A Report

on

Dividend Decisions

for

Corporate Finance (BM511H)

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DECLARATION

We hereby declare that we have written this project with our own ideas in our own words and wherever others' ideas or words have been used, have adequately been cited and mentioned in the original sources. We also declare that we have cohered to all principles of unpragmatic honesty and honour and have not simulated or forged or falsified any idea/data/fact/source in our submission.

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Introduction

Running an organization involves making countless decisions every day, but the ones that are most important are related to money. These decisions are called ‘Financing Decisions.’ There are three types of financing decisions that financial managers have to take.

1. Investment Decision
2. Financing Decision and
3. Dividend Decision

Dividend decision is one of the most important areas of financial management decisions, and our assignment is mainly focused on Dividend Decisions.

What does dividend mean?

Dividend refers to that portion of the profits after tax that are distributed among shareholders of the firm. When a firm brings in earnings they can either give dividends to the shareholders or retain their earnings to invest in future growth prospects. There is no statutory obligation to distribute dividends, it is discretionary. Giving away dividend is not always good for the company and it is not always the sign of growth or good financial position of the company. There are multi-fold implications of dividend decisions.

There are 3 main components of dividend decisions -

1. <u>Quantity:</u> The quantity of the dividend refers to the amount of money that the company will distribute to shareholders. Financial managers must consider the company's financial health, profitability, cash flow, and growth prospects when deciding on the quantity of the dividend.
2. <u>Time:</u> The time of the dividend refers to when the company will distribute the dividend to shareholders. Financial managers must decide on the timing of the dividend payout based on the company's cash flow and financial obligations. Dividends can be paid on a quarterly, semi-annual, or annual basis.
3. <u>Form:</u> The form of the dividend refers to the method used to distribute the dividend to shareholders.

Forms of Distribution - Dividends can be distributed to shareholders in different forms, depending on the company's policies and the shareholder's preference.

1. Cash dividends: Cash dividends are the most common form of dividend distribution. In this form, the company pays cash directly to its shareholders based on the number of shares they own.

2. Stock dividends (Bonus Shares): A stock dividend is a distribution of additional shares of stock to the shareholders. For example, if a company declares a 10% stock dividend, a shareholder who owns 100 shares will receive an additional 10 shares.

3. Stock Repurchase: Stock repurchase is when a company buys its own shares either through a fixed-price tender offer or open market purchases. It can be used to return excess cash to shareholders, improve financial ratios, or signal confidence in the company's future prospects, and can increase the value of each remaining share by reducing the number of outstanding shares.

Theories of Dividend Policy

There are two conflicting school of thought regarding Dividend Policies-

a) School of Irrelevance - The supporters of this school of thought believe that dividends have no impact on the price of the company's shares or its market value.

   i) Residual Theory: This theory suggests that a company should first invest in all positive net present value (NPV) projects, then use the remaining cash to pay dividends to shareholders. According to this theory, dividends should be considered the residual, or leftover, after all investment opportunities have been explored.

   ii) Modigliani and Miller Theory: This theory, proposed by economist Merton Miller and Franco Modigliani, argues that dividend policy has no effect on a company's stock price or the wealth of its shareholders. The theory assumes that investors can buy or sell shares of stock to create their own dividend streams and that companies can raise capital by issuing new shares or borrowing money. Therefore, according to this theory, a company's dividend policy is irrelevant and does not affect its value.

b) School of relevance - The supporters of this school of thought believe that dividends affect the price of the company's shares or its market value.

i) Gordon approach or Bird-in-hand Theory: This theory (advanced by John Litner in 1962 and Myron Gordon in 1963) suggests that investors prefer to receive dividends rather than wait for future capital gains, which are uncertain. Thus a "bird in the hand is worth more than two in the bush". According to this theory, paying dividends signals financial health and stability to investors, leading to higher stock prices. Therefore, a company should pay out as much in dividends as possible, without sacrificing its long-term growth potential.

ii) Walter Model: According to him, giving dividends affect the firm value, he had several assumptions like retained earnings is the only source of financing, rate of return and cost of capital remains constant, firm has infinite life.

Formula: $P = Div/Kc + {}_{r/k}(EPS - Div)/Kc$

Analyzing Dividends Returned

To analyze dividends paid back to shareholders, we have to consider the following factors:

1. Dividend Yield: The dividend yield is the ratio of the annual dividend paid per share to the current stock price. This measures the percentage return that shareholders receive from dividends.
2. Dividend Payout Ratio: The dividend payout ratio is the percentage of earnings that a company pays out as dividends. A high payout ratio may indicate that a company is mature and has limited growth prospects, while a low payout ratio may suggest that the company is reinvesting earnings into growth opportunities.
3. Dividend History: Examining a company's history of dividend payments can provide insight into its financial stability and commitment to returning value to shareholders.
4. Dividend Growth: A company's ability to consistently grow its dividend payments over time is a positive indicator of financial health and long-term stability.
5. Industry Comparisons: Comparing a company's dividend yield and payout ratio to those of its peers in the same industry can provide context and highlight potential strengths or weaknesses.

By analyzing these factors, we can gain a better understanding of a company's dividend policy, financial health, and potential for long-term growth. However, it's important to remember that dividend payments are not the only indicator of a company's performance, and should be considered alongside other financial metrics and market trends.

Companies generally distribute cash to owners in the form of dividends, but over the past several years, stock buybacks have become an increasingly popular substitute. How much did firms pay back to investors during the past several years, and how much more might they have paid back? Would we prefer these companies to alter their existing policies and return more or less money to shareholders?

Share buyback? - Firms have two options to return cash to stockholders: Dividends or Equity repurchases. The choice depends on various factors such as the sustainability and stability of excess cash flow, stockholder tax preferences, predictability of future investment needs, undervaluation of the stock, and management compensation. If excess cash flows are temporary or unstable, firms should repurchase stock. If stockholders are taxed at higher rates on dividends, they will be better off if the firm repurchases stock. If future investment opportunities are uncertain, firms should use equity repurchases. If managers believe their stock to be undervalued, an equity repurchase makes even more sense.

A Cash Flow Approach

There are various ways for firms to analyze if they are returning an appropriate amount to their stockholders. One major way is to determine how much cash is available for return to stockholders after taking into account reinvestment needs and debt payments. This amount is then compared to the actual amount returned to stockholders. Firms are classified into three categories: those that return more cash than they have available, those that return the exact amount available, and those that return less than they have available. By examining firms that consistently return more or less than they have available, we can understand the impact of these policies on the firms.

Step 1: Measuring FCFE (Free Cash Flow to Equity) – It is the cash available to be returned to stockholders. It represents the cash that can be used to pay dividends, buy back shares, or make other investments that benefit the shareholders. FCFE is calculated by subtracting capital expenditures and changes in net working capital from operating cash flow and then adjusting for any debt payments made.

The formula for Free Cash Flow to Equity (FCFE) is:

FCFE = Net Income - (Capital Expenditures - Depreciation) - Change in Non-cash Working Capital + Net Borrowing

Step 2: Assessing their project quality - A company's investment opportunities play a crucial role in determining its dividend policy, as reinvesting cash into the business is an alternative to returning it to stockholders. Therefore, firms with stronger investment opportunities have greater flexibility in deciding on dividend policy and can better resist pressure from shareholders for higher dividends, assuming all other factors remain constant.

A firm’s current project portfolio can be evaluated by – Using the Cash Flow Return on Investment (CFROI), which compares the real cost of capital to the real internal rate of return on existing investments according to projected cash flows and the remaining life of the investments. And with

Economic Value Added, which may be calculated on an equity or capital basis and evaluates the extra return made on capital invested in existing investments.

Step 3: Evaluating the dividend policy – FCFE represents the cash flow available to be distributed to shareholders after all necessary investments have been made in the business, while ROE represents the company's profitability in relation to the amount of shareholder equity invested.

There dividend decisions are to increase, maintain, review, reduce, suspend payout.

	High ROE	**Medium ROE**	**Low ROE**
High FCFE	Increase	Maintain	Review
Medium FCFE	Maintain	Review	Reduce
Low FCFE	Review	Reduce	Suspend

Companies chosen are as below, belonging to the same sector i.e., refineries:

- **Indian Oil Corporation Ltd. (IOC)**
- **Oil and Natural Gas Corporation (ONGC)**
- **Bharat Petroleum Corporation Ltd. (BPCL)**

1. How has your company returned cash to its owners? Has it given dividends or brought back shares?

All the three companies paid out cash dividends. The following charts represent the amounts of dividends paid out:

IOC:

Announcement Date	Ex-Date	Dividend Type	Dividend per share(Rs.)	Share price	Dividend yield
17-05-2022	11-08-2022	Final	2.4	73.62	3.26%
31-01-2022	09-02-2022	Interim	4	79	5.06%
01-11-2021	11-11-2021	Interim	5	89.43	5.59%
19-05-2021	05-08-2021	Final	1.5	69.67	2.15%
10-03-2021	23-03-2021	Interim	3	64.8	4.63%
29-01-2021	09-02-2021	Interim	7.5	66.53	11.27%
13-03-2020	23-03-2020	Interim	4.25	54.67	7.77%
17-05-2019	21-08-2019	Final	1	59.97	1.67%
13-03-2019	27-03-2019	Interim	1.5	52.33	2.87%
13-12-2018	21-12-2018	Interim	6.75	97.03	6.96%
22-05-2018	20-08-2018	Final	2	106.33	1.88%
30-01-2018	08-02-2018	Interim	19	129.62	14.66%
26-05-2017	18-08-2017	Final	1	142.33	0.70%
23-03-2017	24-03-2017	Interim	4.5	124.9	3.60%
31-01-2017	09-02-2017	Interim	13.5	128.9	10.47%

BPCL:

Announcement Date	Ex-Date	Dividend Type	Dividend per share(Rs.)	Share price	Dividend yield
25-05-2022	19-08-2022	Final	6	342.45	1.75%
31-01-2022	10-02-2022	Interim	5	372.7	1.34%
29-10-2021	11-11-2021	Interim	5	425.95	1.17%
26-05-2021	16-09-2021	Final	23	437.5	5.26%
27-05-2021	16-09-2021	Special	35		
16-03-2021	25-03-2021	Interim	5	426.45	1.17%
08-02-2021	17-02-2021	Interim	16	404.5	3.96%
12-03-2020	23-03-2020	Interim	16.5	285	5.79%
20-05-2019	21-08-2019	Final	8	328	2.44%
08-02-2019	21-02-2019	Interim	11	388	2.84%
29-05-2018	31-08-2018	Final	7	356	1.97%
09-02-2018	22-02-2018	Interim	14	431.2	3.25%
30-05-2017	08-06-2017	Final	1	483.23	0.21%
23-03-2017	24-03-2017	Interim	12	422.6	2.84%
10-02-2017	28-02-2017	Interim	19.5	460	4.24%

ONGC:

Announcement Date	Ex-Date	Dividend Type	Dividend (Rs) per share	Share price	Dividend yield
09-02-2023	24-02-2023	Interim	4	153.7	2.60%
09-11-2022	21-11-2022	Interim	6.75	136	4.96%
30-05-2022	18-08-2022	Final	3.25	138.25	2.35%
08-02-2022	21-02-2022	Interim	1.75	167.4	1.05%
08-11-2021	22-11-2021	Interim	5.5	156.6	3.51%
25-06-2021	08-09-2021	Final	1.85	119	1.55%
15-02-2021	17-02-2021	Interim	1.75	102	1.72%
28-02-2020	23-03-2020	Interim	5	60.65	8.24%
30-05-2019	22-08-2019	Final	0.75	121.2	0.62%
19-03-2019	26-03-2019	Interim	1	159	0.63%

04-02-2019	28-02-2019	Interim	5.25	144.4	3.64%
30-05-2018	19-09-2018	Final	1.35	173.25	0.78%
19-02-2018	13-03-2018	Interim	2.25	182.4	1.23%
18-10-2017	03-11-2017	Interim	3	187.15	1.60%
01-06-2017	21-09-2017	Final	0.8	167.7	0.48%
18-01-2017	07-02-2017	Interim	2.25	198	1.14%

IOC and ONGC both bought back shares only in 2019 between the 2017-2022 period. However, BPCL did not buy out any of its outstanding shares over the last 6 years. The following tables show the details of share buyback of the two companies:

ONGC:

Buyback Type:	**Tender offer**
Buyback Record Date:	Jan 04 2019
Buyback Opening Date:	Jan 29 2019
Buyback Closing Date:	Feb 11 2019
Buyback Offer Amount:	₹ 4402 Cr
Date of Board Meeting approving the proposal:	Dec 20 2018
Date of Public Announcement:	Dec 20 2018
Buyback Offer Size:	1.97%
Buyback Number of Shares:	25,29,55,974
FV:	10
Buyback Price:	₹ 159 Per Equity Share

IOC:

Buyback Type:	**Tender offer**
Buyback Record Date:	Dec 25 2018
Buyback Opening Date:	Jan 22 2019
Buyback Closing Date:	Feb 04 2019
Buyback Offer Amount:	₹ 4435 Cr
Date of Board Meeting approving the proposal:	Dec 13 2018

Date of Public Announcement:	Dec 13 2018
Buyback Offer Size:	3.06%
Buyback Number of Shares:	29,76,51,006
Buyback Price:	₹ 149 Per Equity Share

2. How should the company return cash to its shareholders given that it has excess cash?

There are several ways these companies can return cash to its shareholders such as through dividends, share buybacks, special bonuses or distributions, debt reduction etc.

- **Dividends:** They could give out cash to the shareholders in the form of dividends. Dividends are given out of company's profit. can pay out one-time special dividend or increase its regular dividend payment.
- **Share Buybacks:** By share buyback they can return cash to its shareholders. Share buyback happens when company start to repurchase its own shares from the primary market. It reduces the outstanding shares and increases the value of existing shares of the company. So buying back share is a great way to return cash to its shareholders.
- **Special Bonuses or Distributions:** They can also provide special bonuses or distributions in the form of cash payments, stock options or compensation. The bonus payments are mainly cash payment. So it can immediately increase shareholders' return on investments. It is kind of short term boost for shareholders' return. Along with that if a company is giving special bonuses then it is actually signaling that the financial condition of the company is good which attracts the investors. So they invest money in it and thus stock price increases.
- **Debt Reduction:** Excess can be used to pay down debt. So by reducing the company's debt load they can improve financial condition and increase the value of shares. This would indirectly increase the benefits of shareholders.

So these are the ways they can return cash to shareholders. Though ultimately it will also depend on their financial condition, priorities, preferences of shareholders. For this the board of directors and the management team need to consider all the factors and make decision on it which will benefit the company and shareholders as well.

3. How much cash this company could have returned to its shareholders over the past few years? How much of it did the company actually return?

The ratio of cash returned to stockholders to FCFE shows how much of the cash available to be paid out to stockholders is actually returned to them in the form of dividends and stock buybacks. If this ratio, over time, is equal or close to 100%, the firm is paying out all that it can to its stockholders. If it is significantly less than 100%, the firm is paying out less than it can afford to and is using the difference to increase its cash balance or to invest in marketable securities. If it is significantly over 100%, the firm is paying out more than it can afford and is either drawing on an existing cash balance or issuing new securities (stocks or bonds).
Whereas the conventional measure of dividend policy, the dividend payout ratio, gives us the value of dividends as a proportion of earnings. In contrast, our approach measures the total cash returned to stockholders as a proportion of the free cash flow to equity:

Dividend Payout Ratio = Dividends / Earnings
Cash to Stockholders to FCFE Ratio = (Dividends + Equity Repurchases) / FCFE

IOC: (all data in millions of Rs.)

Year	Cash from operations	Capex	Net issuance of debt	FCFE	Net income	Total dividends paid	Payout ratio	Buyback	Cash returned to shareholders	Cash returned/FCFE
Mar-17	282161	147861	46420	180720	279558	127736	46%	0	127736	70.68%
Mar-18	291153	224448	23552	90257	344502	114672	33%	0	114672	127.05%
Mar-19	127465	254949	309209	181725	259269	116790	45%	44350	161140	88.67%
Mar-20	86533	321774	326531	91290	-71770	58029	-81%	0	58029	63.57%
Mar-21	498617	238332	-133807	126478	307507	83832	27%	0	83832	66.28%
Mar-22	245703	230371	125965	141297	342886	108960	32%	0	108960	77.11%
Avg.	1531632	1417735	697870	811767	1461952	610019	42%	44350	654369	80.61%

As we can see, IOC paid out 42% of its aggregate earnings as dividends over the period of 2017-22.

Over the same period, it returned 80.61% of its FCFE to its stockholders in the form of dividends and stock buybacks. Though the payout ratio gives us little information about the company, the cash returned as a percent of FCFE suggests that IOC accumulated cash during this period.

Similarly, we can judge for the other two companies:

BPCL: (all data in billions of Rs.)

Year	Cash from operations	Capex	Net issuance of debt	FCFE	Net income	Total dividends paid	Payout ratio	Buyback	Cash returned to shareholders	Cash returned/FCFE
Mar-17	90	96	127	121	137	55	40%	0	55	45.45%
Mar-18	111	78	15	48	142	36	25%	0	36	75.00%
Mar-19	102	105	66	63	129	40	31%	0	40	63.49%
Mar-20	80	123	118	75	37	53	143%	0	53	70.67%
Mar-21	235	91	-127	17	224	49	22%	0	49	288.24%
Mar-22	203	78	-19	106	160	145	91%	0	145	136.79%
Avg.	821	571	180	430	829	378	46%	0	378	87.91%

ONGC: (all data in billions of Rs.)

Year	Cash from operations	Capex	Net issuance of debt	FCFE	Net income	Total dividends paid	Payout ratio	Buyback	Cash returned to shareholders	Cash returned/FCFE
Mar-17	458	363	160	255	292	154	53%	0	154	60.39%
Mar-18	568	449	241	360	261	95	36%	0	95	26.39%
Mar-19	615	428	-31	156	339	101	30%	44.02	145	92.96%
Mar-20	716	550	-34	132	116	83	72%	0	83	62.88%
Mar-21	472	430	-4	38	214	31	14%	0	31	81.58%
Mar-22	780	445	-182	153	493	129	26%	0	129	84.31%
Avg.	3609	2665	150	1094	1715	593	35%	44.02	637	58.23%

4. How is this company’s dividend policy relative to the other peer companies and the market?

Dividend policies of all the three companies are pretty much similar where they return majority of their cash to the shareholders. IOCL, BPCL and ONGC returned to its shareholders an average of 80.61%, 87.9% and 58.23% cash respectively over the period of 2017-22.

All of these are mature companies with minimal growth potential, and in order to be an attractive option to the existing and potential shareholders, they decide to pay good dividends (relatively high dividend yield as compared to growth companies).

After determining a company's ability to pay dividends and the calibre of its projects, we can determine if it should stick with its current policy of distributing cash to stockholders, return more cash, or return less cash. The evaluation will be based on the amount of free cash flow to equity returned to stockholders on a period-by-period basis and the attractiveness of the firm's project opportunities (higher IRR). There are four possible scenarios:

	Poor projects (IRR < Kc)	Good projects (IRR > Kc)
Cash Returned < FCFE	Increase payout, Reduce Investment	Flexibility to accumulate cash
Cash Returned > FCFE	Cut payout, Reduce Investment	Cut payout, Invest in Projects