Optimum dividend policy

Finance

INTRODUCTION

It is becoming increasingly difficult to ignore the significance of dividend policy, considering the fact that payment of dividend reduces earnings available for investment and increase external financing for investment purpose. Most households, investors and pensioners rely heavily on the dividends from their investments to make ends meet. A lot of theories have emerged regarding the dividend decisions made by companies. While some are of the opinion that the choice of dividend is irrelevant to the value of shareholder wealth, provided all retained earnings are invested in projects that give a positive net present value, others held the view that the capital structure decision is relevant as the cost of loan capital is cheaper than that of equity and as such advocates external source of financing as oppose to the use of dividends. This report will therefore examine some of the theories on dividend policies using five year dividend policy of Tesco Plc and Apple Incorporation.

TESCO PLC

Tesco is a retail store whose head office is in United Kingdom. It has an unrivalled FTSE 100 record of increasing dividend for the 26th consecutive year. Its major shareholders as at July 2010 are Blackrock Inc which owns 5. 24%, Legal & general Investment Management Limited which owns 3. 71% of the issued share capital of the company, Berkshire Hathaway Inc, 3. 02% (Annual report, 2010, pp. 1-3 & 45). Tesco Plc final dividend payout extracted from the annual reports between 2006 to 2010 is:

APPLE INCORPORATION

Apple is an American multinational corporation incorporated in 1977 which manufactures computers, computer accessories and mobile phones. In 1980, the company went public, selling 4. 6 million shares at a price of $22 per share and closing at $29. (CNET news, 1997). The company does not pay dividends despite its continuous increase in shares arising from the success in new products lunch. Below gives an overview of Apple dividend history.

- Year 2009 20082007 2006 2005
- Dividends $0 $0$0 $0 $0
- Price $170. 31$110. 99 $198. 08 $84. 84 $0
- Estimated EPS (year) $5. 84, Estimated EPS (quarter) $1. 38 Estimated EPS Growth 18. 58%, Payout Ratio0. 00%.

DIVIDEND AND DIVIDEND POLICY

Dividend is a cash payment made to shareholders on a quarterly or twice in a year basis based on the amount of shares held and dependent upon the dividend policy adopted by the company. It is normally paid to every shareholder at the record date and can be either in cash or reinvested into the business to generate capital gains (Atrill and McLaney, 2008, pp. 138-139). They are paid out of profit after deducting interest and tax liabilities and the Company Act 1985 makes it mandatory for companies to pay dividend out of accumulated net realised profit, taking into consideration any accumulated loss according to Consultative Committee of Accountancy Bodies (Watson and Head, 2007, p. 84). Dividend can be also in the form of bonus shares whereby instead of shareholders receiving cash as dividend, they receive additional share known as script dividend (Atrill, 2009, p. 365).

Some companies likeGoogleand Apple have a zero-dividend stock while others like Tesco Inc pays dividend.

THEORIES OF DIVIDEND POLICY

There is increasing pressure for companies to cut dividend in order tofinanceprojects that gives a positive net present value using retained earnings which is a major source of finance for companies in the United Kingdom (Watson and Head, 2007, p. 285). Retained earnings are being used because there are no issue costs involve and are quick to raise (ACCA F9, 2010, p. 556). However, the decision of a company to use retained earnings to finance its investments will be dependent on the attitude of shareholders and capital market to a reduction in dividend, availability and cost of external sources of finance and amount of fund require relative to the available distributable profits (ACCA F9, 2010, p. 285).

The following are some of the dividend policy theories that will be discussed in this report.

DIVIDEND IRRELEVANCE THEORY

This theory was pioneered by Modigliani and Miller in 1961. It argued that in a perfect capital market where there is the absence of transaction costs, taxation and market imperfections, shareholders are concerned with increase in wealth and will be indifference to whether the increase is a result of capital gain or dividend (ACCA F9, 2010, p. 556). To an investor, whether a firm pays dividend or not should make no difference to the value of the firm and it does not counts whether it is paid out as dividend or reinvested to yield a capital gain as dividend policy does not have any effect on share

price (Chiang et al, 2006, pp. 64&13). This supports Human Resource Director of Aspire Plc of one dividend policy being as good as another as it has no effect on share price. Thus a company can choose to pay any amount of dividend and use retained earnings to finance projects that have positive net present value and maintain that shareholders who invest in a financial geared business will want a return that is the same with the return they will get from investing in a similar business that is ungeared and that returns the shareholders require from borrowing will remain unchanged with increase in levels of borrowing (Atrill, 2009, p. 344). Their argument is founded on the assumption that having a good security for the loans will prevent lenders from seeking additional returns. Modigliani and Miller fail to realised that human nature being naturally selfish and the businessenvironmentbeing chaotic, complex and unpredictable will make lenders seek higher returns so as to safe guard against such risk as global recession. Investors suffered dividend cuts with investments worth billions reduced to nothing in the wake of the financial crisis which were not matched by a reciprocal austerity on the part of investment bankers (Jones, 2011). Shareholders will require higher return due to the risk, inflation and interest. Moreover, their argument is founded on three assumptions of an ‘ ideal business world’ devoid of share issue costs, market imperfections, transaction costs and taxation whereas in reality, these exist. A perfect market assumption of market prices not being influenced by a single seller or buyer (Hussainey et al, 2011, p. 59) is unlikely to hold. The financial markets operate in a chaotic and unpredicted world and in reality, costs like agency, bankruptcy, and transaction costs are incurred when investors buy or sell their shares and tax will be charged as well as inflation (Abor and Bokpin, 2010, p. 180). Moreover, monopoly exists

where a single seller can influence price. The ongoing war in Libya for instance has led to a large increase in fuel price all around the world (Barbajosa, 2011). However, the third assumption of no taxation will hold to a great extent giving that the United Kingdom no taxation rule on capital gains below ? 9200 applies, whereas all dividends are tax charged (Atrill, 2009, p. 372). The tax position of an investor to a great extent will determine whether they prefer a capital gain to dividend and vice versa and shareholders will invest in companies whose dividend policies are in line with their investment needs

DIVIDEND RELEVANCE THEORY

This theory propounded by Lintner (1956) and Gordon (1959) is founded on the assumption that a shareholder will prefer to receive a dividend payment which is certain as oppose to investing the same amount in an investment whose value is not certain corroborating the point made by Aspire Plc Director of Operations that a known dividend now is preferred by shareholders to an uncertain capital gain in the future. This is similar to the bird in the hand dividend theory which says that a bird (dividend) in hand is worth more than two (capital gains) in the bush. Giving that future cash flows are uncertain, an investor will prefer dividends to retained earnings (Hussainey, 2011, p. 59). It therefore maintained that dividends are preferred to capital gains as a result of shareholders being risk averse. Some of their arguments is founded on the assumptions that dividends are a signal to shareholders and investors about the prospects of a company. This arises as a result of the asymmetry of information between shareholders and managers (Alnold, 2007, p. 429). Thus shareholders see dividend as a means

of passing across information to them as to the well being of their investments. A rise in dividend to the shareholder is a sign that the company has good prospects and share price tends to rise while a cut in dividend signals a poor performance (Tse, 2005, p. 14). Share prices thus go up when there is increase in dividend and go down when there is a cut in dividend and market makes use of announcement of changes in dividend payments in assessing the value of a security (Tse, 2005, p. 14 in Pettit (1972). A pitfall of this notion is that an increase in dividend may implies that the company is short of positive net present value projects to invest in or has weak investments opportunities and as a result dispense cash out as dividend to shareholders (Baker and Wurgler, 2004, p. 1128). Apple does not pay dividend partly because of a similar reason that dividend payments give a negative perception that the company has run out of investments opportunities and as such will not grow much more (Elmer-Dewitt, 2010). Alternatively, companies with zero dividend shares like Berkshire Hathaway face a dilemma as to how to convey information about current performance and future prospects of the company if dividends are a means of passing on such information to the shareholders. Although investors invest in companies for various reasons, while some rely on dividend as a source of regular income like the pensioner and institutional investors who rely on dividend payments to meet various obligations and needs to meet, others prefer capital gains. However, like the argument put forward by the Sales Director of Aspire Plc that dividend policy should be structured to suit the type of shareholders a company has and dividend paid according to their needs, company dividend policy should be drafted base on the company's clientele (shareholders) base and their needs or income requirements. Aspire Plc

shareholders are majorly individuals, pension funds and insurance companies having total shares holdings of 66. 7%, giving the obvious that the company's majority clientele base is mainly shareholders who have liabilities to meet and would therefore prefer that dividend be paid as against having them invested for capital gains which a unit and investment fund company will have a preference for. Regardless of the fact that shareholders want dividends paid to meet obligations and income needs, they are also interested in the growth of the company.

In dispensing cash as dividends to shareholders or reinvesting to yield a capital gain, a company should also consider shareholders tax preference. While some shareholders want dividends, they do not want the tax liability that comes with it. The United Kingdom tax law exempt capital gains below ? 9200 whereas dividends are taxable. As a result, shareholders will want to delay dividend being paid to them to take advantage of this exemption. Similarly, if there is share appreciation, the tax benefits of deferring capital gains into the future may outweigh the cost of paying a higher tax rate on a relatively small dividend (Whitworth and Zhang, 2010, p. 681). In an attempt to send a positive signal about future prospects of a company, company pays dividend despites its tax disadvantages. The cost of this signalling is that cash dividends are taxed higher than capital gains. While some investors would rather have capital gains to cut down on tax impact, others may prefer dividends because they prefer immediate cash in hand (Hussainey, 2011, p. 60).

RESIDUAL THEORY

The theory which share a similar view with Modigliani and Miller's except that it recognises issue costs but there is no taxation and market imperfections and argued that though dividend are important, the pattern is not. It further reiterates that a firm should pay dividend from cash remaining after investing in net positive value projects. The problem is how an investor knows that a company is investing in projects that will enhance the value of a company due to the asymmetry of information between management and investors or shareholders?. Payments of dividend is a means by which managers signal the true value of the firm and communicate insider information about the company to the shareholders (Tse, 2005, p. 13). It brings about the issue of agency as an investor cannot tell that his or her dividend accrued to him or her has been reinvested in positive or negative net present value projects or used by the directors to pursue their own interest of empire building to the detriment of investors. A typical example is Enron Corporation that has its managers claimed to have been reinvesting shareholdersmoneyand creating value through acquisition of over forty one companies, investments worth billions of dollars and increase in share price from $57. 10 to $90. 56 within 1998 by cooking fraudulent accounting information which the shareholders relied on. Its pre-initial public offering shares went from $10 million to $372 million within a day. It was soon discovered that the managers indulged in creative accounting to hide losses worth about $35 billion and had overstated income by $586 million. The share price went from $90. 56 to $8. 40 and subsequently to 61 cents (Gini et al, 2009, pp. 110-114). Shareholders of firms can thus avoid incurring agency costs by reducing the cash available to the shareholders through the

demand for dividend to reduce excess free cash flow. (ACCA F9, 2010, pp. 375-376) and (Hussainey, 2011, p. 60).

ZERO DIVIDEND POLICY

Some companies adopted a zero dividend policy whereby they do not pay dividends to their shareholders rather plough the cash back into the business to generate future capital gains. Companies such as Berkshire Hathaway, Google, Apple, and Microsoft until recently do not pay dividends. Apple do not pay dividend despite its holdings in cash and marketable securities which have grown from $24. 5 billion to $46 billion. Its Chief executive Officer had said that the company has no plans of paying dividend in the near future. The company believes that cash hoard is a fast and easy means of financing investments projects such as acquisition, Research and Development in new products and put the company in less fewer risks by using retained earnings as opposed to external sources of finance to avoid exposing the entire company to risk (Ghosh, 2011). This may be due to the fact that the company's major shareholders are co-founder Steve Jobs, who owns more than 5. 5 million shares, Apple engineer and vice president Sina Tamaddon with 290, 000 shares, and retail chief Ron Johnson with 232, 000 shares. Other shareholders are institutional and Mutual Fund Holders. However, as of April 2009, more than 71 percent of Apple's stock was owned by institutions and mutual funds with the largest institutional stock holder being FMR LLC, with 39. 2 million shares, followed by Barclays Global Investors with 37 million. The top mutual fund holder is The Growth Fund of America with 24. 1 million shares. In July 2009, the company's stock was trading at $142. 40 per share (Desjardins, 2011). This goes to show that 71% of its shareholders are

mutual fund trusts who do not have immediate pressing needs to meet and would therefore prefer a capital gain to dividend, hence the use of retained earnings by Apple to finance its business. Also, giving the nature of Apple's business, the company needs to invest in research and development which most times takes years for a breakthrough to manifest.

Apple would have also chosen not to pay dividend due tofailureof who had almost $60-billion of cash on the balance sheet, from which they used about $32-billion to make a special one-time dividend in 2004. Microsoft's share chart showns that its share price has gone nowhere in ten years. Not even a number of stock buybacks have helped push up the stock price. Also, Cisco Systems announcement to start paying a dividend had its shares plunged from almost $70 in 2000 to just above $20 no, while Apple shares have skyrocketed from $7 per share in 2003 to more than $333 currently (Ghosh, 2011).

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