UNIT 19 DIVIDEND POLICY-AN INTRODUCTION

19.1 INTRODUCTION

Dividend policy represents the blueprint as per which company declares dividend to its shareholders. There are many views related to dividend declaration and stakeholder perceptions, and some theories propounds the importance of dividend on market price of shares whereas, some suggest that dividend have no relevance on shares as investors can sell their shares when they need cash. This unit tries to cover the various theories and tries to make them easily understandable for the students.

19.2 OBJECTIVES

After reading this unit, you would be able to;

- understand the different forms of dividend policy
- understand the relevance of dividend policy
- understand the factors influencing dividend decision making.

19.3 DIVIDEND POLICY

As per Weston and Bringham, "Dividend Policy determine the division of earnings between payments to shareholders and retained earnings"

In other words, Dividends are the payments received by the investors from time to time. Dividends are important as they tend to be the income of the shareholders and shareholder too expects certain return from their investments in the form of dividends. Dividend policy is an important decision as they tend to show the guidelines according to which dividend are paid by the companies to their shareholders.

Dividend decision of companies depends upon company's earnings and also on their long term investment project. Dividend decision is also important because its effect the rating of the firm, growth rate and also the value of share price. There are two group of concepts regarding dividend policy and their impact on share value these are irrelevant and relevant concept. Irrelevant concept says that share prices are not affected by dividend policy whereas relevance concept says that share price is affected by dividend policy. These concepts will be discussed later in this module

Dividend Policy depends on three things:

- To retain earning for investments
- To distribute earning to shareholders in terms of dividends
- To have some corpus as retained earnings and distribution of wealth to share holders

19.3.1 DIMENSIONS OF DIVIDEND POLICY

This section covers the parameters on which dividend payout ratio depends:

Some of the dimensions are:

1) Fund requirement: This covers the total requirements of fund by the company of the organization.
2) Liquidity: This denotes the ready cash available by the company so to meet the future or immediate needs
3) External Financing: This dimension covers the external sources like bank loans etc.
4) Shareholder choice: This covers the shareholder preference whether they need dividend or further investments
5) Difference in the cost of retained income and external financial sources: If external financing is cheaper than dividend distribution is preferred or else company will retain the earning or further investments.
6) Control: This denotes the control of management or the shareholders.
7) Taxes structure also impact the dividend distribution decision.

19.3.2 TYPES OF DIVIDEND POLICY

1) Periodical return Policy: When it is paid at par rate then it is called regular dividend or periodical dividend. It is generally preferred by pensioners and old age people as it is a stable source of income. It is generally issued by the company which have a stable long term earnings.
   - It helps in maintaining a stable good will of the company
   - It promotes a fair value of share price

- It also builds confidence among the shareholders

However, regular dividend rate is generally less than the earning of the company.

2) Stable dividend: It means when regular dividend is paid and there is consistency in dividend payment. This type of Dividend falls into three category:

   - When dividend is fixed in respective of per share.
   - When there is constant payout ratio, this ratio fluctuates in respective of earnings.
   - Stable dividend plus extra depend upon profit.

There are also few other approaches related to dividend policy:

1) Residual Dividend policy: This policy entails dividend payment after all sort of investment are done i.e. the leftover profit is distributed as dividend after taking out capital for all sort of long term investments.
   The long term advance of this approach is it helps in long term planning and disadvantage is that it hinders in stable dividend payment.

   Steps in Residual Dividend Policy:
   - To determine the payout ratio considering optimum capital budget.
   - Determination of Equity needed for optimum capital budget
   - Distribution of dividend from the left over after doing retained earnings.

   This policy is beneficial for long term planning and investment as dividends are paid from left over but the disadvantage is dividend is not stable it keep on changing as per the need of the investment.

2) Dividend Stable policy: This policy is opposite to residual policy as this promotes stable dividend of yearly earnings. This policy reduces the uncertainty of dividend

3) Hybrid Approach: This framework is is a result of Residual and stable dividend framework. Under this methodology, companies overviews debt/equity ratio in longer aspect.

Examples of Approaches:

Regular Dividend, Say Company pays Rs 10 as dividend on per share than under this policy company will always pay Rs 10 as dividend per share.

Constant payout ratio says that as a company has a policy of paying 10 percent of its earnings as dividends. Than under this policy irrespective of earnings dividend will be 10percent of their earnings.

In stable and extra profit policy: Some portion of dividend is fixed thus promotes regular earnings and in times of extra profit, extra dividend is added to their regular dividend as a part of profit.

Example of Residual dividend policy, let's assume that there exist a company named XYZ which has right nowgeneratedRs1,000 and has a rigid rule to manage a debt/equity ratio of 0.5 (one part debt to every two parts of equity). Assuming that this company is having a project in which Rs 900 as capital is required. In its approach to manage the debt/equity ratio of 0.5, XYZ would have to outlay for one-third of this project by using debt (Rs 300) and two-thirds (Rs 600) by using equity. It means ,XYZ would have to raise Rs 300 from market and use Rs 600 of its own equity to manage the 0.5 ratio, leaving a residual amount of Rs 400 (Rs 1,000 –Rs 600) for dividends. This approach of dividend outlay initiatesfluctuations the dividend outlay that some investors may render it unsuitable.

Stable Dividend Policy Example says that a company earns Rs 2000 yearly and company policy says that company will distribute 25% as dividend than will be Rs 500 out of total earnings.

Hybrid policy example: This policy is a combination of other two policy say company has a policy of distributing 15 % as profit in the form of dividend if the earning is within Rs 3000 per year and if earning exceed Rs 3000 than the shareholder will also get extra dividend apart from usual 15% of profit.

So these are some of the example related to the dividend policy. Dividend decision is important because it not only promotes confidence among shareholders but also help in future investment decisions.

19.4 ACTIVE VS PASSIVE DIVIDEND POLICY

Passive and active dividend policy depends upon the time of distribution of dividend. Active dividend policy is more concern with regular dividend payments whereas passive dividend policy is concern with the payment of dividend when the right time comes or when the management thinks it's time to distribute dividends.

Theories of Dividend

There are generally two major streams of Dividend: One is Relevance and other is irrelevance theories which study the significance of Dividend decision and their impact on the value of firm. Both the theories share contrary views on dividend and market worth of the company.

19.4.1 RELEVANCE THEORY

Prof. James E.Walter and Prof. Gordon supported the theory that value of the firm is affected by the dividend policy and they play a concrete role in affecting the share price of the company. They have studied the importance of the transactional value between internal rate of return (R) and cost of capital (K) in deciding acceptable dividend policy which enhances the wealth of stakeholders.

19.4.1.1 Walter Model valuation of Shares:

Various assumptions of this Model are;

1) Company initiates its investments by utilizing its retained portion of income.

2) The Internal Rate Of return (R) and Cost of Capital (K) of the company is stable.

3) The company revenue are either disbursed as dividends or taken for internal use.

4) The income and dividends of the company is constant.

5) The firm is having perpetual succession.

P= (DPS/k) + [r (EPS-DPS)/K] K

Or

P= [D+r/k * (E-D)]/K

DPS= Dividend per share

EPS= Earnings per share

P=Market price per share

R= firms rate of return

K= firms cost of capital

Evaluation through example:

A company has the following facts:
Cost of capital (ke) = 0.10
Earnings per share (E) = Rs 10
Rate of return on investments (r) = 8%
Dividend payout ratio: Case A: 50% Case B: 25%
Show the effect of the dividend policy on the market price of the shares.

Case A:

D/P ratio = 50%
When EPS = Rs 10 and D/P ratio is 50%, D = 10 x 50% = Rs 5

$$P = \frac{5 + [0.08 / 0.10] [10 - 5]}{0.10} \Rightarrow \text{Rs } 90$$

Case B:

D/P ratio = 25%
When EPS = Rs 10 and D/P ratio is 25%, D = 10 x 25% = Rs 2.5

$$P = \frac{2.5 + [0.08 / 0.10] [10 - 2.5]}{0.10} \Rightarrow \text{Rs } 85$$

Criticism:

- Model assumed that firm investments are totally done through corpus of retained portion of income and not depends upon external borrowing.
- Model assumes that constant r and constant cost of capital are false as r and cost of capital changes with time. Walter Model deduces risk from the value of firm by considering discount rate to be constant.

1.9.4.1.2 Gordon Model Valuation of shares

Gordon Model Assumptions:

1) The company is debt free i.e. only equity ownership.
2) Company is depended totally on the retained portion of income for future investments.
3) The company's IRR is constantly stable.
4) The cost of capital of the company is stable without any fluctuations..
5) The company have its earnings in succession i.e. never ending.
6) Growth ratio and retention ratio is also constant.
7) K>g.
8) Lack of corporate tax

Formula to calculate Market price of shares: P = (EPS * (1-b) / (k-g)

P = Market price per share

EPS = Earnings per share

b= retention ratio of the company

(1-b) = payout ratio of the company

k = cost of capital of the company

g = growth rate of the firm = b*r

Valuation with help of example:

Earnings per share of company T is Rs 30. The rate of market discount is 24% .The dividends are assumed to grow 20% annually. Retain earnings of company is 60%.Calculate market value of shares as per Gordon model.

P= [30*(1-.60)]/ (.24-.20) = Rs 300

Criticism:

- No external financing assumption is unclear and unrealistic
- Constant rate of return and constant cost of capital is vague assumptions as it supposes that shareholder wealth is not tuned. A stable k means the associated business risks are not calculating for valuation of the companies.

Both the model shares common views as they have almost common objectives.

1.9.4.1.3 Traditional Model

This was propounded by B Graham and DL Dodd, they showed a clear existence of relation between dividend and stock market, they argued that high dividend affect the market price of shares positively and vice versa. They have introduced the concept of multiplier for establishing a relationship between market price and dividend.

They argued that price to earnings ratio(P/E ratio) related to dividend payout ratio: a greater dividend payout ratio will enhance the P/E ratio and will be reciprocated.

Formula for valuation:

P= m (D+E/3)

P= Price

M= Multiplier

D=Dividend per share

E=Earnings per share

Criticism:

- Relationship of P/E ratio and dividend payout ratio is not true for firm which have high earning and low payout ratio.

- Approach not applicable for firm with slow growth rate and high payout ratio
- There are investors who prefer dividend instead of unexpected capital gains and vice versa so the approach is not exactly applicable for all the firms.

19.4.2 IRRELEVANCE THEORY

Modigliani-Miller Model supports the irrelevance theory of dividend decision making which says that the investments and earning of the firms are the critical factors in deciding the dividend decision making.

This theory was proposed by Franco Modigliani and Merton Miller in 1960, they focused that the most important things for investors is company investment policy and their future earning if investment and earning is good than investors does not requires the dividend history for the valuation of share price.It means the future investments are driven by company policy on investment not on dividend policy. They further iterated that investors can handle their cash need from the stock itself and they don't need dividend for meeting their cash requirements.

Valuation of shares price as per MM approach:

The assumed the same discount rate/ rate of return for all stocks:

Formula for calculating the shares price: t1= t0*(1+y)-D

t_1 = market price of the share at the end of a period

t_0 = market price of the share at the beginning of a period

y = capital's cost

D = the amount of dividend received

Explanation through Example:

Price of Reliance stock was Rs 1500. The discount rate applicable by the company is 15%. Reliance declares dividend of Rs 100 per share. Calculate the price of Reliance shares as per MM Approach.

Market price of the stock = P1 = 1500 * (1 + .15) – 100 = 1500 *1.15 – 100 = 1625.

Assumptions:

1) Capital markets are of perfect in nature: - Free flow of information having no transactional cost causes rational decision making.
2) There exist no taxes: - Existence of liberal tax regime for capital gains and dividends.
3) The firm has a rigid investment structured with strong policy .So if the retained portion of income is again used, there is no change in the risk pattern of the company. So y remains constant.

4) There is no existence of floatation cost.

Criticism:

- There assumptions of no taxes in capital market cannot be justified as in reality there are taxes in capital market.
- Assumption that no difference in external and internal financing is not correct as there are certain costs which make both the financing different.
- Cash from shares selling as cash from dividend is different as selling cost are also include in share which make dividend more preferable.
- In some cases dividend is relevant for the investors.

So these are the basic approaches which differentiate between the share price and dividend decision relationship.

19.4.3 LINTNER'S MODEL

John Lintner's studied the actual dividend behaviour in the year 1956. The study concluded that investment needs are not so important for dividend decisions rather dividend distribution change affect the earnings of company. This study was done in two phase using interview method for data collection.

19.4.4 RADICAL APPROACH

This approach focussed on tax on earnings and dividend and concluded that if tax on dividend is greater than in that case dividend distribution is not preferred rather than capital gain is good and vice versa.

Check Your Progress-A

Q1. Why dividend policy decisions are important for a company?

Q2. What is the difference between Passive and Active Dividend Policy?

Q3. What are the assumptions of Walter's dividend model?

Q4.What is Lintner's Model?

19.5 DIVIDEND DECISION FACTORS

Dividends are the part of cash shared with shareholders. Dividend distribution depends upon host of factors some of them are mentioned below:

1) Legal requirement: Although there are no legal requirement for dividend distribution subject to certain requirements. If there is profit company is required to pay dividend and if company suffers loss than dividend distribution is not compulsory. Firms are not required to pay dividend of this paid in capital to protect the equity base lastly, if the company is insolvent than it is not required to pay dividend.
2) Firm's liquidity position: Liquidity position denotes cash availability of a firm, if a firm has high liquidity it's easier to distribute cash as dividend.
3) Repayment Debt: If the firm has high repayment obligations than dividend payment will be difficult whereas if the firm has no obligations than dividend payment in cash will be easier.
4) High rate of return: If the firm expect high earnings in future than company will distribute fewer dividends and will retain more for further investments.
5) Stability of Earnings: Stable earnings promote regular dividend for the shareholders.
6) Desire of control: If the firm wants to retain power they will issue less stock to prevent dilution of power and to finance the project they will retain their earnings rather than distributing them as profit.

7) Access to capital market: If firm have easy sources of raising fund than they will distribute dividend easily as compared to the firm which have less ease of getting funding.

8) Tax Situation: To prevent dividend taxations sometimes shareholders prefer not to receive cash dividends.

19.6 SUMMARY

Dividend is important as it builds confidence among the shareholders and as per relevance theory it also affects the market price of shares but contrary to this, it also affects the retained earnings of the company as profit of company is used in the distribution of dividend and thus future investments are hampered.

Irrelevance theory propagates that shares are not affected by the dividend company pay. So keeping all this objectives a firm makes investment payout decision.

19.7 GLOSSARY

Dividends: Dividends are the payments received by the investors from time to time.

Liquidity: This denotes the ready cash available by the company so to meet the future or immediate needs.

Stable dividend: It means when regular dividend is paid and there is consistency in dividend payment.

19.8 REFERENCES

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19.9 SUGGESTED READINGS

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19.10 TERMINAL QUESTIONS

Q1. Enumerate the important parameters relevant to dividend decision making.

Q2. Differentiate between relevance and irrelevance theory.

Q3. Discuss the dividend policy and the various types of dividend policy.

Q4. The following information relates to BSNL Ltd.:

Earnings of the Company Rs 6, 00,000

Dividend payout Ratio 20%

No. of shares outstanding 2, 00,000

Rate of return on investment 8.5%

Equity capitalization rate 7%

Calculate:

a. Market Value Per Share by using Walter Model.

b. What is optimum dividend payout ratio?

c. What is market value of Company’s share to payout ratio?

Q5. How far do you agree that dividends are irrelevant?