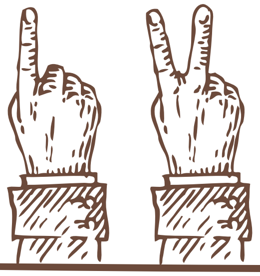
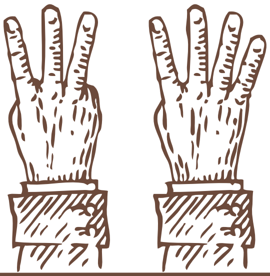


THE RIGHT SIGNAL



Dividend policies are a way for companies to convey messages to their investors. Will Spinney explains

This article looks at dividend policy. It concerns those dividends paid by publicly quoted companies on their common stock. Dividends paid by privately owned companies or subsidiaries of groups are subject to different criteria.

Dividend policy should be part of an overall financial strategy that comprises strategies on returns for shareholders, leverage, investment and risk management. Because dividends are essentially voluntary, and broadly decided by management, equity investors look for a dividend policy.

From an academic point of view, there are broadly three approaches to dividends (see table below).

In practice, a further factor is that some investors seek out the regular income that dividends provide.

Let us look at two extremes of dividends to illustrate these approaches and lead us to the concept of signalling:

Firstly, a high-growth company, say in the technology sector, should always have projects in which it wishes to invest, and so paying cash to shareholders would be curtailing opportunities for this growth. It should not pay dividends.

Secondly, a mature company, such as in the tobacco industry, has very few projects in which to invest and so should pay high dividends, returning cash to shareholders so that they can invest in other opportunities offering higher returns.

If the high-growth company starts to pay dividends, then this might be because the high-growth period is at an end. If the mature business suddenly discovers a new product, it may curtail dividends to finance it. Both these actions are signals to shareholders. Cutting of a dividend has always been difficult, however, sometimes leading to management change, so such cuts are often deferred for too long.

In between these extremes sit the vast majority of quoted companies with differing approaches to dividends. Many try to have regular increases, possibly upsetting the investment/distribution balance, thus building up problems. Many look to what their peer group does for guidance.

Signalling theory is a major aspect of dividend policy. It says that dividends and dividend policy indicate information that management wishes to communicate to shareholders. This may seem odd in today's world, but the theory does carry weight, since dividends are a real commitment by management to distribute cash.

There are four broad approaches to setting dividends:

1. Dividend cover – It is calculated as after-tax earnings per share divided by dividend per share. A dividend cover of 1.5x or 2x may be acceptable for a mature industry. On the other hand, a company that is in a risky sector might be expected to have a dividend cover in excess of 5x. Note that dividend cover conventions vary considerably in different markets.

2. Stabilisation – The Lintner theoretical model says that the dividend depends partly on current earnings and partly on the dividend for the previous year, which in turn depends on that year's earnings and the dividend in the year before that. It has been confirmed by research that dividends are a function of a weighted average of past and current earnings, and this accords with the observable practice of maintaining a stable, smoothed dividend over time. This means that dividends will not automatically increase in line with earnings, but instead will be a lower proportion of earnings in good years and a higher proportion of earnings in bad years. Investors, therefore, can be reasonably confident about the cash element of their return. The policy, for example, might be for dividends to grow at the long-term rate of profit growth subject to maintaining adequate dividend cover.

3. Pay out a fixed proportion of earnings – A policy that is adopted by some companies is for dividends to be, for instance, one half of profits after tax, which often results in large fluctuations from year to year. This effectively relies on Franco Modigliani and Merton Miller's dividend irrelevance theory, but requires clear communication with investors if dividend rises and falls are not to be misconstrued. The '*payout ratio*' is the inverse of cover, but tends to be indicative of a shorter-term approach.

4. Pay a sustainable dividend – Companies tend to forecast their financial position a few years into the future. This gives some idea of the funding requirements for investment projects and thus the medium-term outlook for free cash flow (after funding projects). The company can then aim to pay a sustainable regular dividend without the need to raise additional equity, providing some certainty to investors and sending a consistent signal.

A treasurer should ask these questions when dividend policy is discussed:

- In what form do shareholders prefer their returns?
- How does the policy fit in with the financial strategy?
- What signal will the dividend policy give?

Approaches to dividends

Dividend irrelevance theory	This theory says that shareholders should be indifferent as to whether returns are through cash returns or share price growth.
Dividends are bad	If capital taxes are lower than income taxes, then dividends are a poor return for shareholders.
Dividends are good	A company paying dividends has some form of commitment to shareholders, firstly to generate sufficient cash to pay them, but also to signal the prospects of the company. It also allows investors to invest elsewhere. Some might also argue that cash left with the company might be wasted on poor opportunities.

Will Spinney is associate director of education at the ACT