

Dividend Theories

The term dividend refers to that part of the profits of a company which is distributed amongst its shareholders.

Types of Dividend

1. Cash Dividend
 - a) Regular Dividend
 - b) Interim Dividend
2. Stock dividend (bonus Shares)
3. Scrip Dividend
4. Bond Dividend
5. Property Dividend

Factors Affecting Dividend Policy

1. Stability of earnings
2. Liquidity of funds
3. Nature of business
4. Financing policy of the concern
5. Dividend policy of competitive concerns
6. Maintaining effective control
7. Need for expansion
8. Cash position
9. Taxation policy
10. Legal requirements
11. Investment opportunities
12. Legal Requirements
13. Investment opportunities

Theories of Dividend

Different theories are developed by many experts regarding dividend decision on the valuation of the firm. The theories can be grouped into two heads:

A) Relevance Concept of Dividend

1. James Walter's Approach
2. Myron Gordon's Approach

B) Irrelevance Concept of Dividend

1. Modigliani – Miller's Approach

Relevance Concept Dividend

1. James Walter's Approach:

James Walter (1966), has developed a relevance concept of dividend model and strongly supports that dividend policies of a firm almost always affect the value of the firm.

If return on investment is higher than the cost of Capital ($r > k$), the firm should, the optimum dividend policy would distribute the entire earnings as dividend. In this case, the shareholders will be better-off.

Walter's Model also implied that when normal firm is $r = k$, it does not matter whether earnings are retained or distributed. The value of market price of share will not be adversely affected with change in the dividend rate.

Assumptions:

1. Retained earnings is the only source of entire financing of a firm.
2. External sources of funds such as debt or new equity capital are not used.
3. Return on firm's investment (r) and cost of capital (k_0) of a firm remain constant.
4. Firm's business risk does not change with additional investment undertaken.
5. The firm has an infinite or very long life.

Formula

$$P = \frac{D}{k_e} + \frac{(E - D)}{r}$$

Where

P = market price of an equity share

D = Dividend per share

r = Internal rate of return on investment

E = Earnings per share

E-D = Retained Earnings per share]

K_e = Cost of Equity Capital (or) Capitalization Rate

2. Gordon's Model

Mynon J. Gordon (1979), suggested a relevance of dividend decision for valuation of a firm. This model is also called as dividend capitalization model. According to this model, dividend policy of a firm affects its value, and is based on the following assumptions:

1. The firm is an all equity firm
2. Retained earnings represent the only source of a firm for financing its investment programmes.
3. The rate of return(r) on the firm's investment is constant.
4. The cost of capital remains unchanged for all times to come
5. The firm has perpetual life
6. Corporate taxes do not exist.
7. The retention ratio, once decided upon is constant. Thus, growth rate ($g = br$) is also constant.
8. Cost of capital is greater than the growth rate ($K_o > br$)

Valuation Formula

$$P_o = \frac{E(1-b)}{K_o - br}$$

Where,

P_o = Price per share at the beginning of the year

E = Earnings per share at the end of the year

B = retention Ratio

1-b = Dividend payout ratio (Percentage of earnings distributed as dividends)

K_o = Capitalization rate or cost of capital

br = Growth rate of earning and dividends.

r = Rate of return earned on investment made by the firm

Modigliani and Miller's Approach

According to them, dividend policy of a firm does not affect the value of a firm. Thus, the dividend payout ratio does not affect the wealth of shareholders.

Assumptions:

1. It assumes that capital markets are perfect
2. Non-existence of brokerage/commission
3. Availability of free information to all investors
4. No transaction costs and floating costs.

Investment policy of the firm does not change at any circumstances

Proof for MM Hypothesis

According to MM hypothesis, the market value of a share in the beginning of the periods is equal to the present value of dividends paid at the end of the period plus the market price of the share at the end of the period.

This can be put in the form of the following equation:

$$P = \frac{D_1 + P_1}{(1 + K_e)}$$

Where

P_o = Prevailing market price of a share

K_e = Cost of equity capital

D_1 = Dividend to be received at the end of period one

P_1 = Market price of a share at the end of period one.

From the above equation, the following equation can be derived for determining the value of P_1

$$P_1 = P_0 (1+K_e) - D_1$$

