INVESTMENT, FINANCING AND DIVIDEND **DECISIONS**

Financial management is essentially about managing the finances of an organization engaged in business. As outlined in the introduction the three key decisions that a finance manager needs to make are decisions about investments, decisions about financing and decisions about dividends. The three decisions are interrelated.

A SMALL SENARIO

Let’s consider how these three decisions work. Assume you are the finance director at one of world’s major oil production companies. The key types of decisions that you would be involved in making would typically be:

Investment Decisions

Should the company invest in the exploration and development of potential new oil fields, perhaps in deep water or sensitive environmental areas? Should the company invest significantly more in health and safety – perhaps appropriate for some oil companies you might think!

Making these decisions is, of course, a complex and in many ways a very subjective process involving consideration of strategic, economic, political, environmental, social and financial factors.

The **Investment Appraisal** topic is devoted to considering the evaluation of **investment decision.** There are techniques that can be used to help a finance director whether an investment is financially viable, that is, whether investment meet the financers required return. Of course, even if an investment is financially viable, the board of a company may still decide that the company will not proceed with the investment, perhaps because politically or environmentally it is too difficult to proceed, or perhaps because there are other investment opportunities that are better from a financial point of view.

Financing Decisions

Any decision about a significant new investment cannot be considered without also considering **how that investment will be financed.** Suppose the oil production company has estimated that an investment in developing a potential new oil field will cost $300 million over the next five years, and will not generate any sales revenue until the development is complete? The next question to be asked therefore is how will that investment be financed?

The company could, perhaps, raise the finance from ordinary shareholders through issuing new shares. Alternatively the company could raise the finance through issuing debt capital, perhaps through borrowing from a number of different banks or through selling books of debt capital on a stock market. Different ways of financing new investments have different implications for a business.

The **Business Finance** topic considers how a business raises long time finance and the implications for a company and its investors of raising finance in different ways.

Dividend Decisions

When a company generates profit, provided that the profit also results in cash being generated (and the accounts amongst you will know that the two are not the same!!) an important decisions to make is how much of the profit should be distributed to shareholders as a dividend payment, and how much should be retained and reinvested within the company.

The decision is really a special kind of financing decision. If profits (and cash) are retained within the business then this can be used to finance (at least in part) new investments that a company undertakes. If, however, profits are not distributed to shareholders as a dividend, shareholders may not be happy with the decisions and the company's share price may fall. A balance therefore needs to be found between paying cash dividends to shareholders and retaining profits, and cash, to reinvest.

DIVIDEND POLICY AND SHAREHOLDER WEALTH

How does dividend policy influence shareholder wealth?

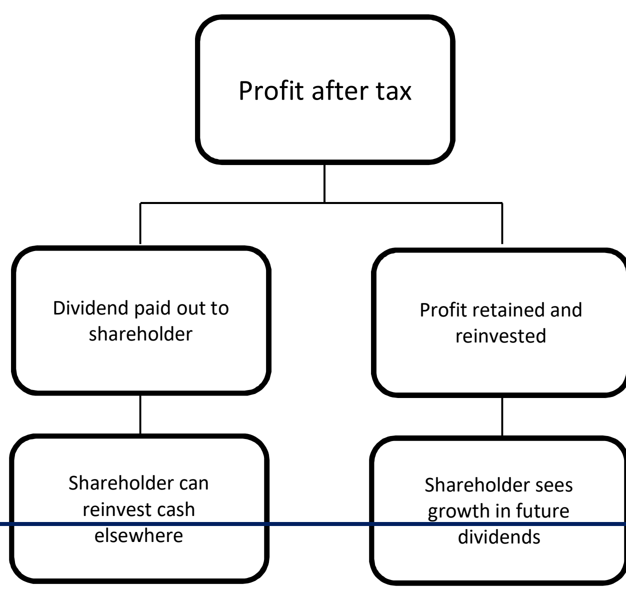
Shareholder wealth – we have already seen above how important it is to consider shareholder wealth when making finance decisions. Dividend policy is no exception. The key question to ask when assessing dividend policy is therefore – how does dividend policy influence shareholder wealth?

Shareholders should, at least in theory, benefit to some extent whatever decision is made. If dividends are paid out to shareholders they could reinvest those dividends elsewhere, if dividends are not paid out, but instead earnings are retained and reinvested (wisely) this should lead to growth in future earnings, and therefore dividends.

Exam tip – Dividend policy and shareholder wealth

A common error made by students, when discussing dividend policy is to state that shareholders will not benefit unless the profits are distributed as a dividend.

Always make the point that shareholders should benefit whether profits are paid out as a dividend, or retained and reinvested. The key question is which policy will benefit the shareholders the most?



If shareholders benefit either way can we draw any conclusions about which has the greater effect on shareholder wealth – paying profits for earnings) out as a dividend or retaining and reinvesting those profits?

Irrelevancy Theory: Modigliani and Miller's hypothesis (or theory)

Modigliani and Miller (M&M) suggested that, in a perfect capital market, dividend policy becomes irrelevant.

***Perfect capital market** is a capital market in which there are never any arbitrage opportunities.*

Need to know!

According to Modigliani and Miller – in a perfect capital market shareholder wealth is unaffected by the dividend decision i.e. shareholder wealth is the same whether earnings are paid out as dividends, or alternative, earnings are retained and reinvested with the company.

How does this theory work?

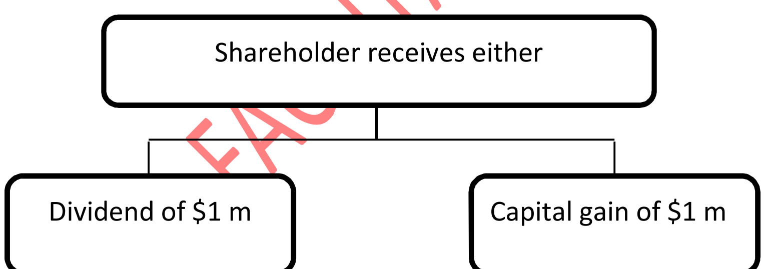
1. Suppose a company is all equity financed and the shareholders required rate of return (or cost of equity) is 15%. If positive NPV projects are available at a 15% discount rate then the company should retain and reinvest earnings in these projects. The return from reinvesting earnings will be greater than the return that shareholders could get elsewhere for the same level of risk.

2. In a perfect capital market, because of arbitrage, other companies would be attracted to set up similar projects to those that have a positive NPV. This would reduce the value of those projects and, eventually, only nil NPV projects at best would be available.

3. At this point dividend policy becomes irrelevant to shareholder wealth.

- Suppose a company generates profits after tax of say \$1 m in an accounting period. This could be paid out to shareholders as a dividend or, alternatively, the company could retain and reinvest \$1 m in nil NPV project.

- If the project has a nil NPV the present value of the future cash inflows must be equal to the amount retained and reinvested in the project i.e. \$1m. In theory the company's value should equal the present value of its future cashflows (we will see this in more detail in a later chapter), and therefore the company's value should rise by \$1 m – exactly the same amount as the dividend foregone.



4. The shareholder could therefore either receive a dividend of \$1m or make capital gain of exactly the same amount. If earnings are retained and reinvested rather paid out as a dividend, and an investor wants cash, the investor could sell some of the higher value share to 'simulate' a dividend.

5. Of course, this doesn't happen in the real world because M&M's assumptions about a perfect capital market do not hold true.

What assumptions underlie M&M's dividend theory?

A perfect capital market, which underlies M&M's theory, is based on the following assumptions.

Assumptions	**Meaning & significance**
All investors have equal access to the same information	One investor would not be able to obtain 'better' information than another investor and therefore benefit at the expense of other investors.
All investors act rationally	If an investor could make a gain without any risk by doing something then we can assume that the investor would always do this.
Taxation is ignored	If there are different tax implications for dividends and capital gains this will affect the investors 'indifference' between receiving a dividend and a capital gain.
No transaction costs or stockholders fees.	Any fees charged for buying and selling shares should mean that an investor selling shares to obtain cash would not get quite as much as the dividend foregone.
Dividend decisions are not used to convey information	Shareholders will not 'read' into the dividend anything 'wider' about the company's future prospects.

DIVIDEND POLICY IN PRACTICE

Dividend is Relevant: Why does dividend policy influence shareholder wealth in the real world?

Research suggests that in the real world dividend policy can and does have a significant impact on shareholder wealth. Therefore are a number of reasons for this, some of which are based on areas where Modigliani and Miller's assumptions do not hold true. The main reasons are:

1. Dividend signaling

Shareholders tend to see the dividend by a company as a 'signal' or indication of how well a company is doing and of how much confidence the managers in the company have about its future prospects. If a dividend is cut, shareholders tend to see this as an indication of problems e.g. back of cashflow. As a result a cut in a dividend, for whatever reason, often leads to a drop in the share price of a company.

2. Clientele 'effect'

Shareholders may well have invested in the company in the past partly because of the dividend policy that the company had adopted.

A company, for example, that has consistently retained a high proportion of its earnings is likely to have shareholders who were seeking high share price growth rather than significant cash dividends, if the company suddenly changed its dividend policy, the current shareholders may decide to sell share and the share price may fall.

The current shareholders are the 'clientele' of the company. They are likely, therefore, to be unhappy with any deviation away from the current dividend policy.

3. Taxation

Modigliani and Miller ignored taxation. In reality tax implications of dividends and capital gains for both individual investors and institution, like pensions funds, will have a significant impact on their preference for a dividend or a capital gain.

4. Agency theory

The board of directors will make the dividend decision. This decision should be based on the directors' perception of what is best for the shareholders of the company (agency theory). In reality, the decision may be based on their own personal interests.

Managers in a manufacturing business may, for example, feel that the best policy for long term shareholder wealth might be to return earnings and use the funds to finance major new investment in research and development needed for long term growth. They may, however, decide to increase the dividend instead, despite the long term consequences, because of a fear that shareholders will remove the board if dividends are not increased.

5. Cash and profit

Modigliani and Miller's theory assume that all of the profit could be distributed as a dividend, or alternatively retained and reinvested within the company.

In practice there may be very significant differences between the levels of product and the amount of cash that is generated. A company may, therefore, face significant liquidity problems if it seeks to pay out more than a certain proportion of its profits as a dividend.

Common dividend policies

Ok – if we now accept that, in the real world, dividend policy does have an influence on shareholder wealth then what are the more common dividend policies pursued by companies in the real world?

1. Constant dividend or constant growth in dividends

The most common dividend policy is to increase the dividend by a predictable amount each year e.g. 5%. Ideally this increase will be above the rate of inflation so that shareholders see a real increase in the dividends that they receive from year to year.

Real life illustration – Tesco

Over a 10 year period, between 2000 and 2010. Tesco increased its dividend by an average of 11.32% a year – an impressive performance!

What is also notable about Tesco's dividend history is how consistent the growth rate has been from year to year. To lowest rate of growth was 9.1% (in 2010) whilst the highest was 14.5% (in 2006).

This type of policy leads to share price stability as investors can predict future dividend income more accurately, and with more certainty i.e. there is less risk to shareholders.

The initial dividend paid should be set well below the earnings level to allow dividends to grow significant whilst at the same time ensuring that there is significant retention and reinvestment of earnings.

A major difficulty with this type of policy is that companies may struggle to maintain growth in dividend when earnings are flat, or are falling, and may be forced into change of policy if they do seek to maintain the dividend growth rate when earnings are flat, this could create significant liquidity problems and may also result in a significant reduction in long term investment which would impact on future growth rates.

2. Constant payment ratio

An alternative to constant dividends or constant growth in dividends would be for companies to pay a constant percentage of earnings out as a dividend, for example, approximately 40% of earnings are paid out as a dividend each year.

This policy has the advantage of ensuring that the company continues to retain earnings, and hence reinvest in the business, even if earnings fall. It overcomes the difficulties created when companies seek to pay an unrealistically high dividend in order to maintain a growth trend in dividends

A major problem with this type of policy is that as earnings can be quite volatile, dividends may also be quite volatile, and difficult to predict, which may have an adverse effect on the share price.

3. Residual dividend

In this case a company pays a dividend to shareholders only if the earnings cannot be reinvested in positive NPV projects within the company.

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The major benefit of this type of policy is that the company is able to take advantage of good investment opportunities, and finance these in the simplest way possible (retained earnings. The company is in theory acting in the best interests of their shareholders by doing this i.e providing them with a return which is greater than the return that they could get elsewhere themselves.

The type of policy could only work in the real world if the shareholders (clientele) are looking for high share price growth rather than dividend income.

Conclusively the dividend policy of the company will depend on a number of factors:

1. Profits and retained earnings
2. Law
3. Liquidity
4. Gearing
5. The signalling effect
6. The need for finance
7. Inflation
8. Other restrictions – covenants

DVIDEND ANALYSIS WITH RELEVANT RATYIOS:

1. Dividend Growth
2. Dividend Payout
3. Dividend Cover
4. Dividend Per Share
5. Dividend yield

SCRIP DIVIDEND AND SHARE BUY-BACK

Scrip or bonus dividend

This is an alternative to a cash dividend. In this case a dividend is 'declared' by the company but instead of being paid out to shareholders as cash the dividend is 'converted' into share capital and share premium. This is an essence exactly the same as a dividend paid followed immediately afterwards by a rights issue.

The double entry (so that accountants feel at home) would be

Dr. Dividend

Cr. Share capital / share premium

Share buy – back

A shares buy-back is an alternative way of returning cash to shareholders to paying a cash dividend. If a company has built up significant earnings and cash that it does not wish to invest in projects if could return this cash to shareholders by declaring and paying a very significant one-off dividend. This would, however disturb the normal pattern of dividends.

A more sensible way of returning the cash to shareholders would be to 'buy back' some of the share capital

The double entry for this would be:

Dr. Share capital / reserves	X
Cr. Cash	X

An individual shareholder would own the same proportion of the company before and after they buy back the shares would be bought back in proportion to the original shareholding). The effect on the investors' wealth is therefore exactly the same as if a dividend had been paid.

Students often confuse a scrip dividend with a share buy-back. They are very different.