Advantages and disadvantage of four alternative dividends polices

The firm’s dividend policy must be produced with two basic objectives in mind, which are maximizing the wealth of the firm’s owners and providing for sufficient financing for future projects. According to Gitman, Juchau & Flanagan (2008) dividend payout ratio indicates the percentage of each dollar earned which is distributed to the owners in the form of cash. Constant-payout-ratio dividend policy is when a firm establishes a certain percentage of earnings that will be paid to owners each year. Through out the history Adamson has followed the practice of paying out approximately 60 percent of its earnings as cash dividend constantly each year. The dividend fluctuated with earnings from year to year. A major shortcoming of this policy is that if the firm’s earnings drop or are volatile in a given period, the dividends may be low or even non-existent.

According to Gitman, Juchau & Flanagan (2008) Regular dividend policy is based on the payment of a fixed-dollar dividend in each period. It provides investors with positive information indicating that the firm is doing well and it minimizes uncertainty. Usually firms using this policy will increase the regular dividend once a proven increase in earnings has occurred. Under this policy, dividend almost never decreases. One of the advantages of the regular dividend policy is that it results in a stable dividend stream over time, meeting the needs of shareholders who require resolution of uncertainty. Adamson Manufacturing Company’s majority shareholders are retired individuals, college endowment funds, income-oriented mutual funds and other investors who are seeking high return and over the past years the company’s dividend has been fluctuating with its earnings which does not gave a good impression about the company’s financial health. Such could

like to get a regular dividend each year so that they are confident enough to continue holding shares in the company. On the other hand, disadvantages of regular dividend policy are there may be times when the company will need to access capital from external source such as borrowing loan to pay dividend when the company is not generating enough earnings per share. Also, there may be times when the company will have excess cash on hand.

Low-regular-and-extra dividend policy can be established when the company is paying a low regular dividend, supplemented by an additional dividend called extra dividend. By adopting the low regular dividend, the company can give investors the stable income necessary to build confidence in the company, and the extra dividend permits them to share in earnings if the company experiences a cash surplus. When considering Adamson Manufacturing Company, Joel Norman and Allison Crane strongly suggested that the dividend payout ratio should be reduced from 60 percent, because they think high dividend payout is inappropriate for the company because of the capital limitation which recently forced the company to turn down some expansion opportunities that promised relatively high rate of return and they have also noted that several other directors who has large holdings in the company has been paying high tax rate of 40 percent of all dividends received to the government. The company should consider low-regular-and-extra-dividend policy, as it also addresses the issues of resolution of uncertainty and allows the company to distribute extra funds. However, under this policy there still may be some times when the firm will have to go to external equity market when it faces a great need for equity capital

because of many good projects. Also, if the company declares too many extras in a row, the investors may expect the extra dividend all the time.

Under Residual Dividend Policy dividend paid by a firm should be viewed as a residual that is the amount left over after all acceptable investment opportunities have been undertaken. The advantages of residual dividend policy are that lower cost sources of financing are used and funds are distributed to shareholders on which the company cannot earn a rate of return greater than weighed average cost of capital. However, the disadvantages of residual dividend policy can be the number of good capital projects will vary from year to year and because the profit will also vary from year to year, the dividend over time will be highly variable including no dividend in one year and high dividend in another year. The stream of dividend will spoil the reputation of Adamson Manufacturing Company of paying generous dividend over the past years and a lot of shareholders will be forced to sell their shares and reinvest in other company who will be offering high dividend payout ratio.

Gitman, Juchau & Flanagan (2008) states that clientele effects exists where the firm will attract shareholders whose preference with respect to the payment and stability of dividends correspond to the payment pattern and stability of firm itself. Shareholders who desire stable and predictable dividend as a source if income holds the shares of a firm that pay about the same dividend amount each period and shareholders who prefer to earn capital gain are more attracted to growing firms that reinvest a large portion of their earnings.

Question 2

Advantages and disadvantages of an announced dividend policy.

The main advantage of having an announced dividend policy is that it reduces investor's insecurity, and reductions in insecurity are generally associated with lower capital costs and higher stock prices, other things being equal. The disadvantage is that such a policy might decrease corporate flexibility. However, the announced policy would possibly include elements of flexibility. Therefore, it would be attractive for directors to announce their policies. The profits of a company can either be re-invested in the company or paid to its shareholders as a dividend. In New Zealand, the amount and frequency of dividends is decided by the board of directors. When a company announces the dividend policy even though it has made a loss during a year, it has to continue paying dividends from the retained earnings from previous years or to suspend the dividend. Where a company receives a non-recurring gain, e. g. from the sale of some assets, and has no plans to reinvest the earnings is often returned to shareholders in the form of a special dividend. This type of dividend is often better than usual and occurs outside of the normal dividend distribution schedule.

Question 3

Effect of payout policy on growth rate of earnings per share.

Sustainability growth rate is calculated by multiplying Plough-Back ratio by Return on Equity. Plough-Back ratio shows the proportion of earnings that is not paid out as dividend but retained in the company for future investment. Return on Equity is the amount of net income returned as a percentage of

shareholders equity. It measures a company's profitability by stating how much profit a company generates with the shareholders has invested. According to Tatum (2010), a sustainable growth rate is the amount of growth that a company can achieve and maintain on an ongoing basis without borrowing money. It is the highest growth rate the firm can maintain without increasing its financial leverage. Sustainable growth rate depends on plowback rate and return on equity, firm may grow rapidly in short term by depending on debt finance but these type of growth cannot be maintained without incurring excessive debt levels.

Question 4

Low payout ratios have high price/earnings ratio.

According to Ogilvie & Parkinson, (2006) the relationship between dividend payout policy and Price Earnings Ratio is that entity with high Price Earnings ratio ha a low dividend payout ratio. The data shown in Table 3 for selected Stock Market shows Companies with low dividend payout ratio has high average price-earnings ratio and vice versa. Gitman, Juchau and Flanagan, (2008) states that the firm's financial requirements are directly related to how much it experts to grow and what assets it will need to acquire. A growth firm is likely to depend on internal finance which is through retained earnings and is likely to pay out only a very small percentage of its earnings as dividend. Investors looking for capital growth may prefer lower payout ratio because capital growth is taxed at lower rate and a high growth firm generally pays low or zero dividend. Wikipedia (2010) states Price-Earnings ratio is a measure of price paid for share relative to the annual profit earned by the firm per share. Stocks with higher forecast earnings growth will

usually have higher Price-Earnings, and those expected to have lower earnings growth will in most cases have a lower Price-Earnings.

As per Table 3, Data General has zero dividend payout percentage with highest average Price-Earnings ratio of 22. Avon Products has highest dividend payout ratio of 57 and low average Price-Earnings Ratio of 13. Data General is a growth firms who is retaining all its earnings for future investments and the shareholders can benefit from capital gain.

Question 5

Reduction in the dividend payout rate would increase the price of stock versus such a reduction would drastically reduce the price of the stock.

Some investors prefer company to reinvest its earnings back into the business for future growth but many appreciate a generous cash dividend payment. Investors prefer dividends is because of the tax advantage they are getting. New Zealand has dividend imputation credit policy where the company pays tax on its profit and then distributes the dividend to the shareholders. The investors are given the tax credits (imputation) so that the dividend is not double taxed.

Dividend payout ratios provide important insight into a company’s dividend policy. Adamson Manufacturing Company is currently paying 60 percent of its profit and retaining 40 percent for future growth. There is an argument between Rose and Walker, that if the dividend payout ratio is decreased, the price of the stock will increase and if the dividend payout is decreased, the share price will also decreased. A high payout ratio like Adamson

manufacturing Company's, it suggests that the company might be paying out more than it can comfortably afford. It not only does leave a small percentage of profits to plough back into company, but also it leaves the company highly vulnerable to a decline in future dividend payments. Because the act of decreasing dividend is usually interpreted as a sign of weakness, when a dividend cut announcement is made it will trigger a decline in share price. Even if the company plans to keep the 60 percent dividend payout ratio, it will end up having increased debt ratio. The company debt ratio has increased from 16. 80% in 2001 to 60. 80% in 2009.

According to Wikipedia (2010), share price is strictly a result of supply and demand. If the demand exceeds supply then the share price increases. Conversely, if supply exceeds the demand then the share price decreases. The principle theory is that the price movement of the share indicates what investors feel a company is worth. Some investors might understand that it is for positive reason why the company is decreasing its dividend payout ratio, decreasing dividend payout ratio is generally positive sign, it shows that company is more able to cover its dividend payout with its earnings and reduces the borrowings. Thus, the debt ratio for the company would improve in future.

Question 6

Would a stock dividend or a stock split be if use in this situation?

According to Gitman, Juchau & Flanagan, (2008) share split is a method commonly used to lower the market price of a firm's shares by increasing the number of shares belonging to each shareholder. For example, in a 2 for

1 stock split, investor who owns 100 shares of stock valued at $100 per share before the stock split will own 200 shares valued at $50 per share after split. After share split the investor owns twice as many shares, with each share worth half as much as before the stock split. The main purpose of share split is to reduce the share price of a share in order to make the share more affordable to investors.

According to Mapsofworld (2008) stock dividend is the distribution of additional shares to the investors. The main purpose to offer stock dividend is to generate funds for the company. When company makes profit, a certain percentage of the profit is distributed to investors according to their amounts of shares in the company. These dividends are in form of additional shares known as stock dividend. There are several reasons why companies might choose to provide share dividend to its investors. The company may have some shortage of liquid cash, because of this the company might it difficult to provide cash dividend to its shareholders. It is also possible for the company to invest more money from earned profit to raise the production level.

The company should use stock dividend, the reason being the company has been paying out a constant cash dividend of 60 percent every year to its investors and has been loosing all the opportunity of expansions with relatively high rate of return and also, investors has been paying 40 percent of their dividend to government in the form of tax. Cash dividend is downfall for the company and as well the investors. Moreover, company’s current ratio has deteriorated from 505 in 2001 to only 1. 71in 2009 and debt ratio is increased from 16. 8% in 2001 to 60. 80% in 2009. These fluctuations in the

ratio shows that the company is loosing all its liquid cash in form of paying dividend and further, the company is borrowing money to maintain the 60 percent payout ratio. By adopting stock dividend the company can overcome the cash problem and also can keep investors happy by issuing high dividend payout in form of shares and not cash.

Question 7

Specific dividend policy should be recommended to the board of directors.

I would recommend Adamson Manufacturing Company to adopt low-regular-and-extra dividend policy. Dividend policies of companies around the world vary considerably. In New Zealand one of the major incentives for investing in the stock market is that New Zealand has no capital gain taxes. Therefore, investors should show a preference for companies that retain earnings rather than paying high percentage dividend. Companies with many growth opportunities tend to pay lower dividends, which is to be expected because the funds are required to finance growth and shareholders are willing to forgo current income of hope of greater future benefits. Because company’s goal is to maximize shareholders wealth the dividend policy is one that maximizes the value of firm. When a company pays out dividend, it decreases the amount of earnings that can be used to finance growth. As a result, companies pay little or no dividends because earnings are retained to reinvest in the company.

Adamson Manufacturing Company would in better position if adopting low-regular-and-extra-dividend policy. By establishing low-regular dividend that is paid each period, the firm gives investors the stable income necessary to

build confidence in the firm and extra dividend permits them to share in the earnings if the firm experiences an especially good period. Firms using this policy must raise the level of dividend once proven increase in earnings have been achieved. The extra dividend should not be regular event, otherwise it will become meaningless. Adamson Manufacturing Company should reduce dividend to around 10 percent to less than 30 percent to pay regularly depending on how much profit the management wants to retain for future growth. Paying regular dividends is often considered a sign of confidence in the company and retaining part of the profit can reward shareholders by adding more shares and wealth. Low dividend payout and retaining majority of it profit can help improve the company’s current ratio and debt ratio. Current ratio shows the company’s ability to pay short-term obligations. The higher the ratio, more capable the company is of paying its obligation. A ratio under 1, suggests that the company would be unable to pay off its obligation if they came due at that time. Adamson Manufacturing Company’s current ratio decreased drastically to 1. 71 mainly because the current asset decreased due to decline in cash by paying 60 percent of its retained earnings as cash dividend. Debt ratio compares the company’s total debt to its total assets which shows the amount of leverage being used by the company. If the ratio greater than 0. 5, most of the company’s assets are financed through debt. Adamson Manufacturing Company’s debt ratio increased significantly due to the company borrowing debt to finance cash dividend. Low-regular-and-extra-dividend policy will help the company to overcome its ratio problems and will company to hold its dividend payment consistency.