SNS COLLEGE OF ENGINEERING

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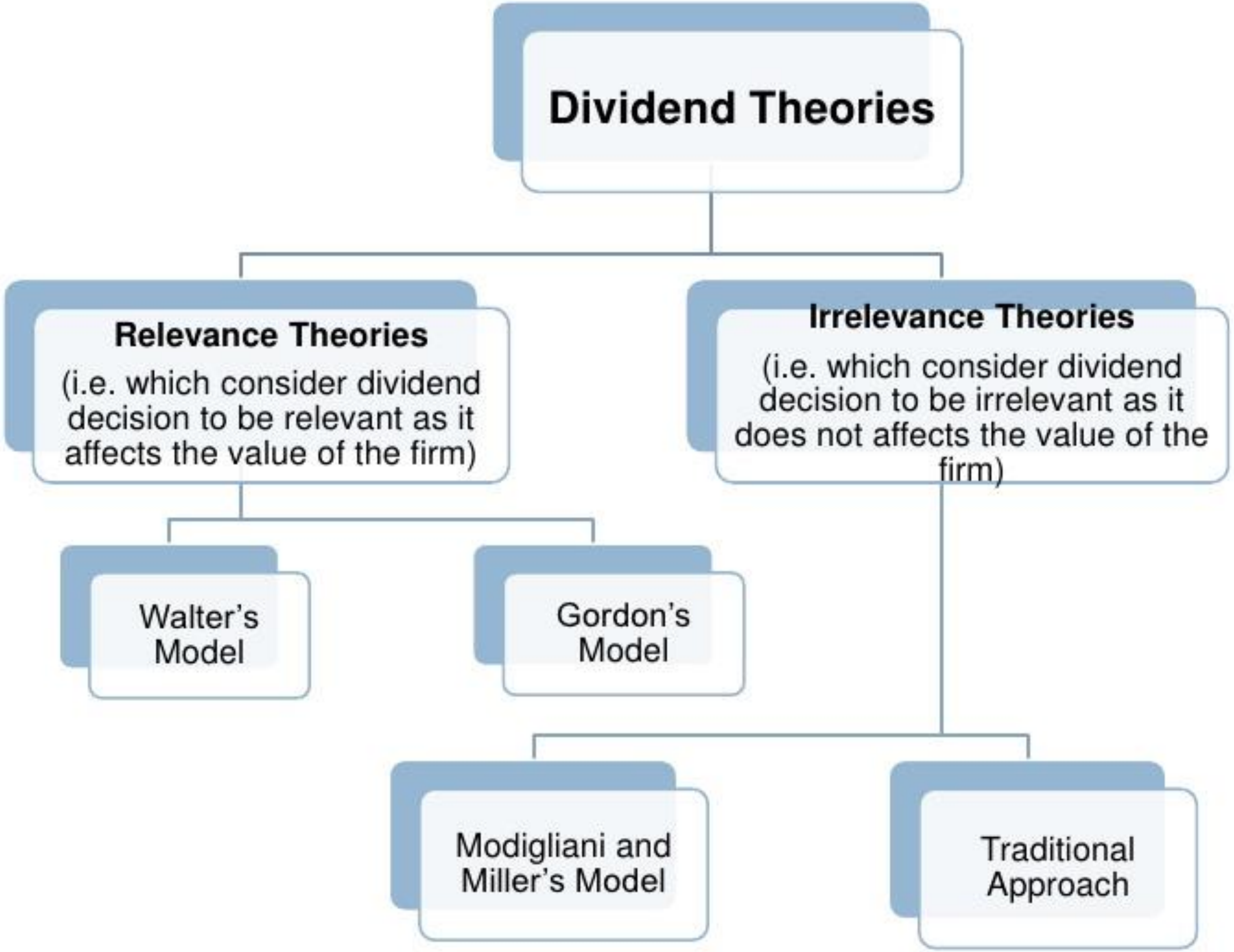
DEPARTMENT OF MANAGEMENT STUDIES

COURSE NAME : 19BA201 FINANCIAL MANAGEMENT

I YEAR / II SEMESTER

UNIT 4 - DIVIDEND POLICY

Dividend Decision



Dividend Theories

- ❖ The dividend theories relates with the impact of dividend on the value of the firm

- ❖ Thus there are conflicting theories on dividends.

- Irrelevance Theory of Dividend
- Relevance Theory of Dividend

Irrelevance Theory of Dividend

- ✓ The advocates of this school of thought argue that the dividends have no impact on the share price or market value of the firm.
- ✓ The argue that the shareholders do not differentiate between the present dividend and the future capital gains and are basically interested in higher returns either earned by the firm by investing the profits in future profitable investments.
- ✓ They believe that the profits are distributed as dividends only if no adequate investment opportunities for investments for the business.

- ✓ The various theories supporting this thought are as follows:
- Residuals Theory of Dividends
- Modigliani and Millers Approach

Residuals theory of Dividends

- ✓ The theory is based upon the assumptions that since the external financing has excessive costs and may not be available to the firm.
- ✓ The firm finances its investment by retained earnings or by retaining earnings.
- ✓ The retaining earnings are that portion of profits that is not distributed to the investors.
- ✓ The residual theory of dividend policy is that the firm will only pay dividends from residual earnings, that is, from earnings left over after all suitable (positive NPV) investment opportunities have been financed.
- ✓ With the residual dividend policy, the primary focus of the firm's management is indeed on investment, not dividends.

Residuals theory of Dividends

Thus the firm's decision to pay the dividends is influenced by:

- ✓ The investment opportunities available to the business
- ✓ The availability of the internal funds.
- ✓ If the internal funds are excessive and all the investments are finances the residual is paid as dividends.
- ✓ Thus, the divided policy is totally passive in nature and has no influence on the market price of the firm.

Modigliani and Miller (MM) Approach

- This theory was proposed by Franco Modigliani and Merton Miller in 1961 who argued that the value of the firm is determined by the basic earning power, the firm's risk and not by the distribution of earnings.
- The value of the firm therefore depends on the investment decisions and not the dividend decision.
- However, their argument was based on some assumptions.

Modigliani and Miller (MM) Approach

Assumptions of MM hypothesis

- ✓ The capital markets are perfect and all the investors behave rationally.

- ✓ There are no taxes and floatation costs and if the taxes are there then there is no difference between the dividends tax and capital gains tax.

- ✓ No transaction costs associated with share floatation.

- ✓ The firm's investment policy is independent of the dividend policy. The effect of this assumption is that the new investments out of retained earnings will not change and there will not change in the required rate of return of the firm.

Modigliani and Miller (MM) Approach

There is perfect certainty by every investor as to future investments and profits of the firm. Thus investors are able to forecast earnings and dividends with certainty.
The MM hypothesis is based upon the arbitrage theory. The arbitrage process involves switching and balancing the operations. Arbitrage leads to entering into two transactions which exactly balance or completely offset the effect of each other.

The two transactions are paying of dividends and raising external capital. Since the firm uses retained earnings to finance new investments, the paying of dividends will require the firm to raise the capital externally. The arbitrage theory suggests that the dividend effect will be exactly offset by the effect of raising additional share capital.

Modigliani and Miller (MM) Approach

When the dividends are paid to the shareholders, the market price of share decreases (because of external financing). Thus what is gained by the shareholders as a result of dividends is completely neutralized by the reduction in the market value of the shares.

According to MM, the investors will thus be indifferent between dividends and retained earnings. The market value of the shares will depend entirely on the expected future earnings of the firm.

Relevance Theory of Dividend

The relevance theory of dividend argues that dividend decision affects the market value of the firm and therefore dividend matters. This theory suggests that investors are generally risk averse and would rather have dividends today (“bird-in-the-hand”) than possible share appreciation and dividends tomorrow. The relevance theory of dividend proposes that dividend policy affect the share price.

Relevance Theory of Dividend

Therefore, according to this theory, optimal dividend policy should be determined which will ensure maximization of the wealth of the shareholders.

Relevance theory can discussed with following models:

Walter Approach
Gorden Approach

Walter Approach

The Walter approach was given by James E Walter and is based on a simple argument that where the reinvestment rate, that is, rate of return that the company may earn on retained earnings, is higher than cost of equity (rate of return of the shareholders), then it would be in the interest of the firm to retain the earnings.

If the company’s reinvestment rate on retained earnings is the less than shareholders’ rate of return, the company should not retain earnings. If the two rates are the same, then the company should be indifferent between retaining and distributing.

Walter Approach

- The Walter's model is based on the following assumptions:

- The firm finances its entire investments by means of retained earnings only.
- Internal rate of return (r) and cost of capital (KE) of the firm remains constant.
- The firms' earnings are either distributed as dividends or reinvested internally.
- The earnings and dividends of the firm will never change.
- The firm has a very long or infinite life.

Walter Approach

Hence, the basis of Walter formula is:

VE = D /KE – g) …………….Eq.

Where,
VE = market value of equity shares
D = initial dividend
KE = costs of equity and
g = expected growth rate of earnings

Gordon Approch

Gordon Approch (The Bird-in-the-Hand Theory): The essence of the bird-in-the-hand theory of dividend policy (advanced by John Litner in 1962 and Myron Gordon in 1963) is that shareholders are risk-averse and prefer to receive dividend payments rather than future capital gains. Shareholders consider dividend payments to be more certain that future capital gains- thus a "bird in the hand is worth more than two in the bush".

Gordon Approch

Gordon contended that the payment of current dividends “resolves investor uncertainty”. Investors have a preference for a certain level of income now rather that the prospect of a higher, but less certain, income at some time in the future.

The key implication, as argued by Litner and Gordon, is that because of the less risky nature dividends, shareholders and investors will discount the firm’s dividend stream at a lower rate of return, ‘r’, thus increasing the value of the firm’s shares.

Gordon Approch

Assumptions of Gordon's Model

The Gordon's Model is based on the following assumptions:

The firm is an all equity firm.
There is no outside financing and all investments are financed exclusively by retained earnings.
Internal rate of return (R) of the firm remains constant.
Cost of capital (KE) of the firm also remains same regardless of the change in the risk complexion of the firm.
The firm derives its earnings in perpetuity
The retention ratio (b) once decided upon is constant. Thus the growth rate (g) is also constant ($g = br$).
Corporate tax does not exist.

According to Gordon, the market value of a share is equal to the present value of the future streams of dividends. A simple version of Gordon’s model can be presented as below:

P = E (1 – b) / KE – br

Where:

P = Price of a share

E = Earnings per share

b = Retention ratio

1 – b = Dividend payout ratio

KE = Cost of capital or the capitalization rate

br = Growth rate (rate or return on investment of an all-equity firm)

DETERMINANTS OF DIVIDEND POLICY	
1.	Legal Restrictions
2.	Magnitude and Trend of Earnings
3.	Desire and Type of Shareholders
4.	Nature of Industry
5.	Age of the Company
6.	Future Financial Requirements
7.	Government's Economic Policy
8.	Taxation Policy
9.	Inflation
10.	Control Objectives
11.	Requirements of Institutional Investors
12.	Stability of Dividends
13.	Liquid Resources

THANK YOU