

# [Dividend policy paper essay sample](https://assignbuster.com/dividend-policy-paper-essay-sample/)

1. Introduction.

The objective of this paper is to carry out an investigation on how companies decide on their dividend payout with particular emphasis on Next Plc, a publicly traded company listed on the London Stock Exchange. The report is divided into two parts. the first part covers the dividend decision, a discussion on share repurchase as another means of transfering wealth to shareholders as well as an analysis of the returns made to shareholders by Next Plc over the last 5 years. The second part of the study presents a valuation of Next Plc using the Dividend Discount Model as well as using the Capital Asset Pricing Model (CAPM). A discussion on the merits and demerits of both models as corporate valuation tools is also presented.

This study is limited only to the means of transfering value to shareholders and to the corporate valuation of dividends using the dividend discount model and the CAPM. It is as well limited only to Next Plc. as a case study. The rest of the paper is organised as follows: Section 2 presents a discussion of Dividends and share repurchase as well as a discussion on the dividend policy of Next Plc over the last five years. Section 3 presents a valuation for Next Plc using the Dividend Discount Model as well as the Capital Asset Pricing model and a discussion of Merits and demerits of both models as corporate valuation tools. Section 4 presents a conclusion and recommendation of the study.

2 Dividend Decision, Share Repurchase and Next Plc.

1. Dividend Decision.

Moore (2004) defines a dividend as (a) a sum of money to be divided among a number of persons, especially that paid by a company to shareholders. (b) a similar sum payable to winners in a gambling pool, to members of a cooperative, or to creditors of an insolvent estate. (c) an individual’s share of a dividend.

Dividends refer to the reward to shareholders for providing capital to the firm. If the firm fails to pay dividends then shares would be worthless.

Since the promise of future payment of dividends provide value to shares, fluctuations in the value of the shares is brought about by shareholders’ expectations of future dividend streams. Dividends can either be paid in cash or in kind (stock dividends) and they are set at the discretion of the Board of Directors usually on a biannual basis in the UK or quarterly basis in the USA. (Dean and Douglas, 1998). Having defined what dividends are and why they are important to shareholders, this report will now move on to discuss how the dividend decision is arrived at.

Dean and Douglas (1998) identify two main approaches to explaining the dividend decision:

Firstly, under perfect capital markets, managers and shareholders should not care about the current dividend anouncement. this is consistent with the Miller and Modigliani indifference proposition.

Secondly,  there is an empirical evidence that directors are reluctant to reduce the divident over time. This is because investors although they may accept short-term fluctuations in earnings seem strongly averse to any signal that the underlying level of earnings trend may not be sustainable. (Dean and Douglas, 1998).

A reduction in dividend conveys negative information concerning the sustainability of earnings in the future as well as the value of the firm. Also, dividend reduction may initiate a hostile takeover and as such managers, being averse to takeovers will do everything possible to make sure that the present level of dividends is maintained. (Dean and Douglas, 1998). Conversly, increase in the current level of dividends should only be made if the directors believe that the new level will be sustainable. (Dean and Douglas, 1998). Having said this, the the next pararagraph looks at the Modigliani and Miller indifference proposition in greater detail.

1. Miller and Modiglani (MM) Indifference Proposition.

According to the MM indifference proposition, firm value is not affected by dividend policy under ideal cricumstances. (Dean and Douglas, 1998). This is because shareholders are indifferent to the announcement of low or high levels of dividend. The basic assumption underlying this principle is that firm value depends solely upon the investment opportunities at the firm’s disposal and that funding for investments is always readily available. (Dean and Douglas, 1998). Consequently, given a set of investment opportunities it is possible for the firm to raise capital both internally and externally to finance both its investment projects as well as its dividends. (Dean and Douglas, 1998). This proposition directly mirrors another proposition by MM, which states that firm value is not affected by capital structure. (Dean and Douglas, 1998).

However, the MM indifference proposition is not always obeyed to the fullest. From the shareholders’ perspective, the dividend irrelevance indicates that shareholders are indifferent between receiving their reward as dividends or as capital gains. (Dean and Douglas, 1998).  Considering an investment project, a lower dividend means higher capital gains whereas higher dividends mean lower capital gains thus making the total returns equal in either case. (Dean and Douglas, 1998). In addition, the indifference proposition too will only work properly in a world without taxes as tax policies may favour one form of reward over the other.

For example, consider an investor who is being taxed differently on capital gains and dividends, assuming that his tax rate on dividends is higher than that for capital gains, such an investor will prefer receiving his returns in the form of capital gains than dividends. Similarly, if his tax rate on capital gains is higher than that for dividends, he will prefer receiving his returns in the form of dividends. (Dean and Douglas, 1998). This process can also be distorted given the fact that retained earnings can also be taxed differently from distributed earnings.

If we assume that retained earnings are not taxed differently from distributed earnings, a company that has its shareholders’ interest at heart will choose a means of reward that minimises the total tax liability of the shareholders. (Dean and Douglas, 1998). For example, in the United States of America, the effective tax rate on capital gains is lower than the effective tax rate on dividends ( Dean and Douglas, 1998; Ross et al, 1999), implying that companies in the United States of Amerca can minimise the tax liability of their shareholders by providing them with low dividends while retaining the rest of their wealth in the form of capital gains.

1. Share Repurchase

Another way of distributing wealth to shareholders is through the repurchase of shares from shareholders. This is usually when a firm wants to get itself rid of extra cash. (Ross et al, 1999). The repurchase of shares is a useful adjunct to dividend policy, when tax avoidance is important. (Ross et al, 1999).  For example assume that Next Plc has 100, 000 shares outstanding and excess cash of £500, 000 (or £5 per share) and is considering paying dividends of this amount as an extra dividend. It foresees that after paying this dividend total earnings for the year will be £750, 000 or £7. 5 per share for the 100, 000 shares outstanding.

Assuming a price earnings ratio of 6 for comparable companies, the shares of Next Plc will trade at a total price of £45 a share. On the other hand, the Next Plc can decide to repurchase about 10, 000 shares by making a tender offer for say £50 a share thereby reducing the number of shares outstanding to 90, 000 shares. with fewer shares the earnings per share will rise to £750, 000/90, 000 = £8. 33. Since the financial risk and business risk remain the same for both dividend and repurchase case (Ross et al, 2006), the price earnings ratio will remain at 6. The price of the share after repurchase will rise from £45 per share to £50per share (£4, 500, 000/90, 000).

In a world without taxes and transaction costs the stockholders will turn to respect the indifferent proposition thereby treating the repurchase and dividend equally. (Ross et al, 1999). With dividends, each shareholder owns a share of stock worth £45 and receives a dividend worth £5 so that the total value is £50. The value will be the same for both selling shareholders and remaining shareholders. The above information is represented in the table below:

Table 1. Dividend versus Repurchase Example for Next Plc.

|  |  |  |
| --- | --- | --- |
|  | Entire Firm  | Per share (100, 000 shares outstanding)  |
| Extra Dividend  |  |  |
| Proposed Dividend  | £   500, 000  | £ 5. 00  |
| Forecast annual earnings after dividend  | 750, 000  | 7. 50  |
| Market Value of stock after Dividend  | 4, 500, 000  | 45. 00  |
| Repurchase  |  |  |
| Forcast annual earnings after repurchase  | £   750, 000  | £   8. 33  |
| Market value of stock after repurchase of stock  | 4, 500, 000  | 50. 00  |

Source: Ross et al (1999)

Ross et al (1999) outlines three main reasons for share repurchase as follows:

1. Taxes

Current tax law in the US inflicts a higher tax rate on dividends than stock repurchase and as such, companies to distrbute wealth to the investors through stock repurchase so as to minimise the tax liability. For example,  a dividend of $1 per share is taxed at ordinary income tax rates. (Ross et al, 1999).

Therefore an investor in the 25% tax bracket who owns 100 shares of a security would pay $25 in taxes, while selling stockholders would pay a far lower tax under a repurchase of $100 of existing shares since taxes are paid only from gains from a sale. Assuming that the shares sold at $100 were originally purchased at $70, the gain on the sale will only be $30 and the tax will be applied only on the capital gain of $30. (Ross et al, 1999). If we assume a capital gains tax of 20%, the capital gains tax will therefore be 0. 20 x $30 = $6. The investor therefore makes an extra gain from the tax advantage of $25-$6 = $19.

Unfortunately, life is not that easy. The tax authorities are quite aware of this tax avoidance strategy and as such are likely to penalise corporations repurchasing their own shares if their main motive is to reduce the tax liability resulting from the payment of dividends, although a one-time-repurchase of shares will most likely avoid the penalty of the tax authorities. (Ross et al, 1999).

1. Targeted Repurchase

Firms also carry out share repurchase as a means of reducing the shareholding of certain large shareholders so as to reduce their influence and control over the activities of the company. (Ross et al, 1999). The price in a target repurchase can be lower than that in a tender offer as well as the legal fees involved. (Ross et al, 1999). In addition to reducing the shareholding (acting in the best interest of remaining shareholders), shares of large stockholders are often bought back to avoid a hostile takeover to management. (Ross et al, 1999).

* Repurchase as Investment

A good number of companies by back their shares as a means of invesment and this is often done when management perceives that its share price is currently undervalued. (Ross et al, 1999). Under such circumstances, management usually believes that (1) Investment opportunities in non-financial instruments are few, and (2) the firm’s own stock price should rise with the passage of time. (Ross et al, 1999).

However, the repurchase of stock does not usually indicate an undervaluation of the share although most capital market reactions to share repurchases have resulted to positive abnormal returns. (Ross et al, 1999). In addition empirical evidence has shown that most stocks have perfomed well in the long-run following a repurchase than stocks that did not repurchase. (Ross et al, 1999).

1. Returns made By Next Plc Over The Last Five Years

Next Plc is a high street retailing and home shopping of womenswear, menswear, childrenswear, interiors, accessories and fashion jewellery; telecommunication software services (http://www. advfn. com/p. php? pid= ukfinancials&symbol= LSE%3ANXT)

From appendix 1 below, which shows Next Plc’s perfomance chart for the returns to shareholders for the period 2002-2007, it can be observed that the returns profile witnessed a less growth between 2002 to 2003. The returns profile picked up in 2003 and has been growing and at an increasing rate since then. Also, the returns profile for next PLc has been above its peer index the FTSE General Retail index as well as above the FTSE all shares index. Next Plc has also been engaged in repurchasing programs.

Next Plc rewards its shareholders both through the payment of dividends and share repurchase. It considers the tax implications before carrying out the necessary actions. For example the company is determined to act in the best interest of the saherholder as it repurchase shares only if the decision to repurchase will result in an increase in earnings per share. (Next Plc Annual Report, 2005).

Following shareholder authority granted at the November 2004 Extraordinary General Meeting, the Company entered into two contingent purchase contracts and as at 21 March 2005 had bought back off-market a total of 1, 200, 000 ordinary shares for cancellation at a total cost of £19. 0m. Under these contracts, and subject to a pre-determined barrier share price level not being reached, the Company had to make further purchases of up to 1, 150, 000 shares for cancellation.

Special resolution 13 had to give the Company authority to enter into further contingent purchase contracts with each of Goldman Sachs International, UBS AG and Deutsche Bank AG under which shares could be purchased off-market at a discounted price to the market price prevailing at the date each contract is entered into. (Next Plc Annual Report, 2005). The company also repurchased 15 million shares in 2006 at a price of 1449p amounting to a total of £218million.

1. Corporate Valuation

Valuing Next Plc

To value the stocks of Next Plc, the study will make use of the Gordon-Shapiro (1956) constant growth of dividends model cited in Rozeff (1984). According to this model, the expected return on the stock market equal a dividend yield variable on the market plus anticipated growth of dividends. This model can be written thus:

Where

the current dividend yield on the market, and

= the nominal expected growth rate of the market dividends

Subtracting out the nominal risk-free rate that is the rate of return on Treasury bills RBILL, gives an expression for the risk premium

According to Rozeff (1984), this view of risk premium has some helpful features. It focuses attention on the two facets of expected returns, namely, yield and growth. The yield varies daily and creates an observable variation in the current risk premium that is not moved by averaging over many possible irrelevant years. The growth terms focuses attention on future growth making this version of the risk premium future oriented in a way that looking at historical returns is not. The model’s drawback is the unpleasant shortcoming that anticipated growth rate of dividends is unobservable. Because of this, the model cannot measure the risk premium without an estimation of the anticipated long-run growth rate of dividends.

Yield Spread Measure.

Yield spreads between different risk classes are thought to provide observable risk premiums among bond classes. They can also help measure equity risk premiums if we invoke the Capital Asset Pricing Model (CAPM). In this model, the security market line (SML) is a linear relationship between expected returns and betas of all assets, including bonds and stocks. The intercept of the security market line is the expected stock market return minus the zero-beta return (risk-free rate). In other words, the slope of the security market line is just the equity risk premium. (RSTK –RBILL). (Rozeff, 1984). If we measure two points along the line, then we can infer the slope of the line.

To illustrate, if we measure the expected returns and betas of two different classes of bonds, the difference in yield-to-maturity between the two types of bonds corresponds to approximately the difference in their expected returns. Once we estimate the betas of the bonds, we can then solve for the slope of the line and obtain an estimate of the equity risk premium. For example, suppose that BAA bonds yield 0. 9% more than AAA bonds. Suppose also that their betas are 0. 18 and 0. 06 respectively, then an estimate of the current risk premium is 0. 009/0. 12 or 0. 075 or 7. 5%. assuming that bond betas are stable, then changes in yield spreads tend to reflect changes in the equity risk premium.

The obvious variability in yield spreads through time, suggests that equity risk premiums also vary through time in a systematic fashion, not simply because realizations do not equal expectations. since it focuses on current variation in risk premiums, the yield spread method is more consonant with the constant growth rate method than with the realized returns methods. (Rozeff, 1984). It to has its problems, however, which include measurement of bond betas, the necessity of assuming that the yields-to-maturity are not exactly the same as expected returns. (Rozeff, 1984). In another version of the Capital Asset Pricing Model according to Brealey and Myers, the expected return on a stock i, is given by the risk-free rate on treasury bills plus a risk premium for bearing equity market risk. Mathematically, we can write the CAPM as follows:

Where

is the expected return on firm i

is the return on the zero-beta stock

is the return on the market index

is the sensitivity of firm i’s returns to movements in the market.

In effect, what the CAPM is saying is that, because investors bear extra risk for investing in the equity market, they must be compensated for the time value of money as well as provided with a risk premium for taking on extra risk. The expression is referred to as the risk premium and the total amount is determined by the beta of the stock. The higher the beta, the higher will be the risk premium and vice versa.

Having discussed the above, the study will now move on to establish a value for Next Plc.

Using equation 1 above we can establish the a value for the returns on Next Plc’s stock as follows

According to Brealey and Myers (2003), the dividend yield on a stock at time t is given by

Therefore, for Next Plc, we can rewrite equation 3 for its 2006 dividend yield thus:

From the 2006 annual report, the company repurchased 15million shares at a price of 1449p per share amounting to a total price of £218million. Due to difficulties in locating the company’s stock price, we assume that the price of 1449p was the stock price in 2006.

Dividends increased by 11. 3% from 2006 (Next Plc’s Results For the Year ended January 2007), therefore we can assume that the growth rate in dividends G = 11. 3%.

We can calculate the return on the shares as follows:

Therefore, The price of the stock as at 2007 will be given by:

(Brealey and Myers)

1254, 32p

Using the Capital Asset Pricing Model (CAPM),

We have been unable to get information for the beta of the Next plc, so we use the beta of a competor Arcadia Plc to be approximately equal to that of Next Plc since they are in the same industry. The beta of Arcadia Plc is 1. 6. The return on the 10 year bond is 4. 65% and using the market return of 12. 8%, we can calculate the return on the stock as follows:

RSTK =

The stock returns different prices under the two methods. The price under the dividend growth model is greater than the price under the CAPM.

1. Conclusion

The study was aimed at investigating how companies reward shareholders for providing finance to shareholders with particular emphasis on Next Plc. It was also aimed at valuing next Plc by using two approaches, the dividend growth model and the CAPM. In the course of the study, it was found that companies reward shareholders either through share repurchase or dividends.

We also found that managers are reluctant to reduce the amount of dividends over time as a reduction in dividends conveys negative information to the public. Also we find that share repurchases lead to an increase in stock price. Having discussed the theories we found that Next Plc puts these theories into practice by using both approaches to rewarding shareholders, that is, share repurchase and dividends. In trying to establish a value for the company’s shares we find a smaller value under the CAPM while we find a larger value under the Dividend growth model.

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