Critique for fpl group inc’s case

Business

Generally, the report team have a well-presented PowerPoint presentation about their analysis of dividend policy at FPL group Inc. They have demonstrated the process of how they come up with these results briefly. They have also examined the company’s history, financial figures and some related industry information, and gave reasonable recommendations. The report team expected that the company would most likely to hold their currently dividend policy and suggested their clients to sell the company shares in short term.

However, we strongly suggest that the report team should include more relevant financial calculations to backup their point of views; in addition, the application of theory was not aliment with their arguments. After our group had studied and researched about the same case, our opinion is very different from the report team. The detailed analysis will be explained in the following paragraphs. Through our analysis, we believe that the dividend cut would be more likely to happen in the near future for the company. Thus, we suggest that our clients could sell their shares for the short term; and for medium to long term investing strategies, our clients could buy back shares when the price start to go up. For the following paragraphs, we will, firstly, analysis the company’s financial situations, follow by the theoretical evidences, and finally, conclusion.

If company has reduced their dividend payout, they will have a sum of $150 million per year; we believed the company could definitely get a better use of their retained earnings to improve their financial situation. For example, the company could reinvest in a new project to create future profits (cash inflows) or repay the interest debts to reduce the risk of company. Generally, according to FPL's bad circumstances, we were not expect firm's earning will grows faster than dividend payout ratio, so we predicted FPL group will cut its dividend payout ratio in the next few years. The reasons of why we forecast FPL will cut dividend payout ratio can be concluded as followed. Firstly, as can be seen from the table below, utilities industry had relatively high levels of debt and could not possibly pass all their increase in interest expense to consumers. It means that, FPL group need more money to pay for the increased interest expense on debt.

[pic] Moreover, during this period of rising interest rates and increasing competition from deregulation, FPL's stock price had fallen by 19. 6%, which made some bad effect on FPL. For example, falling in share price can be portrayed that the business is not performing well and create a loss of current shareholders or potential investor. Additionally, FPL uses a stable payout policy to pay dividend. The stable payout policy argues that the percentage of profit paid out to shareholders is their dividends.

Shareholders can obtain growth dividends with the development of FPL. The short-term cutting in dividend ratio will encourage FPL made more profit in the future. Finally, FPL was a low-beta stock, share price not reflect much with market changes and we analysis that most problems occurring recently comes from company's internal issues. Therefore, share price can be increased by adjusting FPL's management and financial methods. Overall, if we cut dividend payout ratio, $150million will be retained for investment and paying off interest debt each year, and Funds can also be used for growth – to meet expected increase in demand. Furthermore, cutting dividend payout ratio, thereby putting it at the lower end of the industry in terms of payout ratio, it could increase its dividend in future years faster than without the cut.

Therefore, good performance can be expected in the future years. Theoretically, many empirical evidences showed that managers regard dividend payout policy is significant to a company, Lintner(1956) in Pearson (2009) also founded out that in most of cases, dividends were an “ active decision variable”, and that most of managers “ were reluctant to make changes in dividend that are likely to have to be reversed in the near future” (Pearson, 2009, p. 325) However, Miller and Modigliani (MM) (1961) in Pearson (2009) stated that company shareholder’s wealth would not be affected by company’s dividend payout policy. Eventually, the value of the company is only depending upon its investments. The residual-the different between company’s profits and investments- is then the net cash that can be paid out to company investors.

The form of the payout is disregarded-“” shareholders are equally happy with a dollar of dividend or a dollar of paid out to repurchase shares” (Pearson, 2009, p. 329) Therefore, from the perspective of company shareholders, even though FRL might have to cut back their dividend due to the market conditions , according to MM’s the irrelevance of payout policy theory, company shareholder’s wealth would not be affected by the dividend cut decision. From the company’s point of view, in practice, if FRL keep paying high dividend, its retained profits are insufficient to meet its investment or operational needs, for example, the fund are unable to meet the expected increase of demand for the upcoming years, or paying off their cost of debt, then FRL might have to consider raising fund externally if they are not considering increasing the fund that are available internally by reducing its dividend. The flotation costs incurred by raising fund externally could be quite substantial. Pearson (2009) argued that “ the existence of flotation costs provides an incentive to preserve shareholders’ wealth by restricting dividend” (p.

330) Pearson (2009) even suggested that due to the flotation cost incurred by the company, the residual dividend policy might be the best outcome for shareholders as the company will only provide dividend to the extent that company’s retained earning cannot profitably reinvested. Empirical evidence also suggested that the dividend cut will normally result in the drop of share price as investors regard that change in dividends as company to convey new information about company value. However, studies suggested that relationship between current dividend and future earning are positive but weak. (Watt, 1993 in Pearson 2009) Furthermore, Benartzi, Michaely and Thaler (1997) in Pearson (2009) stated that “ in the case of dividend decreases they found that profits tend to increase over the next two years. (p.

338)There is also a similar study finding by Grullon, Michaely and swaminathan (GMS) (2002) in Pearson (2009), “ dividend decreases follow a period of declining ROA, but after the dividend decrease company profitability tends to recover rather than decline further”. (p. 339) It is expected that FRL’s share price will drop after the announcement of the dividend cut, but it is also expected that the share price will recover well with the growing ratio of the company in the next few years. In conclusion, we expect that the company would very likely to cut their dividend in the near future, and decrease dividend payout ratio. Therefore, Stark could suggest her clients to sell their shares in the short term to prevent the loss; meanwhile, for the medium to long term strategies, since we are still optimistic about the company’s future, thus, it is suggested the investors could buy back stocks when the stock price is started to go up. References

Peirson, G.

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