What managerial implications can be drawn from capital structure theories for div...

Business

When a firm procures funds from investors or owners, there will be an explicit or implicit promise to pay return to them. The return is paid in terms of interest which is compulsory paid to all investors and owners, but the return paid to owners in the form of dividends is optional.

The dividend decision by any firm, like the investment and financing decisions is also taken for maximization of market price of the share. The term dividend refers to that the portion of profit (after tax) which is distributed among owners/shareholders of the firm and the profit which is not distributed is called as " retained earnings" – Managerial Finance " Weston J. Fred and Brigham, The Dryden Press, Illinois, Fifth Edition, p. 698. Dividend Payout Ratio is determined by the dividend policy adopted by the company, and it is implemented to decide about the percentage of profits to be distributed by the firm to its owners/shareholders. Dividend is always depends on the total profit that a firm acquired after taxes. There are a few factors that affect the Dividend policy of a company they are 1. Liquidity 2.

Growth Plans 3. Control Dividend Payout Ratio is also called as DP Ratio which is a mathematical value as DP Ratio = Dividend paid to the Shareholders / Net Profit after tax. Page 2 Capital Structural Theories Capital structural theories are designed with a concept of valuation of the firm; it is the earnings of the firm and the investments made by the firm. Capital Structural Theories also used to find the dividend payout for its owners/shareholders. Cost of the capital, investment and return on investment (ROI) are a part of dividend policy. The relationship between leverage cost of capital and the value of the firm can be analyzed in different ways. Factors determining Capital Structure are minimization of risk, control, flexibility and the profitability of the firm. A firm's capital structure is a combination of the firm's liabilities (debts) and the assets (equity and profits).

For Example: A firm with 100 billion as capital structure has 40 billion from equity (shareholders and owners) and the 60 million as debt (Loans and Funding), then the firm is said to be 40% – equity financed and 60% – debt financed. With cost valuation of the firm determined using capital structure and the net operating profit using EBIT analysis we can determine the dividend payout for owners and shareholders for the firm. Every firm has a dividend payout policy and it was always analyzed after the capital structure methods.

There are some managerial implications that can be analyzed under capital structure theories for dividend policy, saying that dividend policies are always affected by the capital structural theories. " Fundamentals of Financial Management, Harper and Row Publications, New York, 4th Edition P. 80" Page 3 There are two types of Capital Structural Theories 1. Non-Traditional Theories 2. Traditional Theories Non-Traditional Capital Structural Theories Net Income (NI) approach is to determine the relationship between leverage, cost of capital and the value of the firm. As suggested by Durand, this theory states that there is a relationship between the capital structure and the value of the firm, therefore the firm can affect its value by increasing or decreasing the debt proportion in the overall finance mix. Debt financing proportion is also considered in this approach, and then determines the distribution of funds as dividends.

Three variables are taken into consideration, E – Value of Equity O – Constant Value and D – Value of Debt For all levels of debt financing the “ O” is constant and “ E” and “ D” are variable values, If D is less than E then there is an increase in the value of the firm. Under NI approach, the firm will have the maximum value capital at a point where constant (O) is minimized. With a judicious use of debt and equity, a firm can achieve optimal capital structure. Traditional Theories Net Operating Income (NOI) approach is just an opposite of NI approach. According to the NOI approach, the market value of the firm depends upon the net operating income or profit and the overall cost of capital. NOI approach is based on the argument that the market values the firm as a whole for a given risk complexion. Thus, for a given value of the firm remain the same irrespective of the capital composition and instead on the overall cost of capital. Mathematically Net Operating Income (NOI) is Value of the Firm = Earnings before Tax / Cost of Equity Capital.

Net Operating Income approach says that an increase in debt proportion of the capital source will always result in increase of the equity proportion of the firm. Modigliani-Miller Model Modigliani-Miller model which was presented in the year of 1958 on the relationship of leverage, cost of capital and the value of the firm. This is widely used capital structure method to analyze the value of the firm. They have shown that the financial leverage doesn’t matter and the cost of capital and the value of the firm are independent of the capital structure. Modigliani-Miller methods show that there is nothing which may be called as Optimal Capital Structure – to get high valuation of the firm. Page 5 Modigliani-Miller model is based on following assumptions: The capital markets are perfect and complete information is available to all the investors free of cost. The implication of this assumption is that investors can borrow and lend funds at the same rate and can move quickly from one security to another, Securities are infinitely divisible; Investors are rational and well informed about the risk-return of all the securities.

Modigliani-Miller model says that the total value of the firm is equal to the capitalized value of the operating earnings of the firm. The capitalization is to be made at a rate appropriate to the risk class of the firm. Managerial implications that can be drawn from capital structure theories for dividend policy? Dividends are given to owners/shareholders only when the firm is having profits after tax. In order to make a dividend policy the firm should have a capital structure theory that will determine the value of the firm and the operating income.

In dividend decisions, a finance manager should decide one or more of the following: Should the profits be ploughed back to finance the investment decisions – Whether any dividend be paid? – How much dividends to be paid? – When these dividends be paid? – In what form the dividends are paid? Page 6 Growth Plans, are involved in capital structural theories in which a certain amount will be allocated for the growth plans. A finance manager should draw a plan according for the dividend policy. For Example: The firm has $10 million as equity capital and $6 million as debt capital and the firm made a profit (after tax) of $2 million, and the fund allocated to the growth plan was $1 million. For suppose there are 10, 000 shareholders in the company and as per capital structural theories some amount will be allocated for the liquidity that is five hundred thousand and the remaining amount should be distributed as “ Dividends”. In this case each shareholder or the owner will receive $50 as dividend. Legal and Procedural Considerations: When the firm issues shares to public, the firm should issue a share information brochure which contains the details of dividends and extra bonus -according to company laws. Capital structural theories say that if a firm is in profit and it is looking to expand the business, the profit can be rolled over to the investment option.

In this case there will be no dividends or bonuses issued to the shareholders or the owners. For Example: Low-payout consequences, which is done when the cash gets accumulated the financial manager may be tempted to take on more projects that do don’t meet the minimum rate of return investments. Page 7 If a firm has $1 million as operating income with 1000 shareholders and firms adopts to take new projects with the profit. Then this may cause unrelated relationship balances between the shareholders and the management of the firm. Payment of Dividend & Raising of fresh Capital: Finance manager has task to do the both the works i. e. payment of dividend to the shareholder’s and owner’s and also raising the fresh capital. Modigliani-Miller Model proves that this can be done, and every investor should be known with these details.

“ Implications in Dividend Payout, Kalyani Media Journal – Dividend Management, 2006” Modigliani-Miller Model has shown that the dividend payment will not have any effect on the value of the firm. If firm pays the dividends resulting in increase in the market value of the share and the firm. The effect on the value of the firm will be neutralized by the decrease in the terminal value of the share. For Example: A firm has 1, 00, 000 shares outstanding and is planning to declare a dividend of $5 at the end of current financial year. The present value of the share is $100.

The cost of equity capital " E" may be taken at 10%. The expected market price at the end of the year may be under two options. 1. Dividend of $5 is paid 2. Dividend is not paid If the dividend of $5 is paid (The value of D = 5) P – Present value of the share (P = 100) E – Cost of equity (E = 10) P1 – Expected Market Price of the Share Page 8 As per Modigliani-Miller Model P1 = P (1+E)-D P1 = 100(1+10) – 5 P1 = 105 So, the market price of the share is expected to be $105, if the firm pays dividend of $5.

If dividend of $5 is not paid (The value of D = 0) P1 = P (1+E)-D P1 = 100 (1+10) – 0 P1 = 110 So, the market price of the share is expected to be $110, if the firm does not pay the dividend of 5$. Stability of Dividends: Another important implication of dividend policy is the stability of dividends that is how stable and regular the dividends are paying out. It is said that generally the shareholders favor stable dividends and those dividends which have prospects of steady upward growth. So, while designing a dividend policy for the firm, it is also to be considered as to whether the firm will have a consistency in dividend payments or the dividends will fluctuate from one year to another.

" Managerial Finance, Sec. Edition, R. P. Singh, New Age Publishing Company, p. 159" Firms should maintain constant DP ratio (Dividend Payout Ratio) Page 9 A firm may have a policy of distributing a fixed percentage of earnings as dividends to its shareholders. The higher the profits will result in higher absolute dividends while lower the earnings will result in lower absolute amount of dividends. For Example: A firm having the dividends payout ratio of 60% will distribute 6 hundred thousand dollars for a profit of $ 1million and it will distribute $ 2, 40, 000 only if the profits are $ 4, 00, 000 and so on…Thus, the percentage of the dividend rate or dividend per share may fluctuate from year to year depending upon the earnings of the firm.

Optimal Capital Structure: Even though Modigliani-Miller Model says that there is nothing like Optimal Capital Structure, but the non-traditional methods say that a firm can attain profits only by implementing Optimal Capital Structure. Some firms adopt this capital structure to minimize the risk, flexibility on the investments and the profitability. The finance manager should be able to identify that optimal point (profit point) for the firm precisely, but not to attempt to track the optimal range for the capital structure.

Optimal Capital Structure differs from different firms, Existing Firm and a New Firm. For Example: Existing Firm may require additional capital funds for meeting the requirements of growth, expansion, and diversification or even for working capital management. The decision for a particular source of funds is to be taken in the totality of capital structure, i. e.

n the light of the resultant capital structure after the proposed issue of capital or debt. Page 10 The Capital Structure of the new firm is designed in the initial stages of the firm and the financial manager has to take care if many considerations, the present capital structure be designed in the light of a future target capital structure. Future plans, growth and diversifications strategies should be considered and factored in the analysis, so optimal capital structure greatly influences the dividend policy of any firm, depending upon there capital structure. Fundamentals of Shares and Dividends, Michael Ian, Oxford Publications, 3rd Edition, P.

258” Conclusion Broadly speaking the dividend policy can be determined by two basic analyses required to find the valuation of the proposed capital structure of the firm, i. e. one from the point of view of profitability and another from view of liquidity. Capital structure will always determine the profits of the firm and the development of the firm.

Equity and Debt capital are well managed by the capital structure of the firm. A well designed capital structure will have a very good impact on the dividend policy of the company.