predictable earnings are more likely to adopt stable or constant payout ratio policies. Those with volatile earnings may prefer residual or irregular dividend policies.
* **Investment Opportunities**: Companies with high growth prospects may retain earnings for reinvestment in growth opportunities, leading to a no dividend or low payout policy initially.
* **Tax Considerations**: Dividend policy may also be influenced by tax implications for both the company and its shareholders. Tax laws regarding dividend income can impact decisions on the timing and size of dividend payments.
* **Shareholder Preferences**: Understanding the preferences of shareholders, including income-oriented investors versus growth-oriented investors, influences how companies structure their dividend policies to attract and retain investors.

**Dividend Decision theories**

1. **Walter's Model**

Walter's Model, proposed by Professor James E. Walter, is a dividend decision theory that establishes a relationship between the firm's dividend policy and its value. Walter's Model suggests that the choice of dividend policies almost always affects the value of the enterprise. This model operates under the assumption that investments are financed solely through retained earnings and not through external financing.

**Key Assumptions of Walter's Model**

1. **Internal Financing Only:** The firm finances all investments through retained earnings. No new equity or debt is issued.
2. **Constant Return and Cost of Capital:** The firm's rate of return on investments (r) and its cost of capital (k) remain constant.
3. **100% Payout or Retention:** Earnings are either completely distributed as dividends or entirely reinvested.
4. **Perpetual Life:** The firm has an infinite life.

**Interpretation of Walter's Model**

* **When r>kr > kr>k:** The firm can generate a higher return on retained earnings than the cost of capital. It suggests that the firm should retain earnings and not pay dividends. High retention will lead to higher value for the firm.
* **When r<kr < kr<k:** The return on retained earnings is less than the cost of capital. The firm should distribute earnings as dividends because retaining earnings would not benefit the shareholders.
* **When r=kr = kr=k:** The return on retained earnings is equal to the cost of capital. The firm's dividend policy does not affect the market value of the firm. Both retention and distribution of earnings will yield the same value.

**Implications of Walter's Model**

1. **Growth Firms:** Firms with high returns on retained earnings compared to their cost of capital (r > k) should retain all earnings to maximize the firm’s value.
2. **Normal Firms:** Firms with returns on retained earnings equal to their cost of capital (r = k) will find their value unaffected by the dividend policy.
3. **Declining Firms:** Firms with returns on retained earnings less than their cost of capital (r < k) should distribute all earnings as dividends to maximize the firm’s value.

**Limitations of Walter's Model**

1. **Assumption of Internal Financing:** The model assumes that the firm relies solely on retained earnings for financing, ignoring external sources.
2. **Constant Return and Cost of Capital:** It assumes that the return on investment and the cost of capital are constant, which is unrealistic in dynamic market conditions.
3. **Perpetual Life:** The assumption that the firm has an infinite life is not practical.
4. **No Taxes or Transaction Costs:** The model does not consider taxes or transaction costs, which can impact dividend decisions.

Walter's Model provides a clear framework for understanding the impact of dividend policy on the value of a firm, but its practical application is limited by its simplifying assumptions.

1. **Gordon's Model**

Gordon's Model, also known as the Gordon Growth Model or the Dividend Discount Model (DDM), is a method for valuing a company's stock price based on the theory that a stock is worth the sum of all its future dividend payments, discounted back to their present value. This model was popularized by Myron J. Gordon and is especially applicable to companies that pay regular dividends and are expected to grow at a constant rate.

**Key Assumptions of Gordon's Model**

1. **Constant Growth Rate:** Dividends are expected to grow at a constant rate indefinitely.
2. **Perpetual Earnings:** The firm will continue to operate and pay dividends forever.
3. **Constant Required Rate of Return:** The required rate of return for investors remains constant over time.
4. **Retention Ratio and Return on Equity:** The retention ratio and the return on equity are stable, ensuring consistent growth in dividends.

**Formula of Gordon's Model**

The formula to calculate the present value of a stock according to Gordon's Model is:

P0=D0(1+g)k−gP\_0 = \frac{D\_0 (1 + g)}{k - g}P0​=k−gD0​(1+g)​

or

P0=D1k−gP\_0 = \frac{D\_1}{k - g}P0​=k−gD1​​

Where:

* P0P\_0P0​ = Current stock price
* D0D\_0D0​ = Most recent dividend paid
* D1D\_1D1​ = Dividend expected next year
* kkk = Required rate of return (or discount rate)
* ggg = Growth rate of dividends

**Interpretation of Gordon's Model**

* **Stock Price Sensitivity:** The stock price is highly sensitive to the growth rate (g) and the required rate of return (k). Small changes in these rates can significantly affect the stock price.
* **Growth Rate vs. Required Return:** For the model to be valid, the growth rate (g) must be less than the required rate of return (k). If ggg approaches kkk, the stock price can become infinitely large, which is unrealistic.

**Implications of Gordon's Model**

* **High Growth Firms:** Firms with a high growth rate in dividends will have a higher stock price, assuming the growth rate is less than the required rate of return.
* **Stable Firms:** For firms with stable and predictable dividend growth, Gordon's Model provides a straightforward method to estimate the stock's intrinsic value.
* **Dividend Payers:** This model is most applicable to companies that have a history of paying dividends and are expected to continue paying and growing dividends at a consistent rate.

**Example Calculation**

Suppose a company paid a dividend of $2 per share last year (D\_0 = $2), the expected growth rate of dividends is 5% (g=0.05g = 0.05g=0.05), and the required rate of return is 10% (k=0.10k = 0.10k=0.10). The current stock price would be calculated as follows:

P\_0 = \frac{D\_0 (1 + g)}{k - g} = \frac{2 (1 + 0.05)}{0.10 - 0.05} = \frac{2.10}{0.05} = $42

**Limitations of Gordon's Model**

1. **Constant Growth Rate:** The assumption of a constant growth rate is often unrealistic for many companies, especially those in rapidly changing industries.
2. **Dividend Payments:** The model is not applicable to companies that do not pay dividends or have unpredictable dividend patterns.
3. **Required Rate of Return:** Estimating the required rate of return can be difficult and subjective.
4. **Economic Conditions:** The model does not account for changes in economic conditions that could affect the growth rate and required rate of return.

Gordon's Model is a useful tool for valuing dividend-paying stocks with stable growth rates, but its assumptions must be carefully considered and applied to appropriate scenarios.

1. **Modigliani-Miller (MM) approach**

The Modigliani-Miller (MM) approach, proposed by Franco Modigliani and Merton Miller in the 1960s, argues that in perfect capital markets, dividend policy is irrelevant to the valuation of a firm. This is known as the Dividend Irrelevance Theory. According to this theory, the value of a firm is determined solely by its earning power and the risk of its underlying assets, and not by how it distributes its earnings between dividends and retained earnings.

### Key Assumptions of the MM Approach

1. **Perfect Capital Markets:** There are no taxes, transaction costs, or issuance costs associated with securities.
2. **Rational Investors:** Investors behave rationally and have access to all relevant information without cost.
3. **No Uncertainty:** Future investment opportunities and earnings are known with certainty.
4. **No Influence of Dividends on Investment Policy:** The firm's investment decisions are independent of its dividend policy.

### Core Idea of MM Approach

The MM approach posits that the value of the firm is unaffected by its dividend policy because shareholders can create their own dividend policy by selling a portion of their shares if they desire cash, or reinvesting dividends if they prefer growth. This process is known as "homemade dividends."

### MM Proposition on Dividend Irrelevance

### Implications of MM Approach

* **Dividend Policy Irrelevance:** The firm's dividend policy does not affect its value. Investors can adjust their portfolios to achieve their desired income and investment goals regardless of the firm's dividend decisions.
* **Investment Policy Relevance:** The firm's value is determined by its investment policy and the expected returns on its investments.

### Criticisms and Limitations of MM Approach

1. **Taxes:** In reality, taxes exist, and dividends and capital gains are often taxed differently. This can affect investor preferences and the firm's value.
2. **Transaction Costs:** Buying and selling shares to create homemade dividends incurs transaction costs, which the MM approach ignores.
3. **Information Asymmetry:** Investors do not always have access to all relevant information, leading to different perceptions of value.
4. **Market Imperfections:** Real-world markets are not perfect, and factors such as agency costs, signaling effects, and investor preferences can influence dividend policy.

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