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Dividend policy

Topic list	Syllabus reference
1 Internal sources of finance	E3 (a)
2 Dividend policy	E3 (b), (c)

Introduction

In the previous chapter we looked at **external** sources of finance. In this chapter we will consider **internal** finance in the form of surplus cash.

There is a clear link between financing decisions and the wealth of a company's shareholders. **Dividend policy** plays a big part in a company's relations with its equity shareholders, and a company must consider how the stock market will view its results.

Study guide

		Intellectual level
E3	**Internal sources of finance and dividend policy**	
(a)	Identify and discuss internal sources of finance, including:	2
(i)	Retained earnings	
(ii)	Increasing working capital management efficiency	
(b)	Explain the relationship between dividend policy and the financing decision	2
(c)	Discuss the theoretical approaches to, and the practical influences on, the dividend decisions, including:	2
(i)	Legal constraints	
(ii)	Liquidity	
(iii)	Shareholder expectations	
(iv)	Alternatives to cash dividends	

Exam guide

This chapter is likely to be examined as a discussion question, perhaps combined with ratio analysis.

1 Internal sources of finance

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Internal sources of finance include **retained earnings** and **increasing working capital management efficiency**.

1.1 Retained earnings

Retained earnings is surplus cash that has not been needed for operating costs, interest payments, tax liabilities, asset replacement or cash dividends. For many businesses, the cash needed to finance investments will be available because the earnings the business has made have been retained within the business rather than paid out as dividends. We emphasised in Chapter 1 that this **interaction** of investment, financing and dividend policy is the most important issue facing many businesses.

Retained earnings **belong to shareholders** and are classed as **equity** financing.

Exam focus point

It is important not to confuse retained earnings with the accounting term 'retained profit' from the income statement and statement of financial position. 'Retained profit' in the accounting statements is not necessarily cash and does not represent funds that can be invested. It is the **cash generated** from retention of earnings which can be used for financing purposes.

A company may have substantial retained profits in its statement of financial position but no cash in the bank and will not therefore be able to finance investment from retained earnings.

1.1.1 Advantages of using retained earnings

(a) Retained earnings are a **flexible source** of finance; companies are not tied to specific amounts or specific repayment patterns.

(b) Using retained earnings does not involve a change in the pattern of shareholdings and no dilution of control.

(c) Retained earnings have no issue costs.

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1.1.2 Disadvantages of using retained earnings

(a) Shareholders may be **sensitive** to the **loss of dividends** that will result from retention for re-investment, rather than paying dividends.

(b) Not so much a disadvantage as a misconception, that retaining profits is a cost-free method of obtaining funds. There is an **opportunity cost** in that if dividends were paid, the cash received could be invested by shareholders to earn a return.

1.2 Increasing working capital management efficiency

It is important not to forget that an internal source of finance is the **savings** that can be generated from more efficient management of trade receivables, inventory, cash and trade payables. As we saw in Part C of this study text, efficient working capital management can reduce bank overdraft and interest charges as well as increasing cash reserves.

2 Dividend policy 12/07

FAST FORWARD

- **Retained earnings** are the most important single source of finance for companies, and financial managers should take account of the proportion of earnings that are retained as opposed to being paid as dividends.
- Companies generally **smooth out dividend payments** by adjusting only gradually to changes in earnings: large fluctuations might **undermine investors' confidence**.
- The dividends a company pays may be treated as a **signal** to investors. A company needs to take account of different clienteles of shareholders in deciding what dividends to pay.

For any company, the amount of earnings retained within the business has a direct impact on the amount of dividends. Profit re-invested as retained earnings is profit that could have been paid as a **dividend**.

A company must restrict its self-financing through retained earnings because shareholders should be paid a **reasonable dividend**, in line with realistic expectations, even if the directors would rather keep the funds for re-investing. At the same time, a company that is looking for extra funds will not be expected by investors (such as banks) to pay generous dividends, nor over-generous salaries to owner-directors.

The dividend policy of a business affects the **total shareholder return** and therefore **shareholder wealth** (see Chapter 1).

2.1 Dividend payments

Shareholders normally have the power to vote to **reduce** the size of the dividend at the AGM, but **not** the power to increase the dividend. The directors of the company are therefore in a strong position, with regard to shareholders, when it comes to determining dividend policy. For practical purposes, shareholders will usually be obliged to accept the dividend policy that has been decided on by the directors, or otherwise to sell their shares.

2.2 Factors influencing dividend policy

When deciding upon the dividends to pay out to shareholders, one of the main considerations of the directors will be the amount of earnings they wish to retain to meet **financing needs**.

As well as future financing requirements, the decision on how much of a company's profits should be retained, and how much paid out to shareholders, will be influenced by:

(a) The **need to remain profitable** (Dividends are paid out of profits, and an unprofitable company cannot for ever go on paying dividends out of retained profits made in the past).

(b) The **law on distributable profits** (A Companies Act may make companies bound to pay dividends solely out of **accumulated net realised profits** as in the UK).

(c) The government which may impose **direct restrictions** on the amount of dividends companies can pay. (For example, in the UK in the 1960's as part of a prices and income policy).

(d) Any **dividend restraints** that might be imposed by loan agreements.

(e) The **effect of inflation**, and the need to retain some profit within the business just to maintain its operating capability unchanged.

(f) The company's **gearing level** (If the company wants extra finance, the sources of funds used should strike a balance between equity and debt finance).

(g) The company's **liquidity position** (Dividends are a cash payment, and a company must have enough cash to pay the dividends it declares).

(h) The need to **repay debt** in the near future.

(i) The ease with which the company could raise **extra finance** from sources other than retained earnings (Small companies which find it hard to raise finance might have to rely more heavily on retained earnings than large companies).

(j) The **signalling effect** of dividends to shareholders and the financial markets in general – see below.

2.3 Dividends as a signal to investors

The ultimate objective in any financial management decisions is to **maximise shareholders' wealth**. This wealth is basically represented by the **current market value** of the company, which should largely be determined by the **cash flows arising from the investment decisions** taken by management.

Although the market would **like** to value shares on the basis of underlying cash flows on the company's projects, such information is **not readily available to investors**. But the directors do have this information. The dividend declared can be interpreted as a **signal** from directors to shareholders about the strength of underlying project cash flows.

Investors usually expect a **consistent dividend policy** from the company, with stable dividends each year or, even better, **steady dividend growth**. A large rise or fall in dividends in any year can have a marked effect on the company's share price. Stable dividends or steady dividend growth are usually needed for share price stability. A cut in dividends may be treated by investors as signalling that the future prospects of the company are weak. Thus, the dividend which is paid acts, possibly without justification, **as a signal of the future prospects** of the company.

The signalling effect of a company's dividend policy may also be used by management of a company which faces a possible **takeover**. The dividend level might be increased as a defence against the takeover: investors may take the increased dividend as a signal of improved future prospects, thus driving the share price higher and making the company more expensive for a potential bidder to take over.

2.4 Theories of dividend policy

2.4.1 Residual theory

A **'residual' theory** of **dividend policy** can be summarised as follows.

- If a company can identify projects with positive NPVs, it should invest in them
- Only when these investment opportunities are exhausted should dividends be paid

2.4.2 Traditional view

The **'traditional' view** of dividend policy, implicit in our earlier discussion, is to focus on the effects on share price. The price of a share depends upon the mix of dividends, given shareholders' required rate of return, and growth.

2.4.3 Irrelevancy theory

In contrast to the traditional view, **Modigliani and Miller** (MM) proposed that in a tax-free world, shareholders are indifferent between dividends and capital gains, and the value of a company is determined solely by the 'earning power' of its assets and investments.

MM argued that if a company with investment opportunities decides to pay a dividend, so that **retained earnings** are **insufficient** to finance all its investments, the shortfall in funds will be made up by **obtaining additional funds** from outside sources. As a result of obtaining outside finance instead of using retained earnings:

Loss of value in existing shares = Amount of dividend paid

In answer to criticisms that certain shareholders will show a preference either for high dividends or for capital gains, MM argued that if a company pursues a consistent dividend policy, 'each corporation would tend to attract to itself a clientele consisting of those preferring its particular payout ratio, but one clientele would be entirely as good as another in terms of the valuation it would imply for the firm'.

2.4.4 The case in favour of the relevance of dividend policy (and against MM's views)

There are strong arguments against MM's view that dividend policy is irrelevant as a means of affecting shareholder's wealth.

(a) Differing rates of taxation on dividends and capital gains can create a preference for a high dividend or one for high earnings retention.

(b) Dividend retention should be preferred by companies in a period of capital rationing.

(c) Due to imperfect markets and the possible difficulties of selling shares easily at a fair price, shareholders might need high dividends in order to have funds to invest in opportunities outside the company.

(d) Markets are not perfect. Because of transaction costs on the sale of shares, investors who want some cash from their investments will prefer to receive dividends rather than to sell some of their shares to get the cash they want.

(e) Information available to shareholders is imperfect, and they are not aware of the future investment plans and expected profits of their company. Even if management were to provide them with profit forecasts, these forecasts would not necessarily be accurate or believable.

(f) Perhaps the strongest argument against the MM view is that shareholders will tend to prefer a current dividend to future capital gains (or deferred dividends) because the future is more uncertain.

Exam focus point

Even if you accept that dividend policy may have some influence on share values, there may be other, more important, influences.

Question

Dividend policy

Ochre is a company that is still managed by the two individuals who set it up 12 years ago. In the current year the company was launched on the stock market. Previously, all of the shares had been owned by its two founders and certain employees. Now, 40% of the shares are in the hands of the investing public. The company's profit growth and dividend policy are set out below. Will a continuation of the same dividend policy as in the past be suitable now that the company is quoted on the stock market?

Year	*Profits*	*Dividend*	*Shares in issue*
	$'000	$'000	
4 years ago	176	88	800,000
3 years ago	200	104	800,000
2 years ago	240	120	1,000,000
1 year ago	290	150	1,000,000
Current year	444	222 (proposed)	1,500,000

Answer

Year	*Dividend per share cents*	*Dividend as %of profit*
4 years ago	11.0	50%
3 years ago	13.0	52%

2 years ago	12.0	50%
1 year ago	15.0	52%
Current year	14.8	50%

The company appears to have pursued a dividend policy of paying out half of after-tax profits in dividend. This policy is only suitable when a company achieves a stable EPS or steady EPS growth. Investors do not like a fall in dividend from one year to the next, and the fall in dividend per share in the current year is likely to be unpopular, and to result in a fall in the share price.

The company would probably serve its shareholders better by paying a dividend of at least 15c per share, possibly more, in the current year, even though the dividend as a percentage of profit would then be higher.

2.5 Scrip dividends

Key term

A **scrip dividend** is a dividend paid by the issue of additional company shares, rather than by cash.

When the directors of a company would prefer to retain funds within the business but consider that they must pay at least a certain amount of dividend, they might offer equity shareholders the choice of a **cash dividend** or a **scrip dividend**. Each shareholder would decide separately which to take.

Recently **enhanced scrip dividends** have been offered by many companies. With enhanced scrip dividends, the value of the shares offered is much greater than the cash alternative, giving investors an incentive to choose the shares.

2.5.1 Advantages of scrip dividends

(a) They can **preserve** a company's **cash position** if a substantial number of shareholders take up the share option.

(b) Investors may be able to obtain **tax advantages** if dividends are in the form of shares.

(c) Investors looking to **expand their holding** can do so **without incurring** the **transaction costs** of buying more shares.

(d) A small scrip dividend issue will **not dilute the share price significantly.** If however cash is not offered as an alternative, empirical evidence suggests that the share price will tend to fall.

(e) A share issue will **decrease** the company's **gearing**, and may therefore **enhance** its **borrowing capacity.**

2.6 Stock split

A stock split occurs where, for example, each ordinary share of $1 each is split into two shares of 50c each, thus creating cheaper shares with **greater marketability**. There is possibly an added psychological advantage, in that investors may expect a company which splits its shares in this way to be planning for substantial earnings growth and dividend growth in the future.

As a consequence, the market price of shares may benefit. For example, if one existing share of $1 has a market value of $6, and is then split into two shares of 50c each, the market value of the new shares might settle at, say, $3.10 instead of the expected $3, in anticipation of strong future growth in earnings and dividends.

The difference between a stock split and a scrip issue is that a scrip issue converts equity reserves into share capital, whereas a stock split leaves reserves unaffected.

2.7 Share repurchase

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Purchase by a company of its own shares can take place for various reasons and must be in accordance with any **requirements of legislation**.

In many countries companies have the right to **buy back shares from shareholders** who are willing to sell them, subject to certain conditions.

For a **smaller company** with few shareholders, the reason for buying back the company's own shares may be that there is no immediate willing purchaser at a time when a shareholder wishes to sell shares. For a public company, share repurchase could provide a way of withdrawing from the share market and 'going private'.

2.7.1 Benefits of a share repurchase scheme

(a) Finding a **use for surplus cash**, which may be a 'dead asset'.

(b) **Increase in earnings per share** through a reduction in the number of shares in issue. This should lead to a higher share price than would otherwise be the case, and the company should be able to increase dividend payments on the remaining shares in issue.

(c) **Increase in gearing**. Repurchase of a company's own shares allows debt to be substituted for equity, so raising gearing. This will be of interest to a company wanting to increase its gearing without increasing its total long-term funding.

(d) **Readjustment of the company's equity base** to more appropriate levels, for a company whose business is in decline.

(e) Possibly **preventing a takeover** or enabling a quoted company to withdraw from the stock market.

2.7.2 Drawbacks of a share repurchase scheme

(a) It can be **hard to arrive at a price** that will be fair both to the vendors and to any shareholders who are not selling shares to the company.

(b) A repurchase of shares could be seen as an **admission** that the company **cannot make better use of the funds** than the shareholders.

(c) Some shareholders may suffer from being **taxed on a capital gain** following the purchase of their shares rather than receiving dividend income.

Case Study

Germany's largest bank, Deutsche Bank, announced on 16 April 2003 that it had completed a €3 billion share buyback aimed at supporting its stock price and pushing up shareholder return on equity and earnings per share. The scheme was launched after the bank's share price dipped in the first months of 2002. The bank planned to seek approval for another programme later in 2003 of up to 10% of share capital.

Chapter Roundup

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- **Retained earnings** are the most important single source of finance for companies, and financial managers should take account of the proportion of earnings that are retained as opposed to being paid as dividends.

  Companies generally **smooth out dividend payments** by adjusting only gradually to changes in earnings: large fluctuations might **undermine investors' confidence**.