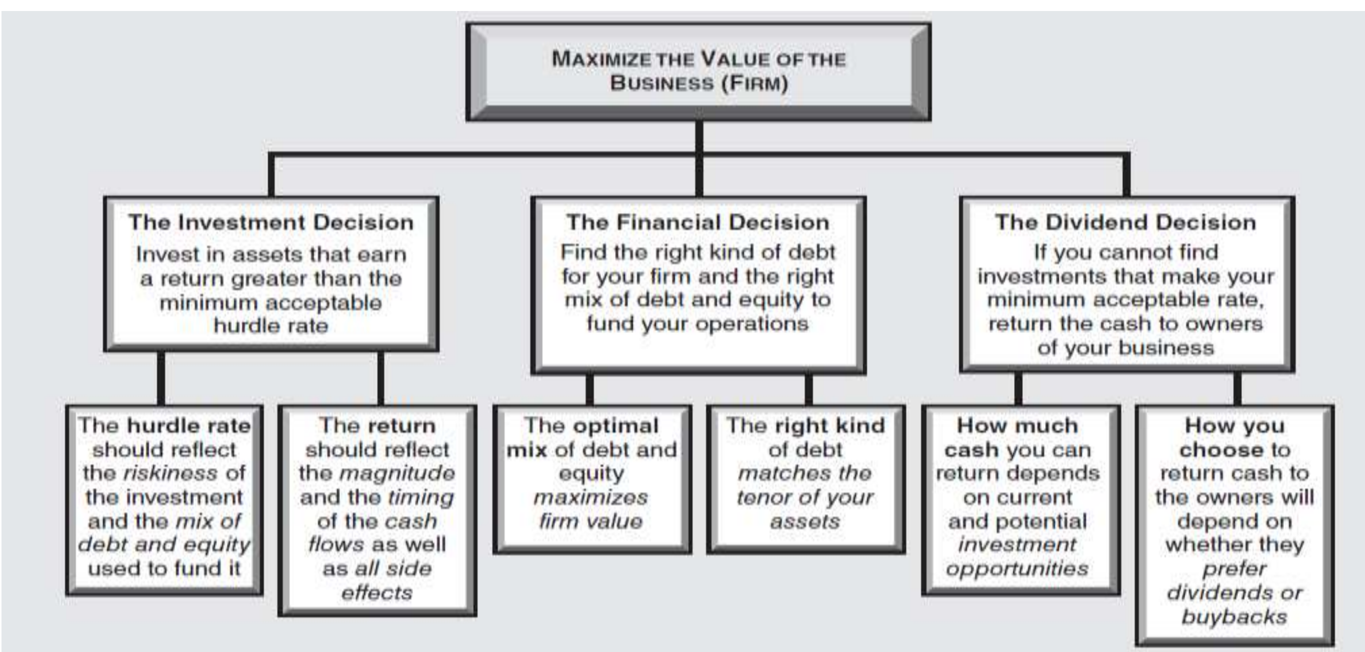
THE DIVIDEND DECISION

FACTS ABOUT PAYOUT	THE PAYOUT CONTROVERSY	GOOD-BAD SCHOOL

I will be talking from finance perspective only, and let me assure I am not biased. Primarily I will be discussing the above three mentioned topics. Let me introduce you on my topic of interest. Initially see the big picture.

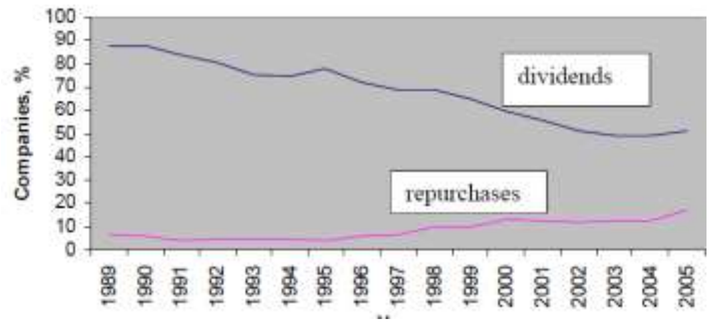
The Big Picture Detailed



FACTS ABOUT PAYOUT: Generally, dividends are paid annually in India while the same are paid quarterly in United States. Dividend decision is the decision relating whether to return cash to its stockholders and, if so, then how much. Even the owner of a private company/ firm has to visualize the same (ie, decision about how much cash he or she plans to withdraw from the business and how much to reinvest.)

Payout policy presents **2** specific questions -how much cash should the corporation pay out to its shareholders? and the next is mode of distribution –either by dividends or by buy back.
Some companies used to pay dividends, but then fell on hard times and ceased to do so. Most non–dividend payers are young growth companies that have never paid a dividend and will not pay one in the foreseeable future (say Berkshire Hathaway, Amazon, and Google & smaller growth firms too)

The graph shows the % of companies in European Union paying dividends or repurchasing, it is clear that dividend payouts are declining while repurchasing are increasing from 1997. Research shows that ***dividends are more stable than repurchases***. **<u>I don't think talking about "How Firms Pay Dividends" would be a value addition as we all are aware on this.</u>** <u>The announcement of the dividend states that the payment will be made to all stockholders who are registered on a particular record date.</u>



<u>Types of Dividends</u> Some of them are:
(i) Cash Dividends (ii) Stock Dividends *[Here, No. of shares increases & generally per share price decreases]* (iii) regular dividend [*annually/semi –annually/quarterly*] (iv) special dividend *[paid in addition to regular dividends- but are paid irregularly]*(v) Liquidating dividends *[**nature**-return on capital rather than ordinary income]*

As clarified from the data companies instead of paying a dividend use the cash to repurchase stock and such shares are kept in the company's treasury and may be resold if the company needs money. As discussed on the stability of dividends in comparison to Buy Back, announcement of a share repurchase is not a commitment to continue repurchases in later years. So the information content of a repurchase announcement is less strongly positive than the announcement of a dividend increase. We do have number of methods for buy back, however, buy back may take place via direct negotiation with a major shareholder.

Interestingly, many countries have banned this method at times, consequently, firms started accumulating large amount of cash and started investing at lower rates had the same cash be in the hands of the investor. At present many countries have relaxed this mechanism. I inform you some economies allowing repurchase. But many of these limitations have now been removed. Japan allowed repurchases in the year 1995, Sweden in 2000 & Germany in 1998. Many multinational giants now repurchase huge amounts of stock. In 2007 the Spanish bank BBVA, BP, Royal Dutch Shell, and Glaxo Smith Kline all spent huge sums on buying back their stock.

Study shows that on average repurchase resulted in an abnormal **price rise of 2%. What investors may think on buy back decision? Do they appreciate?**

- Investors may applaud repurchases if they worry that managers would otherwise fritter away the money on perks or unprofitable empire building.
- Repurchases can also reflect management optimism, perhaps their view that their company's shares are underpriced by investors.
- Stock repurchases may also be used to signal a manager's confidence in the future.

A survey in 2004 talks:
i) Managers focus more on dividend changes than on absolute dividend levels. Hence, paying a dividend of $2.00 per share is an important financial decision if last year's dividend was $1.50, but no big deal if last year's dividend was also $2.00.
ii) Managers "smooth" dividends. Dividend changes follow shifts in long-run, sustainable earnings. Transitory earnings changes are unlikely to affect dividends.
iii) Managers do particularly worry about having to rescind a dividend increase and, if necessary, would issue shares or borrow to maintain the dividend.
I, being an investor have the mentality that announcement of dividend increase is a good news, even more managers do not increase the dividends unless they are confident that the payment can be maintained. Now I am confident that my company is confident in generation future profits.
The information content of dividends implies that dividend increases predict future profitability, but evidences are rarely found.

What this news create is that it results in share price rise as the market expects growth in the companies while the news relating to dividend cut off results in reduction of share price. This means market is efficient as it forecasts the future with the news.

What should corporations do- **DIVIDENDS OR REPURCHASE** **[CONTROVERSY]**
Announcements of dividends and repurchases can convey information about management's confidence and so affect the stock price. But eventually the stock price change would happen anyway as information seeps out through other channels. Does payout policy affect value in the long run?

On the right are conservatives who argue that investors pay more for firms with generous, stable dividends. On the left, another group argues that repurchases are better because repurchases mean higher stock prices, and capital gains have been taxed at lower effective rates than dividends. And in the center, a middle-of-the-road party claims that the choice between
dividends and repurchases has no effect on value. [I will be discussing 2 schools of thoughts on dividends on upcoming para]

DIVIDENDS ARE IRRELEVANT
This school of thought is propounded by Miller and Modigliani and says that dividends do not really matter because they do not affect firm value [**ie, stockholders are indifferent between receiving dividends and earning capital gains (price appreciation)**] which is based on two assumptions. The ***first*** is that there is ***no tax disadvantage*** to an investor to receiving dividends relative to capital gains, and the ***second*** is that ***firms can raise funds*** in capital markets for new investments ***without bearing significant issuance costs***.
The thought is simple since they say that in totality investors get the same. In case a higher dividend is paid it results in low capital appreciation and vice versa, provided tax on dividends and tax on capital gains are same. In India dividends are exempt in the hands of investors. ***If these assumptions do not hold true, then investors who need cash urgently might prefer to receive dividends.***

Now if the company wants to up the dividend without changing their investment policy or capital structure, then there is the need of extra cash which must come from somewhere. *If the firm fixes its borrowing; the only way, it can finance the extra dividend is to sell more shares.*
Alternatively, rather than increasing dividends and selling new shares, the firm can pay lower dividends. With investment policy and borrowing fixed, the cash that is saved can only be used to buy back some of the firm's existing shares. Thus ***any change in dividend payout must be offset by the sale or repurchase of shares.***

Proof of Irrelevance

Let us consider a Balance sheet of a firm pre and post payout based on market values.

Balance Sheet (Market Values, $ millions)

Assets	Amt.	Liabilities	Amt.
Surplus Cash	1	Debt	0
Fixed Assets & Net WC	10	Equity Market Cap.[1 million shares @ $ 11 each)	11
	11		11

Balance Sheet (Market Values AFTER PAYOUT, $ millions)

Assets	Amt.	Liabilities	Amt.
Surplus Cash	0	Debt	0
Fixed Assets & Net WC	10	Equitv Market Cap.	10
	10		10

Assumptions for simplicity:

-Consider there is no debt.

-Net Working capital is enough to meet the business operations.

-All of its fixed assets are paid for.

-Surplus cash is left over cash.

-Market is perfect [stocks are fairly priced]

We do have choices- you may go for dividend payments or repurchase the stock

Now let us say the company goes for paying dividend to its shareholders. $1 per share can be paid as dividend out of surplus cash. The stock price will be $ 10 per share. Finally, a shareholder has $1 (dividend) plus $10 (value of stock) =$11 in his hand.

Say, it goes for buy back. Maximum buy back shall be = [**1 million/ $11 per share**]= 90,909 shares. Post repurchase no. of shares outstanding shall be 909,091. Now share price becomes 11 [ie 10 million divided by 909091 shares]. Again share holder has $11 in his hand.

Hence, at the end the shareholder's wealth is the same with dividends as with repurchases. This is what MM proved in their article in 1961.

It's all rumor to say that "***Repurchases do guarantee a higher stock price***" which we proved in the above example**.** **Repurchases also reduce the number of shares outstanding, so future earnings *per share* are higher than if the same amount were paid out as dividends**.

WHAT WE LEARNT

If MM are correct and payout policy does not affect value, then the choice between dividends and repurchases is merely tactical. *A company will decide to repurchase if it wants to retain the flexibility to cut back payout if valuable investment opportunities arise. Another company may decide to pay dividends to assure stockholders that it will run a tight ship, paying out free cash flow to limit the temptation for careless spending. Firms should never give up a positive NPV project to increase a dividend (or to pay a dividend for the first time). This situation exists in a perfect market.* ***I don't like to create a debatable situation in this short write up on the topic whether market is rational or irrational. Robert Shiller & Eugene Fama both being Nobel Prize Winners have contradictory views on the market. You may refer their research papers & books on the said topic****.*

What We Know And Do Not Know About Dividend Policy -Some Survey Evidence About Dividends

	Policy Statements	% who agree/strongly agree
1	We try to avoid reducing dividends per share	93.8%
2	We try to maintain a smooth dividend from year to year	89.6%
3	We consider the level of dividends per share that we have paid in recent quarters	88.2%
4	We are reluctant to make dividend changes that might have to be reversed in the future	77.9%
5	We consider the change or growth in dividends per share. 66.7	66.7%
6	We consider the cost of raising external capital to be smaller than the cost of cutting dividends	42.8%
7	We pay dividends to attract investors subject to "prudent man" investment restrictions	41.7%

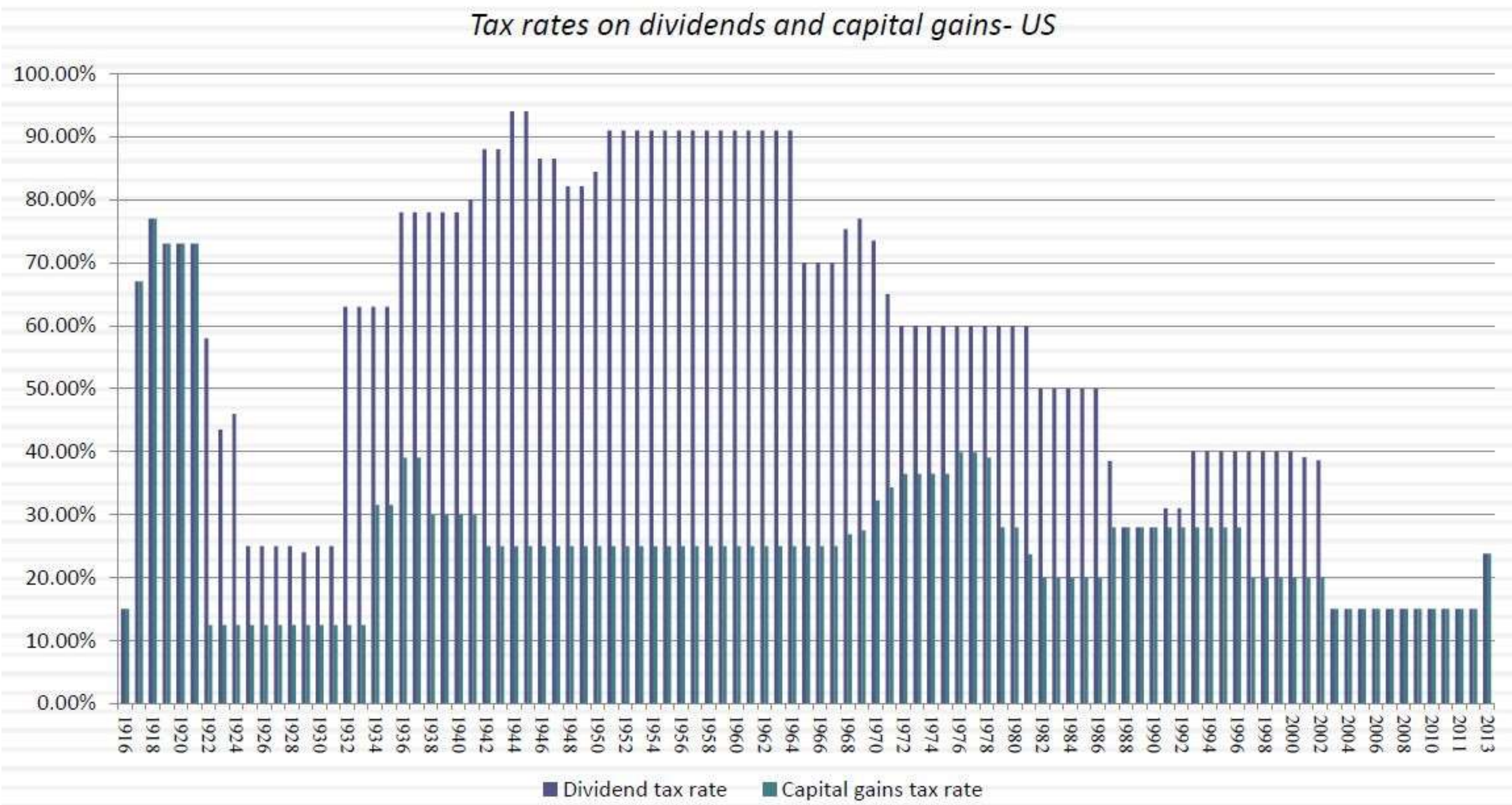
Adapted from Table 4 of A. Brav, J. R. Graham, C. R. Harvey, and R. Michaely, "Payout Policy in the 21st Century," Journal of Financial Economics (2005).

SCHOOLS OF THOUGHT **very brief**

Interestingly we have 2 schools of thoughts - DIVIDENDS ARE BAD SCHOOL & DIVIDENDS ARE GOOD SCHOOL

Dividends have historically been taxed at much higher rates than capital gains in the United States. Based on this tax disadvantage, dividend payments reduce the returns to stockholders after personal taxes. Stockholders, they posited, would respond by reducing the stock prices of the firms making these payments, relative to firms that do not pay dividends. Consequently, firms would be better off either retaining the money they would have paid out as dividends or repurchasing stock. In 2003, the basis for this argument was largely eliminated when the tax rate on dividends was reduced to match the tax rate on capital gains. If this is the case dividends are good in India as dividends are exempt in the hands of shareholders.
If a company does not have excess cash, and/or has several good investment opportunities (NPV>0), returning money to stockholders (dividends or stock repurchases) is bad.

Notwithstanding the tax disadvantages associated with dividends for most of the last hundred years in the United States, firms continued to pay dividends and many investors viewed such payments positively. This gave rise to a thought that argues dividends are good and can increase firm value. Some of the arguments used are questionable, but some have a reasonable basis in fact.
If a company has excess cash, and few good investment opportunities (NPV>0), returning money to stockholders (dividends or stock repurchases) is good.
Even you have these thoughts if you are playing with the live data. See here:



There are much more to express on the topic – I request the readers to consider this be an introductory topic. I am thankful to my teachers, authors, writers, their books and various publications from whom I remain updated in this segment. I must acknowledge my finance guru **CA Rajiv Singh, Prof. Aswath Damodaran, RWJ, Brealey-Myers-Allen** for this write up. The data and references are facts & based on authentic sources research papers.

Thank you for reading!!!

Niraj Thapa
niraj_thapa@hotmail.com