Week 11 Seminar Solutions

ULO5: Analyse theory and practice of dividend policy.

1. **You have the following information on two companies. Can you explain which of the firms will have higher agency conflict between manager and shareholders? Explain your answer clearly.**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Company Name** | **No of Share outstanding** | **No of shareholders** | **Market Value of the company** | **Pays regular and higher dividend** |
| **Exotica Corp.** | **10,000** | **10** | **$1 billion** | **No** |
| **Romaica Corp.** | **2 million** | **1 million** | **$100 million** | **Yes** |

From the table above we can infer that investors in Exotica Corp. have better control over the management since the shares are distributed among small number of shareholders (blockholders). Each of which holds a large block of the company’s shares. These blockholders will closely monitor the actions of management, and the control they exercise should be effective in ensuring that new investments by the company are expected to be profitable. In other words, control by blockholders should prevent overinvestment. Thus investors have a better control over the management. However, in Romaica Corp. ownership is more diffused. In this case control by shareholders is limited. Thus it is easy for manager to overinvest and misuse compnay’s profit. Thus, managers are likely to find that a commitment to pay higher and regular dividends is an effective way of avoiding overinvestment and reduce agency conflict. Thus, based on the above information none of the firms should have any agency conflict between shareholders and managers.

1. **The Initech Corp. has asked your advice on its payout policy. In the past years Initech's earnings, dividends and the company's share price has been relatively stable. The company is thinking of expanding its activities from producing furniture for households to producing furniture for office space. To undertake the proposed expansion activity the company intends to issue new shares. As the expansion is expected to average approximately 30 per cent return on investment each year, it is not expected that there will be any difficulty in convincing shareholders to take up their shares. Below are data on earnings, dividends and share prices for the years 2017–20 and the expected figures for 2021. Make a recommendation on the dividend payment for 2021. Explain your answer clearly.**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Per share | 2017 | 2018 | 2019 | 2020 | 2021 |
| Earnings | $0.40 | $0.42 | $0.44 | $0.43 | $0.44 |
| Cash | $0.60 | $0.67 | $0.67 | $0.66 | $0.66 |
| Dividend | $0.20 | $0.20 | $0.22 | $0.22 | ? |
| Market price | $4.00 | $4.10 | $4.40 | $4.35 | $4.40 |

A policy of reducing dividend in 2021 in order to help finance the investment project, only to increase the dividend payout in a couple of years’ time, will result in a discontinuous dividend pattern which may have an adverse effect on the price of the company’s shares. It may be suggested, therefore, that the company maintain the 22 cent dividend payout and finance the proposed investment by an issue of shares.

1. **Share buybacks are sometimes motivated by the desire to increase earnings per share. Falcon Ltd recorded an operating profit of $2 million in the last financial year. It has 4 million shares on issue and the market price of the shares is $5 each. Falcon announces that it will repurchase 10 per cent of each shareholder's shares at $5 per share.**
2. **Calculate Falcon's price–earnings ratio before the buyback.**

**(b) An observer comments as follows: ‘Falcon's buyback should boost its earnings per share from 50 cents to 55 cents, so with the price–earnings ratio remaining the same, the share price should increase’.**

**(i) If the observer's argument is correct, what will Falcon's share price be after the buyback?**

**(ii) Critically evaluate the observer's argument.**

(a) Earnings per share = 

= $0.50

Price–earnings ratio = $5/$0.50

= 10

(b) (i) If the observer is correct, the price will be: $0.55 × 10 = $5.50.

(ii) The observer may be correct that the share price will increase after the buyback, but the argument, as stated, has two weaknesses. First, it does not necessarily follow that total earnings will remain unchanged and that EPS will increase in line with the lower number of shares. To buy the shares, Falcon will have to outlay cash that could have been invested to earn some profit. Therefore, total earnings may fall after the buyback. Second, if the buyback results in higher financial leverage, the shares will be more risky, in which case the P/E ratio should fall.