DIVIDEND DECISION

Introduction

Dividend is that part of earnings of a company which is distributed by the company among its shareholders. Dividend policy determines how those earnings of a company are to be distributed. Earnings are either retained and reinvested in the company or are paid out to shareholders. Retained earnings are the most important source of equity. Retained earnings can be used to stimulate growth in future earnings and as a result can influence future share values. On the other hand, dividends provide stockholders with tangible current returns.

Rationale for Paying Dividends

Paying a dividend is not an obligation. A company that wants to maximize shareholder wealth in theory invests in all projects that give a higher return than shareholders could make investing the money elsewhere. If that investment amount is less than company earnings, it distributes the rest, either via buybacks or dividends. If that investment amount is more than company earnings, it raises new capital via borrowing or selling new shares. A company that can make consistent 25% to 35% return on equity should not just retain earnings but raise new capital.

Proponents of dividends point out that a high dividend payout is important for investors because dividends provide certainty about the company's financial well-being. Typically, companies that have consistently paid dividends are some of the most stable companies over the past several decades. As a result, a company that pays out a dividend attracts investors and creates demand for their stock.

From the investors' perspective, there are drawbacks to receiving dividends as well such as having to pay tax on those dividends or different investors having different income requirements (a retired person is more likely to need the income than someone who's still working). Hence, dividends are attractive for investors looking to generate income.

However, a decrease or increase in dividend distributions can affect the price of a security. The stock prices of companies that have a long-standing history of dividend payouts would be negatively affected if they reduced their dividend distributions. Conversely, companies that increased their dividend payouts or companies that instituted a new dividend policy would likely see appreciation in their stocks. Hence, dividend payout works as a signalling effect regarding performance of the company and also takes care of the sentiments of its investors.

Also, a company that pays dividend or has a strong dividend history has a certain discipline imposed on them which means they are probably less likely to waste the money on power grabbing projects, or acquisition or buybacks they have overpaid for. There is also plenty of evidence that dividend stocks have outperformed non-dividend stocks over long periods of time.

Determinants of Dividend Policy

Legal Constraints

Most states have laws that regulate the dividend payments a firm can make. These laws basically state the following:

- A firm's capital cannot be used to make dividend payments.
- Dividends must be paid out of a firm's present and past *net* earnings.
- Dividends cannot be paid when the firm is insolvent.

The first restriction is termed the *capital impairment restriction*. In some states, *capital* is defined as including only the par value of common stock; in others, *capital* is more broadly defined to also include the contributed capital in excess of par account (sometimes called *capital surplus*).

The second restriction, called the *net earnings restriction*, requires that a firm have generated earnings *before* it is permitted to pay any cash dividends. This prevents the equity owners from withdrawing their initial investment in the firm and impairing the security position of any of the firm's creditors.

The third restriction, termed the *insolvency restriction*, states that an insolvent company may not pay cash dividends. When a company is insolvent, its liabilities exceed its assets.
Payment of dividends would interfere with the creditors' prior claims on the firm's assets and therefore is prohibited.

Tax Considerations

The tax rate on dividend income is generally higher than the tax rates on long -term capital gains income. The two tax rates might be even equal. But, in spite of this equalization of tax rates on dividend and capital gains income, a tax disadvantage of dividends versus capital gains exists in that dividend income is taxed immediately (in the year it is received), but capital gains income (and corresponding taxes) can be deferred into the future. If a corporation decides to retain its earnings in anticipation of providing growth and future capital appreciation for its investors, the investors are not taxed until their shares are sold. Consequently, for most investors, the *present value* of the taxes on future capital gains income is less than the taxes on an equivalent amount of current dividend income. The deferral of taxes on capital gains can be viewed as an interest-free loan to the investor from the government.

Liquidity and Cash Flow Considerations

Free cash flow represents the portion of a firm's cash flows available to service new debt, *make dividend payments* to shareholders, and invest in other projects. Since, dividend payments represent cash outflows, the more liquid a firm is, the more able it is to pay dividends. Even if a firm has a past record of high earnings that have been reinvested, resulting in a large retained earnings balance, it may not be able to pay dividends unless it has sufficient liquid assets, primarily cash. Liquidity is likely to be a problem during a long business downturn, when both earnings and cash flows often decline. Rapidly growing firms with many profitable investment opportunities also often find it difficult to maintain adequate liquidity and pay dividends at the same time.

Borrowing Capacity and Access to the Capital Markets

Liquidity is desirable for a number of reasons. Specifically, it provides protection in the event of a financial crisis. It also provides the flexibility needed to take advantage of unusual financial and investment opportunities. There are other ways of achieving this flexibility and security, however. For example, companies frequently establish lines of credit and revolving credit agreements with banks, allowing them to borrow on short notice. Large well - established firms are usually able to go directly to credit markets with either a bond issue or a sale of commercial paper. The more access a firm has to these external sources of funds, the better able it will be to make dividend payments. A small firm whose stock is closely held and infrequently traded often finds it difficult (or undesirable) to sell new equity shares in the markets. As a result, retained earnings are the only source of new equity. When a firm of this type is faced with desirable investment opportunities, the payment of dividends is often inconsistent with the objective of maximizing the value of the firm.

Earnings Stability

Most large widely held firms are reluctant to lower their dividend payments, even in times of financial stress. Therefore, a firm with a history of stable earnings is usually more willing to pay a higher dividend than a firm with erratic earnings. A firm whose cash flows have been more or less constant over the years can be fairly confident about its future and frequently reflects this confidence in higher dividend payments.

Growth Prospects

A rapidly growing firm usually has a substantial need for funds to finance the abundance of attractive investment opportunities. Instead of paying large dividends and then attempting to sell new shares to raise the equity investment capital it needs, this type of firm usually retains larger portions of its earnings and avoids the expense and inconvenience of public stock offerings. The companies with the highest dividend payout ratios tend to have the lowest growth rates and vice versa.

Inflation

In an inflationary environment, funds generated by depreciation often are not sufficient to replace a firm’s assets as they become obsolete. Under these circumstances, a firm may be forced to retain a higher percentage of earnings to maintain the earning power of its asset base. Inflation also has an impact on a firm’s working capital needs. In an atmosphere of rising prices, *actual* amount invested in inventories and accounts receivable tend to increase to support the same *physical* volume of business. And, because the amounts of accounts payable and other payables requiring cash outlays are higher with rising prices, transaction cash balances normally have to be increased. Thus, inflation can force a firm to retain more earnings as it attempts to maintain its same relative pre-inflation working capital position.

Shareholder Preferences

In a closely held corporation with relatively few stockholders, management may be able to set dividends according to the preferences of its stockholders. For example, assume that the majority of a firm’s stockholders are in high marginal tax brackets. They probably favor a policy of high earnings retention, resulting in eventual price appreciation, over a high payout dividend policy. However, high earnings retention implies that the firm has enough acceptable capital investment opportunities to justify the low payout dividend policy. Also, a policy of high retention when investment opportunities are not available is inconsistent with the objective of maximizing shareholder wealth.

In a large corporation whose shares are widely held, it is nearly impossible for a financial manager to take individual shareholders’ preferences into account when setting dividend policy. Some wealthy stockholders who are in high marginal income tax brackets may prefer that a company reinvest its earnings (i.e., low payout ratio) to generate long -term capital gains. Other shareholders, such as retired individuals and those living on fixed incomes (sometimes referred to as “widows and orphans”), may prefer a high dividend rate.

Protection against Dilution

If a firm adopts a policy of paying out a large percentage of its annual earnings as dividends, it may need to sell new shares of stock from time to time to raise the equity capital needed to invest in potentially profitable projects. If existing investors do not or cannot acquire a proportionate share of the new issue, their percentage ownership interest in the firm is *diluted*. Some firms choose to retain more of their earnings and pay out lower dividends rather than risk dilution.

One of the alternatives to high earnings retention, however, involves raising external capital in the form of debt. This increases the financial risk of the firm, ultimately raising the cost of equity capital and at some point lowering share prices. If the firm feels that it already has an optimal capital structure, a policy of obtaining all external capital in the form of debt is likely to be counter-productive, unless sufficient new equity capital is retained or acquired in the capital markets to offset the increased debt.