CHAPTER 6
DIVIDEND POLICY

1. INTRODUCTION

This involves deciding how much dividend to pay out to the shareholders. Dividend payment contributes to the maximisation of shareholder wealth.

2. THEORIES

Several theories have been put across to assist:

(i) **Residual** – if spare cash exists at the end of the year pay dividend

(ii) **Pattern** – be consistent with dividend payments. Either:

(a) Pay the same dividend per share (DPS) each year

(b) Maintain the payout ratio (DPS/EPS)

(c) Maintain the same year –on-year growth rate in dividends. The latter links into Po via the dividend valuation model (DVM)

$$Po = \frac{Do\ (1 + g)}{Ke - g}$$

(iii) Irrelevancy (M&M)

In a perfect capital market, providing the directors can invest in projects with positive NPV no dividends are required. The value of equity will rise (since share price will increase) and the shareholders can sell shares to create the cash they need (manufacture dividends)

3. PRACTICAL CONSIDERATIONS

- Legal constraints (company's act on distributable profits)
- Liquidity (availability of cash)
- Clientele effect: what dividends do shareholders want?
- Profitability (If company has made losses, it will be unwise to pay out dividend)
- The number of Investment opportunities will restricts dividend payments.
- Risk – paying now is safer than promising to pay next year (resolution of uncertainty)
- Access to other sources of finance (if company has problems raising money, it should pay less dividend.)
- Inflation:-two schools of thought:

  (iv) pay more dividend in line with inflation

  (v) pay less dividend because in times of raising prices the capital is eroding.

- Shareholder preferences-tax (belong to different tax bands)
- Restrictive loan covenants
- Stability of dividend (signaling effects)
- Policies of competitors

4. ALTERNATIVES TO CASH DIVIDENDS

(i) A **scrip dividend** is a dividend payment which takes the form of new shares. Enhanced scrip dividends refer to an arrangement where the value of the shares offered is much greater than the cash alternative thus giving investors an incentive to prefer shares and at same time preserving the liquidity of the company.

The effect of a scrip dividend will be:

- Increased the issued share capital
- Dilution of EPS and share price
- Creates pressure on the board to pay more total dividends in the future as more shares are in issue

(ii) A **bonus issue** (or scrip issue) is the capitalization of reserves.

(iii) **Share splits** are the issue of additional shares at no costs to existing shareholders in proportion to the current holding, but with lower par value. They do not have any effect on cash flows. Reason for share splits:

- To keep share prices within a given trading range as a high share price may deter potential investors from buying shares.

(iv) **Reverse split**: - opposite of share split. Consolidating of shares with lower value into shares with high value.

(v) **Share Buy-backs**: reducing the number of shares in issue:

- Use surplus cash
- Alter capital structure (if say gearing ratio is too low)
- Support share price during periods of weakness
- Deter unwelcome takeover (buy shares from weak shareholders)
- Buy out dissident shareholders (those who actively challenge an established doctrine or policy)
- Less dividend pressure on the board in future
- Improve earnings per share (number of shares reduces, EPS improves)

The shares can be bought on the market or through a tender (off market). The reaction of the market for a share repurchase can be positive (that the company has more cash and greater earnings potential) or negative (that the company has run out of ideas and does not have investments to fully utilise surplus cash)

Dividend Capacity and Free Cash Flows

Free Cash Flows is covered in the under investment appraisal and business valuations. The MAXIMUM DIVIDEND PAYABLE (Dividend Capacity) in any year will be equal to the FCF available to the equity holders. i.e. FCFE