Dividend Policy
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Learning Objectives

- Forms of Dividend
- Dividend Payment Chronology
- Factors affecting Dividend Payment Policy
- The Dividend Controversy
- Valuation Implications of Dividends

Dividend Concept:

- ❑ Portion of Net Income paid out to shareholders
- ❑ Paid to compensate: Risk and time
- ❑ Usually paid periodically
- ❑ Cash or stock

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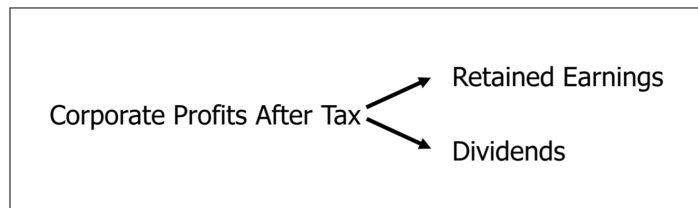
Dividend Policy Concept:

- ❑ Determining the proportion of Dividend Payout and Retention Ratio
- ❑ Choices available: distribute all, or retain all for reinvestment, or distribute part and retain the rest for reinvestment
- ❑ Related with firm's investment and financing decision



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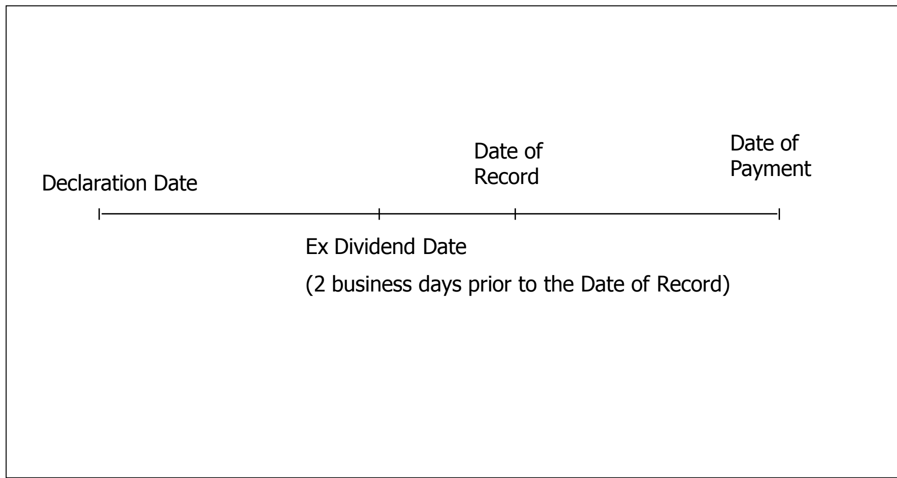
Dividend Payment Chronology Dates:



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Dividend Payment Chronology Dates:

- ❑ Declaration Date: date at which directors meet and announce dividend (to be paid in the future)
- ❑ Date of Record: date on which the shareholders' register is closed. All listed will receive the dividend
- ❑ Ex-Dividend Date: date (after which) share is no longer paid the most recently declared dividend
- ❑ Payment Date: date at which company pays dividend to all the stockholders of the date of record

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Dividend Payment Chronology Dates:

- To get the dividend then:
  - Must be listed as Registered Shareholder by Date of Record
  - Must be owner of stock prior to ex-div date

- Example
  - 10th July: Declaration Date
  - 15th Sept: Date of Record
  - 13th Sept: Ex-Div. Date
  - 10th Oct: Payment Date

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Dividend Policy Factors Affecting Dividend Policy (1):

- Legal Requirements
  - The net profit rule
  - The capital impairment rule
  - Insolvency rule
- Firm's liquidity position
- Repayment need

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Dividend Policy
Factors Affecting Dividend Policy (2):

- Restrictions imposed by bondholders and preferred stockholders
- Expected rate of return
- Stability of earnings
- Desire for control
- Access to the capital markets
- Stockholder's individual tax situation

Dividend Policy
Theory:

- Two schools of thought
  - dividend policy is *irrelevant*
  - dividend policy is *relevant*

Dividend Policy Irrelevance Theory:

- Policy is *irrelevant*
  - Merton Miller and Franco Modigliani (1961)
  - Value of firm depends only on
    - the income generated by its assets (not on how this income is split between dividends and retained earnings)

Dividend Policy Irrelevance Theory (Assumptions):

- Perfect capital markets
- No taxes
- No (issuance) costs
- Existence of a fixed investment policy

Dividend Policy
Relevance Theory:

- Policy is *relevant*
  - Real world: imperfect and inefficiencies
  - Risk Aversion: "Bird in the hand theory"
    - Myron J. Gordon and Johan Linter
  - Taxes:
    - high income tax brackets may prefer low (or no) dividend
  - Transaction costs
  - Flotation costs

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Dividend Policy Schemes
Residual Dividend Policy:

- Residual Dividend Policy: retain earnings as long as there is investment opportunities that promise higher rate of return than the shareholders' required rate of return
- Under residual theory, Amount of Dividend =

Net income – Equity capital component of new project

- If net income is more than the amount of equity financing the firm pays dividend

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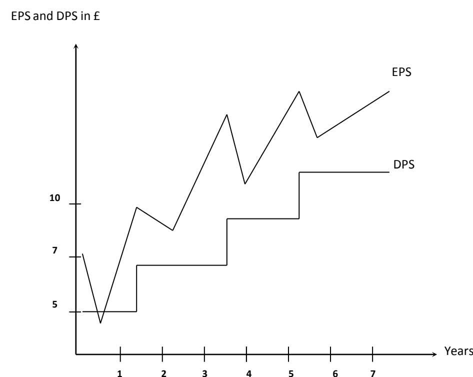
Dividend Policy Schemes
Stable Dividend Policy:

- Under **stable dividend per share**, a constant £ per share dividend is paid
- Example: "£ 2 Dividend per share" or "£ 3 Dividend per share"
- The earnings may fluctuate from year to year but dividends per share remain stable.
- However, it does not mean that dividend per share remains fixed for all the periods to come. The amount of dividend per share is likely to increase over the years along with the increase in earnings.

Dividend Policy Schemes
Stable Dividend Policy:

- Stable Dividend



Dividend Policy Schemes
Stable Policy: Constant Payout Ratio

- **Payout ratio** refers to the ratio of dividends per share to the earnings per share.
- For example, if the dividend payout ratio for a firm is set at 60 percent, the firm always pays 60 percent of its annual earnings as dividends.
- The earnings may fluctuate from year to year but dividends per share remain stable

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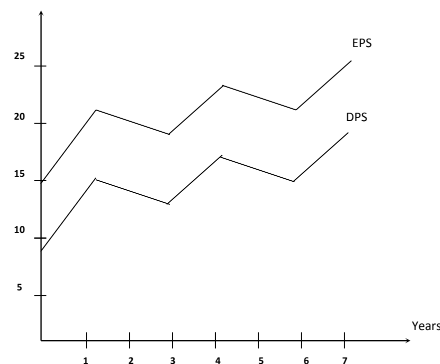
Dividend Policy Schemes
Constant Payout Ratio:

- Dividend under Constant Payout



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Forms of Dividend
Stock Dividend:

- A **stock dividend** simply refers to the dividends paid to existing stockholders in the form of additional shares of common stock
- The purpose of stock dividends is to conserve cash in the firm, so that it can be used in new projects.
- It involves simply a book keeping transfer from retained earnings to the capital stock account.

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Stock Dividend (Example):

- A firm has following total shareholders' equity account before a 20 percent stock dividend announcement:

Common Stock (100,000 shares of £ 10 par)	£ 1,000,000
Additional paid-in capital	200,000
Retained earnings	1,800,000
Total shareholders' equity	£ 3,000,000

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Stock Dividend (Example):

- Assuming current market price of the stock is £ 40

Common Stock (120,000 shares of £10 par)	£ 1,200,000
Additional paid - in capital	800,000
Retained earnings	1,000,000
Total shareholders' equity	£ 3,000,000

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Stock Split:

- An increase in number of outstanding shares
- A proportionate decrease in par value and market price of the stocks
- With a stock split total value of the shares of common stock outstanding remains unchanged along with no change in paid-in capital and retained earnings

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Stock Split:

- Why Stock Split?: Firms with exceptionally high market prices split their stocks in order to bring the market price within reasonable limits
- Small investor can also purchase

Stock Split (Example):

- Before 2 for 1 stock split

Common Stock (4000 shares @ £ 10) Additional paid-in capital Retained earnings	£ 40,000 20,000 90,000
Total shareholders' equity	**£ 150,000**

Stock Split (Example):

- After 2 for 1 stock split

Common Stock (8000 shares @ £ 5)	£ 40,000
Additional paid-in capital	20,000
Retained earnings	90,000
Total shareholders' equity	**£ 150,000**

- Note: Unlike in stock dividend, stock split does not involve transfer of funds from retained earnings to paid-in-capital and common stock accounts.

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Reverse Stock Split:

- A stock split in which a firm's number of shares outstanding is reduced
- Why Reverse Stock Split: When a company's share price falls substantially, the company may want to reduce the number of shares outstanding

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Reverse Stock Split:

❑ Before 2 for 5 reverse stock split

Common Stock (10,000 shares @ £ 10)	£ 100,000
Additional-paid in capital	100,000
Retained earnings	300,000
Total shareholders' equity	**£ 500,000**

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Reverse Stock Split:

❑ After 2 for 5 reverse stock split

Common Stock (4,000 shares @ £ 25 each)	£ 100,000
Additional-paid in capital	100,000
Retained earnings	300,000
Total shareholders' equity	**£ 500,000**

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Stock Repurchase:

- ❑ Buy back of stock by the issuing firm either in open market or by self tender offer
- ❑ Repurchase of shares reduces the number of outstanding shares, raising the earnings per share and the market price per share

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Stock Repurchase:

- ❑ **Why Stock Repurchase?:**
  - ❑ to obtain shares to be used in acquisitions
  - ❑ to have shares available for employee stock option plans
  - ❑ to achieve a gain in the book value of equity when shares are selling below their book value

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Stock Repurchase (Example):

- ❑ A company has earnings of £1,000,000,
- ❑ Number of shares 400,000
- ❑ EPS £ 2.50 EPS, MPS £ 50 MPS and P/E ratio of 20 times
- ❑ Company is planning to distribute £800,000 to shareholders
- ❑ **Cash Dividend or Stock Repurchase?**
- ❑ If Cash Dividend, DPS = £2 per share

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Stock Repurchase (Example):

- ❑ If stock repurchase:
- ❑ If the firm pays £ 52 per share to repurchase stock, it could repurchase approximately 15,385 shares (£ 800,000/£ 52).
- ❑ As a result of this repurchase, 384,615 shares (400,000 – 15,385) of common stock would remain outstanding
- ❑ Earnings per share (EPS) would rise to £ 2.60 (£ 1,000,000/384,615)

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Stock Repurchase (Example):

- If the stock still sold at 20 times earnings (PE = 20), applying P/E multiples, its market price would rise to £ 52 per share (£ 2.60 × 20)
- In both cases the stockholders would receive £ 2 per share- a £ 2 cash dividend in the dividend case or an £ 2 increase in share price (£ 50 per share to £ 52 per share) in the repurchase case

Stock Repurchase (Example):

- The advantage of stock repurchase is an increase in earnings per share and tax benefit to the stockholder.
- In the example, if the cash dividend is paid, the owner will have to pay ordinary income taxes on it, whereas the £ 2 increase in the market price of stock due to repurchase will not be taxed until the stockholder sells the stock.
- Because of the lower capital gains tax rate and the deferred tax on capital gains, repurchases have significant tax advantages over dividends as a way to distribute income to stockholders.

Valuation Implications of Dividends:

- ❑ Discuss:
  - ❑ Valuation Implications of Dividends

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