Dividend Policy

(Relevant to Paper II – PBE Management accounting and finance)

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Dividend policy is the policy used by a company to decide how much it will pay out to shareholders in dividends. In your financial accounting course, you learn that after deducting expense from the revenue, a company generates profit. Part of the profit is kept in the company as retained earnings and the other part is distributed as dividends to shareholders. From the share valuation model, the value of a share depends very much on the amount of dividend distributed to shareholders.

Dividends are usually distributed in the form of cash (cash dividends) or share (share dividends which are beyond the remit of this article). When a company distributes a cash dividend, it must have sufficient cash to do so. This creates a cash flow issue. Profit generated may not be in the form of cash. You may verify this by looking at the cash flow statement of a company. A company may have profit of $400 million but the cash only increase by $190 million in a financial year. This is a concern to the management as insufficient cash may mean the company is unable to distribute a dividend.

Investors earn returns from their shares in the form of capital gains and dividend yield. Dividend yield is an important ratio in evaluating investment. For example, Hang Seng Bank distributed a $6.30 dividend per share in 2008. If you purchased shares in Hang Seng Bank at $87 per share, the company's dividend yield was 7.2% ($6.30/$87) which is much higher than the bank deposit rate.

Dividend payout ratio is another important indicator:

Dividend payout ratio = Dividend per share ÷ Earnings per share

This ratio indicates how much of the profit is distributed as dividend to shareholders. The higher the dividend payout ratio, the more attractive the share is to shareholders.

Dividend payout ratios vary among companies. The following table shows the dividend payout ratio of some Hong Kong listed companies.

Company name	Dividend payout ratio for 2007
Hang Seng Bank	66.04%
HSBC	54.55%
China Construction Bank	68.24%
Cheung Kong Holdings	20.5%
Sun Hung Kai Properties	23%
Henderson	14.59%
Hong Kong Exchange	89.79%
Esprit	80.61%

You may observe that there are drastic differences between the dividend payout ratios in different industries. The banking industry had a higher dividend payout ratio than property developers. This is due to one important accounting issue. A large proportion of the profit earned by property developers is not cash in nature, so these companies cannot distribute high dividends.

Other factors in addition to profit and cash flow may influence the dividend level. In some countries, dividends are taxable. The higher the dividend, the higher the tax an investor needs to pay. In such cases, high dividends are not desirable. If a company is expanding, it needs to keep sufficient cash for its plans rather than having to go to the equity or debt market to raise additional finance.

Dividend policy is based on the answers to several important questions. How much dividend should a company distribute to shareholders? What will the impact of the dividend policy be on the company's share price? What will happen if the amount of dividend changes from year to year?

Common dividend policies are the stable dividend policy, constant payout ratio and residual dividend policy.

In the stable dividend policy, management maintains a fixed dividend per share each year. The impact on share pricing can be seen from the share valuation formula $P_0 = D_1/(r-g)$ where P_0 is the current price, D_1 is the dividend in the coming year, r is the required equity return and g is the dividend growth rate. If there is no growth in dividend, g=0, and $P_0 = D_1/r$. After one year $P_1 = D_1/r$ but $D_1 = D_2$. Thus $P_1 = P_2$ and there is no growth in the share price.

In the constant payout ratio situation, management maintains a fixed percentage dividend payout ratio. For example, both Esprit and Hong Kong Exchanges and Clearing have indicated that they distribute about 80% and 90% of their profit respectively as dividends. This provides clear direction to investors.

In a residual dividend policy, profits are used to fund new projects with the residual or remaining profit distributed as dividends. If a company has a profit of $100 million and is going to fund a new development project costing $60 million, the remaining $40 million will be distributed as dividends. The calculations are slightly more complicated if the company wants to maintain its target debt-equity ratio. Using the same example, assume the target debt-equity ratio is 0.5. If the whole $100 million is kept in the company as retained earnings, equity is increased by $100 million. To maintain the target debt-equity ratio, the company must borrow an additional $50 million. If there is a new project requiring $60 million, this sum is also funded using the same debt-equity ratio. That is, the company needs to raise $20 million debt and $40 million equity. Since the profit is $100 million, the amount of dividend distributed is $60 million ($100 million - $40 million).

Investors prefer steady growth of dividends each year and avoid investment to companies with fluctuating dividend policy. If you analyse the dividend per share of the shares in the above table for the last 10 years, you will discover an interesting pattern. Some companies reduced their dividends during weak economic times but others were still able to maintain the same dividend per share.

Dividend theory includes an argument called dividend irrelevance which was proposed by two Noble Laureates, Modigliani and Miller. They argued that if a company distributed high dividends now it may reduce its dividends later and thus the total effect is zero in time value. For example, a company may distribute a dividend of $1.1 per share and investors may expect it can maintain this payment for some time. Eventually the company reduces its dividend to $0.89 per share and the ultimate time value result is the same.

A sudden increase in dividend may not be a good sign. In an efficient market, investors are able to distinguish between a genuine dividend increase and an artificial dividend increase. Let's consider an analogy, comparing the distribution of dividends to the distribution of lai see at Chinese New year. Distributing $100 lai see does not mean that the person is rich and can maintain these payments in the future. Companies try to maintain a stable dividend because if they reduce their dividend payments, investors may suspect that company has cash flow problem. This is the case for HSBC. Before its announcement of its final results for 2008, there were rumours that the company would not be able to distribute the same dividend as it did in 2007. Now, HSBC both reduced its dividend and announced rights issues. If a person usually distributes lai see of $20 and then suddenly increases it to $40, this may imply that his finances are improving. If he drops the amount to $30 in the following year, recipients may think that he has financial problems.

To conclude, a company must not cut a positive NPV project by paying dividends. Otherwise, dividends cannot be maintained. It must not reduce its dividend as this may imply there are cash flow problems. A company should try to pay dividends but at the same time maintain sufficient retained earnings to avoid having to raise new finance. A company must never allow the distribution of high dividend to be funded by borrowing money and worsening its debt-equity ratio. Finally, the company should set a target dividend payout ratio which is constructive but which also depends on the stability and prospects of the business. **T/D**