
UNIT 15: DIVIDEND POLICY DECISIONS

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The course on corporate finance revolves around three decisions namely investment decision, financing decision and dividend decisions. As wages are reward to labour, dividend is return to shareholders of the company.

The ONGC Limited has paid a dividend of 25%, 35%, 45%, 55%, 65% and 130% in the immediate preceding six years. The 130% dividends means 130% of the par value of the ONGC share. It amounts to Rs. 13 per share as dividends.

The other measure of dividend paid is dividends yield. The dividend yield is the ratio of annual dividends per share to market price per share. The dividend yield is important component of total return on scrip. The other component of return on scrip is the share price appreciation.

The dividend decision of firm pertains to:

- Deciding how much of profits are to be retained with the firm for future growth needs and how much of the profits are to be distributed as dividends amongst the shareholders.
- Should the level of dividends be maintained and funds be raised afresh to finance the profitable growth opportunity?
- Should the dividends be paid in the form of cash or management should go in for share buyback?
- Does dividend decision create firm value?

15.0.1 **Why firms pay dividends?**

The dividend payments involve taxes. First, the profits of the company are subjected to income tax and then distribution of such profits amongst the shareholders is put to income tax. Earlier dividends were taxed in the hands of shareholders. Now, companies are required to pay dividend distribution tax, before payment of dividends. Thus, dividend payments involve value transfer in the form of dividend taxed from shareholders to government. Still firms pay dividends.

- What are the management motivations for payment of dividends?

The possible explanations could be as under:

15.0.1.1 Investors like dividends

The substantial number of investors in India prefers dividends for behavioral reasons. The payment of dividends resolves uncertainty about the firm performance in the minds of the investors. If the firm is continuously paying growing dividend per share, it builds confidence amongst the investors.

The investors can resort to homemade dividends by selling part of their shareholding in the firm. However, they may be reluctant to do so, because they may regret their decision in the event of share price rise subsequently.

The clientele effect has also to be considered while deciding the firm's dividend policy. If most of the investors are old people, and are looking at firm's scrip as dividend scrip, the firm has to pay substantial dividends to keep this segment of investors happy.

15.0.1.2 Dividends as Information Signal

The management of the firm has access to more information about the firm's present and future performance than the shareholders. It is termed as information asymmetry. The dividend decision of the management conveys information to the market as to how the company is likely to perform in the future competitive environment.

A continuously growing dividend payment policy sends positive signals to the market and facilitates the market to price the share of the firm correctly. If management decides to reduce dividends per share, it send negative signal about the firm's future performance resulting in to fall in market price of the share.

Very few firms reduce dividends per share; they do so when they are in financial distress.

15.0.1.3 Dividends as a tool for changing firm's financing mix

The firms use dividend policy to change its debt to total capital employed ratio. If the firm increase dividend payments, it will result in increase in debt ratio and increased use of financial leverage and vice-a-versa.

The management can use dividends as a vehicle to shift value to shareholders from lenders, when they foresee that firm is going to be in a financial distress, The lenders generally put a condition at the time of grant

of loan that dividend payments cannot exceed a particular level. If management wants to pay more dividends, it has to first retire the debt, and then it can pay more dividends. By putting this covenant in the loan agreement, the lenders want to avoid value migration from lenders to the shareholders by the action of the management in the form of increased dividends.

15.0.1.4 Dividends reduce management discretion

The management of firm may pursue a goal of maximizing sales and assets, but this growth may not be profitable to the shareholders. This growth may have a required rate of return greater than the rate of return it generates. For example, the growth opportunity may be generating a return of 18% but the required rate of return commensurate to the risk assumed may be 24%. It is termed as maximizing corporate wealth but to the disadvantage of the shareholders.

Management wants assured jobs and perquisites; hence, certain decisions of the management may not be in the interest of the shareholders. If the firm increases debt ratio through increased dividend payments, it will discipline the management not to diversify into unrelated areas and not to pursue unprofitable growth.

The shareholders also want the management to return the excess cash in the form of dividends, if the firm does not have profitable growth opportunity, where the IRR is greater than the cost of capital.

15.1 DETERMINANTS OF DIVIDEND PAYOUT RATIO

The dividend payout ratio is the ratio of dividend per share to earnings per share. The earnings per share is computed by dividing profits after tax by number of equity shares outstanding. The dividend payout ratio indicates the extent to which the earnings of the firm after tax have been distributed amongst shareholders as dividends.

The determinants of dividend payout ratio are:

15.1.1. Availability of growth opportunity

Generally, mature firms pay most of their earnings as dividends. The dividend payout ratio of growth firm is low, because the firm has opportunities available where internal rate of return is more than the required rate of return.

The example of Hindalco Industries limited substantiates that growth firms employ retained earnings to finance the growth.

Hindalco Industries Limited

Year	EPS (Rs)	DPS (Rs)
1992-93	27.69	4.00
1993-94	36.41	4.50
1994-95	60.81	5.50
1995-96	80.79	6.00
1996-97	52.50	4.50
1997-98	66.64	5.25
1998-99	76.11	6.50
1999-2000	82.33	8.00
2000-2001	91.06	12.00
2001-2002	92.12	13.50

15.1.2 Liquidity position of the firm

The payment of dividends involve cash outflow. Hence, the liquidity position of the firm has an impact on the firm's dividend policy. The firm may be profitable, but may not have adequate cash available to pay dividends, hence may have low dividend payout ratio. This is true in case of highly profitable but rapidly growing firms.

15.1.3 Debt Market conditions

If the debt market is flushed with the funds and firm has financial flexibility, the firm may like to distribute its earnings as dividends and raise resources in the debt market to finance the growth opportunity. On the other hand, if the firm has not so good credit rating or exhausted its debt capacity, it will be compelled to use internally generated funds for growth and will have low dividend payout ratio.

15.1.4 Control considerations

If a firm pays dividends, and raises fresh equity to finance the growth opportunity, it incurs transaction cost and results in dilution of control. The dilution of control means the management's controlling stake is reduced by fresh equity and firm becomes vulnerable to takeover.

For example, there are 100 equity shares outstanding and management owns 25 equity shares. The firm issues 25 fresh equity shares to finance the growth opportunity, as the profits have been used to pay dividends. The total number of outstanding shares after fresh equity issue is 125 and management stake has been reduced from 25% to 20%.

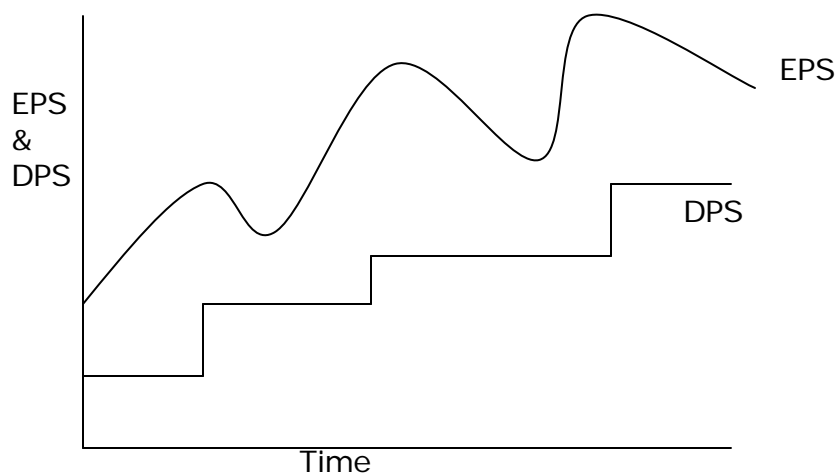
The dilution of control could be avoided in case of a right issue. The financing of growth through internally generated funds, by restricting dividends does not result into dilution of management control.

15.2 STABLE DIVIDEND POLICY

If we look at dividend policy behaviour of the Corporate India during the last decade, very interesting and simultaneously revealing too facts emerge. First, dividends per share tend to follow earning per share i.e. increase in earnings is followed by increase in dividends. Secondly, the Corporate India is reluctant to increase dividends per share, if that increase has to be reversed in the future. It is called, as dividends are “sticky”. Third, the dividend policy of the firm varies over the life cycle of the firm.

John Lintner conducted a survey in the mid-1950s with corporate managers to study the corporate behaviour on dividend policy. His findings were published in the American Economic Review journal in May 1956. The findings were:

- Firms do have long-term dividend payout ratio. The growth companies have low payout and mature companies with stable earnings per share tend to have dividend payout ratio.
- The CFOs are concerned with the change in dividend per share rather than absolute amount of dividend per share
- The change in dividends per share tends to follow long run, sustainable earnings. The managers tend to follow a stable but growing dividend per share policy. Hence, they apply adjustment factor to dividend payout ratio



- The CFO are not willing to increase dividend per share, if that change has to be reversed in the near future.

15.2.1 Dividend follows earnings

If we look at correlation between the dividend per share (DPS) and earnings per share (EPS) of Corporate India over a period, one may find a very high degree of correlation between the two. It is because dividends are paid out of earnings. To substantiate the point, we may look at DPS and EPS data of L&T Limited for the last 10 years.

L&T Limited is conglomerate having construction division, E&C projects division, Heavy Engineering division, Cement division, Electrical & Electronics segment, and Glass Bottles division.

L&T Limited		
Year	EPS (Rs)	DPS (Rs)
1992-93	6.10	3.50
1993-94	9.25	4.00
1994-95	12.72	5.00
1995-96	16.88	6.00
1996-97	16.55	6.00
1997-98	21.39#	6.50
1998-99	18.94#	6.50
1999-2000	13.74#	6.50
2001-2002	12.67	6.50
2001-2002	13.95	7.00

Includes extra-ordinary items of income.

Fama and Babiak (1968) confirmed the findings of Lintner (1956) that dividend changes tend to follow earnings change by identifying the lag between earnings and dividends by regressing change in dividends against change in earnings in the current period and prior periods.

15.2.2 Dividends follow a smoother path than earnings

Firms generally change dividends, when such a change follows a shift in the long-term sustainable earnings. From the L&T example, it is evidently clear that during the years 1997-98 to 1998-99, the earnings per share has grown very high due to extra-ordinary incomes, but L&T maintained its dividend per share at Rs. 6.50.

The dividends are not as volatile as the firm's earnings are. Managers tend to smoothen the change in dividends per share.

15.2.3 Dividends follow life cycle of the firm

The dividend policy and financing choice of a firm tend to follow the life cycle stage where it is in. There are five stages in the growth life cycle: start up, rapid expansion, high growth, mature growth and decline stage.

The firms generally do not have a capacity in terms of liquidity and profitability position to pay dividends during the start up and rapid expansion stage. During the high growth stage, it cannot pay dividends due to tight liquidity position and internal financing is low relative to funding needs.

The firm's capacity to pay dividends increases at mature growth stage and is very high at decline stage. The reason since firm's external funding needs are low and growth opportunities are very few. Thus firm has huge funds to pay dividends.

15.3 DIVIDEND DECISION & VALUE OF THE FIRM

Does dividend decision create firm value? Does dividend decision changes the market price of the share of the firm?

Some financial economists believe that what a firm pays in dividends is irrelevant and the shareholders of the firm are indifferent between the dividend policies of the firm. Brealey & Myers term them as "Middle-of-the-road" party.

The other school of thought is that dividends create a tax disadvantage and shareholders who receive dividends are taxed more heavily on dividend income than on share price appreciation. Thus, dividend decision reduces firm value. Brealey & Myers views them as radical group.

The third set of financial economists believes that dividend decision does create firm value. Brealey & Myers term them as conservative group or the "Rightists"

15.3.1 The Dividend Irrelevance School

The dividend irrelevance arguments have roots in the work of Modigliani & Miller (1961). The arguments is that firms that pay more dividends offer less share price appreciation but must provide same total return to the shareholders, given their risk profile and free cash flows from their investment decisions. Thus, in a world of no taxes, or if dividends and capital gains are taxed at the same rate, the shareholders of the firm will be indifferent between receiving their returns as dividends or as capital gains.

The assumptions of dividend irrelevance model are:

- There are no transaction costs if shareholders make home dividends by partly selling their shareholding in the firm.

- Firms that pay more dividends do not incur any floatation costs for raising fresh equity to invest in the growth opportunities.
- The firm's investment decisions are independent of the firm's dividend decisions. The firm's operating cash flows are independent of firm's dividend decision.
- The managers of the firms that pay low dividends use free cash flows in the positive NPV projects only.

Under the above set of assumptions, the dividend policy is irrelevant both for the firm and the shareholders. Hence, the change in dividends per share does not affect the share price of the firm.

15.3.2 Dividends are Good School

The Traditional view on the subject is that market places a premium on those firms that pay huge dividends vis-à-vis those firms that prefer to retain earnings.

Graham and Dodd (1951) in their book titled Security Analysis: Principles & Techniques on page 432 have observed as under:

"The considered and continuous verdict of the stock market is overwhelmingly in favour of liberal dividends as against niggardly ones. The common stock investor must take this judgment into account in valuation of stock for purchase. It is now becoming standard practice to evaluate common stock by applying one multiplier to that portion of earnings paid out in dividends and a much smaller multiplier to the undistributed balance."

The arguments in the favour of dividend policy are:

- **The Bird-in-the-hand fallacy.** The dividends are certain, whereas capital gains are uncertain. The risk-averse investors will prefer dividends to capital gains. It is fallacy because the choice is not between certain dividends today and uncertain capital gains tomorrow. The choice is between dividends today and almost equivalent amount in share price appreciation today.
- **Temporary excess free cash flows.** It is in the interest of the shareholders that management should return excess cash in the form of dividends today and prefer to raise fresh equity on a future date, when growth opportunity comes.
- **Clientele effect.** Some of the investors who have viewed firm scrip as dividend paying scrip, place value on growing dividends.

The **Gordon share valuation formula** also takes in to account dividend per share. The Gordon's formula is as under:

$$P_0 = \text{EPS}_1 * (1 - b) / (k - br)$$

Where

P_0	=	Equity share price per share today
EPS_1	=	Earnings per share in respect of period 1
$(1-b)$	=	The proportion of earnings firm pays as dividends
b	=	The retention of profits ratio
k	=	Required rate of return to the shareholders
r	=	The IRR on the firm's investment projects

One can make out from the above formula that if firm has growth opportunities available, where IRR is greater than the cost of capital, the market price per share increases, as dividend payout reduces and vice-a-versa. Thus, dividend policy affects the value of the firm.

James Walter has also developed a share valuation formula, which supports the argument that dividend policy affects the firm value.

$$P_0 = \frac{\text{DPS} + (\text{EPS} - \text{DPS}) * r/k}{k}$$

Where

P_0	=	Price per equity share today
DPS	=	Dividends per share
EPS	=	Earnings per share
r	=	IRR on firm's growth opportunities
k	=	cost of capital

The James Walter share valuation formula has two components. First, present value of infinite stream of dividends and second, present value of growth opportunities funded through internally generated funds.

The implications of the James Walter share valuation formula are the same as that of Gordon share valuation formula. The firm's equity share price will rise in a situation where IRR of firm's growth opportunities is greater than its cost of capital and firm reduces its dividend payout ratio.

15.3.3 The Radical position on dividend policy

The argument of radical group on dividend policy is that dividend payments create tax disadvantage as dividends are taxed at higher rate in the hands of the shareholders vis-à-vis capital gains. Thus, dividend payments reduce the return to the shareholders after incorporating personal income taxes. The dividend payment action of the firm thus will reduce its share price vis-à-vis a firm that does not pay dividends.

Brealey & Myers in their book titled Principles of Corporate Finance (seventh edition) illustrate the position of the Radical group with the help of an illustration. Suppose the share of Firm A and Firm B are in the same industry and risk class. The investors expect the Firm A share price to be worth Rs 225 per share next year. The Firm B share price is expected to be Rs. 205 as it is planning to pay a dividend of Rs. 20 per share.

	Firm A (No dividends)	Firm B (high dividends)
Next year share price	Rs.225	Rs 205
Dividends per share	Rs 0	Rs 20
Total pretax payoffs	Rs. 225	Rs 225
Today's share price	Rs 200	Rs 195.56
Capital gains	Rs 25	Rs. 9.44
Before-tax rate of return	=Rs 25/ Rs 200 = 12.5%	= Rs 29.44 / 195.56 = 15.05%
Tax on dividends at 40%	Rs 0	0.40XRs 20= Rs 8.00
Tax on capital gains at 20%	0.20XRs. 25 = Rs 5	0.20XRs 9.44 = Rs. 1.89
Total after tax returns (dividends plus capital gains minus personal income taxes)	(0 + Rs 25 –Rs 5) = Rs 20	(Rs.20 + Rs 9.44) – (Rs. 8 + Rs 1.89) = Rs. 19.55
After-tax rate of return	=Rs 20/Rs 200 = 10%	Rs. 19.55 /Rs 195.50= 10%

The share of Firm B offering a higher pre-tax rate of return vis-à-vis Firm A, yet is selling at a price less than that of Firm A. The answer is apparent. Both the scrip are offering same after-tax rate of return of 10%. The difference in the share price of Firm A and Firm B is equal to the present value of incremental taxes the investors face, if they buy scrip of Firm B.

15.4 LEGAL ASPECTS OF DIVIDENDS

15.4.1 Section 205 of the Companies Act, 1956

Section 205 of the Companies Act, 1956 stipulates that company can pay dividends out of profits only that too after providing for depreciation and for reserves not exceeding 10%. For this purpose, the profits may pertain to current year or undistributed profits of previous years or both. In public interest, the company may pay dividends out of profits before providing for depreciation with special permission from the Central Government of India.

If Company has incurred any losses during the previous years, then it must first set off these losses against the current year profits before declaring any dividends.

15.4.2 The Companies (Transfer to Reserve) Rules, 1975

The company can declare dividends after making provision for general reserves in accordance with the provisions of Section 205 (2A) of the Companies Act and the rules laid down in the Companies (Transfer to Reserve) Rules, 1975. The transfers to reserve requirements are as under:

Proposed dividend range	Transfer to general reserves
10% to 12.5% of the paid up capital	2.5% of current profits
> 12.5% to 15% of the paid up capital	5% of the current profits
> 15% to 20% of the paid up capital	7.5% of the current profits
> 20% of the paid up capital	10% of the current profits

15.4.3 The Companies (Declaration of Dividends out of Reserves) Rules, 1975

The Companies (declaration of Dividends out of Reserves) Rules, 1975 comes into operation in a situation, when the company has either inadequate profits or no profits in the current year and plans to declare dividends out of accumulated free reserves. The conditions laid down under these rules are as under:

Condition I	Rate of dividend that can be declared	Average of last five years declared dividend rate or 10% of paid up capital, whichever is lower
Condition II	Charge to free reserves of previous years for payment of dividend in the current year	Maximum 10% of the paid up share capital and free reserves, but first the current period losses, if any to be set off from this charge
Condition III	Residual reserves	Not to fall below 15% of the paid up share capital

Let us take an example to illustrate the above conditions. ABC Limited has paid up share capital of Rs. 100 crores and accumulated free reserves of Rs 20 crores as on April 01, 2002. During the past five years the company has paid 12.5% of its paid capital as dividends.

During the year 2002-2003, the company has made no profits. Yet the company plans to pay dividends out of previous year free reserves.

As per condition I the company can pay maximum 10% of its paid up capital as dividends. It amounts to Rs 10 crores. As per condition II the company can charge 10% of its paid up capital and free reserves for payment of dividends. It amounts to Rs 22 Crores. As per condition III, the residual reserves should not fall below 15% of the paid up capital i.e. Rs. 15 crores. Hence, the company can pay dividends to the extent of Rs. 5 crores.

15.5 DIVIDEND POLICY IN PRACTICE

Mohanty (1999) survey of the dividend payout ratio of the 2535 Indian companies indicate that firms maintain a constant dividends per share and have fluctuating payout ratio depending on their profits.

Raghunathan and Dass (1999) find that the top-100 and high net-worth companies have maintained a stable dividend payout policy of around 30% during the period 1990 to 1999 in India.

Anand (2002) surveys 81 CFOs of top-500 companies of India and her most valuable PSUs to find out the corporate finance practices with respect to capital budgeting decisions, cost of capital, capital structure, and dividend policy decisions.

81.5% of the respondents strongly agree / agree that their firm has a long-run target dividend payout ratio. 85.2% of the respondents strongly agree / agree that dividend changes in their organization follow shift in long-run sustainable earnings. The dividend policy is a residual decision after meeting desired investment needs, agree only 46.95 of the respondents. The findings of the survey are in agreement with the findings of Lintner (1956) study on dividend policy.

The companies, which are creating shareholder value, are significantly more willing to rescind dividend increase in the event of growth opportunities available to the firm than the non-EVA firms are. The large firms (based on sales) are significantly less willing to rescind dividend increase than the small firms are.

71.60% of the respondents strongly agree / agree that the dividend policy provides signaling mechanism of the future prospects of the firm and thus affects its market value. Investors have different relative risk perceptions of dividend income and capital gains and are not indifferent between receiving dividend income and capital gains, agree 64.2% of the respondents.

82.7% of the respondents strongly agree / agree that management should be responsive to the shareholders' preferences regarding dividends. 53.1% of the respondents strongly disagree / disagree that share buyback programme should replace the dividend payments of the firm.

The large firms (based on sales) significantly strongly disagree to the belief that share buyback programme should replace dividend payments of the firm than the small firms are. The highly profitable and growth firms (based on ROCE and EVA, P/E) significantly less strongly disagree to the

share buyback programme replacing dividend payments than the low profitable and low growth firms are.

55.6% of the respondents agree that dividend payments provide a bonding mechanism so as to encourage managers to act in the best interest of the shareholders. This belief is shared by the CFOs of the private sector than the public sector (mean score of 0.68 and –0.10).

15.6 SHARE BUYBACKS

15.6.1 What are share buybacks?

The management of firm can return excess free cash flows to the shareholders either in the form of special dividends or resort to share buyback. In a share buyback companies buyback its own shares with cash and either cancels them or keeps them in a treasury for reissuing them later. Post buyback cancellation of shares is compulsory in India.

- Cash flows out from the company's coffers into the pocket of the shareholders whose shares are bought back.
- Number of shares outstanding falls (if bought back shares are cancelled).
- The company "pizza" is smaller but so are the numbers of "slices".
- Per-share book value can rise, fall, or remain unchanged.
 - If buyback is done at less than pre-buyback book value, the book value of remaining shares will rise, and vice versa.

Section 77A has been inserted in the Companies Act, 1956 with effect from October 31, 1998. The SEBI has also formulated the guidelines for the share buyback known as the SEBI (Buyback Securities) Regulations, 1998.

The Section 77A(1) allows the companies to buyback its own shares out of:

- Free reserves
- Securities premium account
- Proceeds of any share or other specified securities.

The legal requirements for share buyback have been laid down in Section 77A (2), (4), (6), & (7). These are:

- The articles of association of the company should authorize share buyback.

- The special resolution may be passed in the AGM authorizing the share buyback.
- Buy-back is or less than 25% of its total paid-up capital and free reserves
- Debt/Equity ratio not to exceed 2:1 post buy-back
- All the share for buy-back are fully paid-up
- Buy-back process to be completed within 12 months - Section 77A(4)
- A declaration of solvency of the company to be filed - Section 77A(6)
- To extinguish and physically destroy the securities so bought back within 7 days of last date of completion of buyback - Section 77A(7)
- Cooling -off period 24 months. A company, which has gone for share buyback, cannot issue fresh equity for a period of 24 months from the date of completion of share buyback.

If the company had debt in its balance sheet before the share buyback, then the share buyback will result into a increase in debt to equity ratio. If the share buyback is financed through fresh debt issue, then the debt – equity ratio will rise dramatically. It is termed as leveraged share buyback

15.6.2 Rationale for Share Buybacks

There are several management motivations for share buybacks.

If management is having free cash flows but no profitable growth opportunity is available, the best option is to return cash as special dividends or buyback its own shares and thus create shareholder value. If management increases dividends, it will build expectations for the future. The special dividends or share buyback are normally viewed as one time activity and hence do not build the expectations of the investors in the future.

If management feels that market has not correctly valued its shares, it can go in for share buyback to bring correction in the valuation of a share.

The dividends do not give any option to shareholders, whereas share buyback gives option to shareholders to either tender their shares or continue with the investment.

The share buyback could be used as a vehicle to increase the management shareholding in the company and thus controlling stake, without any cost to the existing shareholders.

“When companies with outstanding businesses and comfortable financial positions find their shares selling far below intrinsic value in the

marketplace, no alternative action can benefit shareholders as surely as repurchases.” – **Warren Buffett**

“One usage of retained earnings we often greet with special enthusiasm when practiced by companies in which we have an investment interest is repurchase of their own shares. The reasoning is simple: if a fine business is selling in the market place for far less than intrinsic value, what more certain or more profitable utilization of capital can there be than significant enlargement of the interests of all owners at that bargain price?” – **Warren Buffett**

15.6.3 How can you use share buybacks to increase shareholder value?

If a company generates a cash, which is surplus to its current operating needs, it can allocate this free cash flow for expansion project, diversification project, debt reduction programme, payment of dividends, or for share buyback programme. The share buyback programme is viewed as capital allocation decision.

The option before the management is share buyback at below the fair value or expansion. To illustrate as to how share buyback increases shareholder value. let us take an example. The Balance Sheet of Company ABC Limited as on April 01, 2003 is as under:

Balance Sheet of ABC Limited As on April 01, 2003		(all figures in Rs cr.)
<u>Application of Funds</u>		
Fixed Capital:		
Fixed Assets at cost	220	
Less Accumulated Depreciation	<u>60</u>	
Net Fixed Assets		160
Working Capital:		
Cash and equivalents	50	
Inventories	120	
Receivables	90	
Payables	<u>-60</u>	
Net Working Capital		<u>200</u>
Net Capital Employed		<u><u>360</u></u>
Sources of Funds		
Paid up Equity share capital	200	
Reserves & Surplus	160	
Loan Funds	0	

Total Sources of Capital	360
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Paid up capital:

No of shares (cr.)	2
Face value per share (Rs.)	100

Paid up capital:

No of shares (cr.)	2
Face value per share (Rs.)	100

ABC Limited has a net capital employed of Rs. 360 crores and is a zero debt company. The book value per share is Rs. 180 as against the market price of Rs. 75 per share. The total number of outstanding equity shares of the company are two crores.

The profit & loss account of the company for the year ended March 31, 2003 is as under:

**Profit & Loss Account of ABC Limited
For Year Ending 31 March, 2003**

(All figures in Rs cr.)

Sales	300
Cost of Sales	140
Depreciation	22
Operating Profits or EBIT	138
Interest	0
Profit before tax	138
Income tax	48.3
Profit after tax	89.7

Depreciation	10%Of Fixed assets at cost
Interest	10%Of Debt
Income tax	35%Of Profit before tax

Share price	75 Per share
Market Capitalization	150 Crores
Loan Funds	0
Market Value of Firm	150Crores

Book value per share	180 Per share
Fair value per share	225Why?
Fair value of firm (Rs 225 per Share X 2 crores equity shares)	450

The management of the company has done fundamental analysis of the company, and estimated the fair value of the company's share at Rs. 225 per share with the help of consulting firm. The management feels that market has grossly undervalued the share of their company at Rs. 75 per share. It will be good alternative to use the excess cash of Rs. 50 crores available in the company's balance sheet for buying back its shares.

Company uses part of cash to buy back its own shares

Cash used for buyback (Rs. Cr.)	50.0
Buyback price (Rs)	100
Number of shares retired (cr.)	0.50

Post Share Buyback

Balance Sheet as on April 01, 2003

(All figures in Rs cr.)

Capital Employed:

Fixed Capital:

Fixed Assets at cost	220
Less Accumulated Depreciation	60

Net Fixed Assets **160**

Working Capital:

Cash and equivalents	0.0
Inventories	120
Receivables	90
Payables	-60

Net Working Capital **150**

Net Capital Employed **310**

Sources of Capital:

Paid up Equity share capital	150
Reserves & Surplus	
(Balancing Figure)	160
Loan Funds	0

Total Sources of Capital **310**

Paid up capital:

(Post Share Buyback)

No of equity shares outstanding (cr.)	1.50
Face value per share (Rs.)	100

Post buyback fair value of firm

Fair Value of the firm pre-buyback less

Cash used for share buyback

(Rs 450 crores – Rs 50 crores) 400.0

Post buyback debt 0

Post buyback equity value (Rs in crores) 400.0

Post buyback number of shares (in crores)	1.50
Post buyback Fair value per share	
= Rs 400 crores / 1.50 crores shares	266.666667
Pre buyback fair value per share	225
Increase in fair value due to share buyback	
= (266.67 – 225) / 225	19%

Buyback vs. Capital Investment Expansion Project

Capital required for project (Rs in crores)	50.0
Expected annual cash inflows	25%
Expected annual cash flows (Rs in crores) = (50 X 25%)	12.5
Cost of capital	15%
Project Present value	
= Expected annual cash flow / cost of capital	83.3333333
NPV of the expansion Project	
= Project Present Value – Capital required for the project	33.3
Taking on this project will increase value of the firm by (Rs. Cr.)	
Post project value of firm (Rs 450 crores + Rs 33.33 crores)	483.3
Number of equity shares outstanding (in crores)	2
Fair Value per equity share post project	
= Post Project Value of the Firm / number of equity shares	
Outstanding	241.666667
Fair Value per equity share pre project	225
Increase in Fair value due to expansion project	
= (241.667 – 225)/225	7%

From the foregoing illustration, it emerges that share buyback gives a return of 19% to the remaining shareholders vis-à-vis 7% return in case of Greenfield expansion project. Hence, it seems to be a rational decision to go in for share buyback when the market price is much below the fair value instead of going in for expansion project.

A share buyback done at below the fair value results in an instant, and risk-less, increase in the fair value of the remaining equity shares outstanding.

In order to make the investor indifferent between both the share buyback option and expansion project option, let us find out the rate at which expected annual cash flows should be generated by the expansion project.

Expected annual cash inflows to make project equivalent to buyback

Capital required for project (Rs in crores)	50.0
Expected annual cash inflows	42.5%
Expected annual cash flows (Rs 50 crores X 85%)	21.25
Cost of capital	15%
Project value (Rs 21.25 crores / 15%)	141.6667
NPV = Rs 141.667 crores – Rs 50 crores)	91.667

Taking on this project will increase value of the firm by (Rs. Cr.)

Post project value of firm (Rs 450 crores + 91.667 crores)	541.667
Number of shares outstanding (in crores)	2
Fair Value per share post project (Rs 541.667 crores / 2 crores)	270.83
Fair Value per share pre expansion project	225
Increase in Fair value due to expansion project = (270.83 – 225) / 225	20.37%

To make expansion option attractive vis-à-vis the share buyback at below the fair price, the management has to identify an opportunity, which provides a return of 42.5% in perpetuity. It is rather very difficult to do so in such a competitive environment.

15.6.4 Share Buybacks as a value migration tool

There are ethical issues involved in the share buyback. These are:

- Buying back expensive scrip from the hostile bidder. It is termed as **greenmail or targeted share repurchase**. This option is not allowed in India. The existing management in order to retain control buys from hostile bidder his stake at a very high premium, which may not be in the interest of the minority shareholders.
- Buying back of the cheap scrip by the company without informing the minority shareholders about the fair value of the share. There is a information asymmetry between the controlling shareholders and the minority shareholders. The research question is who gains in the share buyback: the shareholders who tender their shares in response to the share buyback option or the one who do not tender their shares.
- The concerns have been raised in the financial press that some of the companies may use the share buyback route to transfer wealth of minority shareholders to majority shareholders.

15.7 LET US SUM UP

- The firms do have target dividend payout ratio. However, at the same time they want to have stable with growth dividend policy. The management does not want to increase dividends, if such increase is not sustainable. The change in dividend policy attracts the attention of the management most rather than the absolute level of dividends. The growth companies prefer to retain their earnings vis-à-vis mature companies opt to distribute most of their earnings as dividends.
- The determinants of dividend payout ratio are availability of growth opportunities, liquidity position of the firm, debt market conditions, and control considerations.
- Despite the tax disadvantage associated with dividends and costs involved in raising external equity, the firms do pay growing level of dividends and consider it as a positive signal to the stock market. This is because of investor preferences, information signaling, disciplining the management and changing the financing mix.
- Anand (2002) study of Corporate India finds that most of the firms have target dividend payout ratio and dividend changes follow shift in the long-term sustainable earnings. The findings on dividend policy are in agreement with Lintner's study on dividend policy. Most of the respondents agree that dividend policy provides signaling mechanism of the future prospects of the firm and thus affects its market value.
- The major motivations for share buyback are to provide support to price, control considerations, optional in nature, one time activity to return excess cash, and a tool to create shareholder value. The critics look at it as a value migration tool from minority shareholders to the majority shareholders.
- The sensible arguments on dividend policy are:
 - Firms should avoid cut in positive NPV projects to pay dividends
 - Firms should avoid issuing of equity to pay dividends
 - Share buyback option should be considered when few profitable growth opportunities are available and surplus free cash flows are available

15.8 KEY WORDS

Bonus Shares:	The equity shares issued by the company to the existing shareholders by capitalizing its reserves & surpluses.
Dividend Payout ratio:	The ratio of dividends per share to earnings per share
Dividend Yield:	The ratio of dividend per share to market price per share
Fair value of a share:	It is intrinsic value of a share worked out after considering future free cash flows of firm and risk adjusted rate of discount.
Greenmail:	Buying back by the company expensive stock from the hostile bidder.
Homemade dividends:	An individual investor can undo a firm's dividend policy by selling off shares of his portfolio to get a desired cash flow or by reinvesting excess dividends.
Information asymmetry:	The difference in quality and quantity of information between the controlling shareholders and minority shareholders.
Liquidity:	The cash flow position of the firm to service the debt and pay dividends to the shareholders.
Perpetuity:	An infinite constant stream of cash flows.
Share buyback:	Firm may buyback its own shares from the shareholders. The cash flows out from the company's balance sheet and the number of outstanding shares also are reduced.
Stock Split:	The increase in number of equity shares by reducing the par value of a share while making no change in shareholders' equity
Target payout ratio:	A firm's long-run dividends-to-earnings ratio.

15.9 TERMINAL QUESTIONS / EXERCISES

1. How can an investor make homemade dividends?
2. Are dividends irrelevant? What assumptions are required to substantiate that dividend policy is irrelevant?
3. Does share buyback make more sense than paying dividends?
4. Discuss the real-world factors favoring a high-dividend policy.
5. Do Dividends have information content?
6. "Risky companies tend to have lower target dividend payout ratios and more gradual adjustment rates." Discuss.
7. Which type of firms would you expect to distribute a relatively high or low portion of their current profits after tax? Which would you expect to have a relatively high or low price-earning ratio?
 - a) High-risk companies
 - b) Companies that have suffered unexpected fall in profits
 - c) Companies that expect to suffer unexpected fall in profits
 - d) Growth companies with uncertain future investment opportunities.

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