DIVIDENDS AND SHARE BUYBACKS

Dividend Policy

The term dividend policy subsumes guidelines a company applies in regards to the size, consistency and structure of paying dividends to its shareholders.

In essence, dividends are cash distributions to a firm´s shareholders paid from its earnings. - Whereby, a firm making losses can actually also pay dividends, as - technically - dividends are paid from and subsequently reduce the company´s retained earnings component of its equity position: As long as sufficient retained earnings are available, dividends can be paid; once they are used up, not any longer.

Whilst the availability of retained earnings to pay dividends is an absolute condition, the availability of cash is not. Hence, if a firm lacks sufficient cash to cover dividend payments, then it simply has to raise it, which could be done via loans or bonds.

A sound dividend policy considers the expectations of the firm´s shareholders as well as funding requirements by the company. - Typically, dividends are paid by companies which have reached a rather mature stage in their life cycle. In earlier stages of the life cycle, such as in the start-up and growth phases, firms rather aim to withhold cash to support and fund their respective growth strategies: Cash requirements in these stages are usually driven by considerable capital expenditure requirements as well as investments in working capital (foremost to increase inventory and receivables). – In well-advanced stages in a firm´s life cycle, extra or special dividends may be paid, even exceeding earnings. Thereby, along with the retained earnings position (which is often of no more strategic relevance) also the overall equity is reduced. In this case the purpose of a dividend policy is to hand back part of the capital to shareholders, as far as this may not be required any longer. (Technically such can also be achieved via share buybacks, of course).

Investors in mature firms are frequently focused on a company´s dividend yield, calculated as the stock´s cash dividend paid divided by the share price. This makes sense, as mature or declining companies are usually confronted with a share price deceleration and an increasing amount of shareholder rewards will be derived from cash dividends.

Therefore, in formulating a dividend policy, understanding shareholder reward expectations is key: For example, some shareholder may be required to make regular payments to their clients and stakeholders, such as pension funds or life insurance companies. These institutions require a stable, regular and constant dividend stream. - On the other hand, growth story investors are usually not interested in dividend payments but instead in share price increases. - Therefore, a company´s chief financial officer has to clearly understand the expectations of a firm´s shareholder base in regards to dividends and the dividend policy will have to account for this.

Cutting or cancelling dividend payments usually impact a firm´s share price severely: This is not only because of the signal sent by the firm that it may be confronted with potential challenges or difficulties in regards to its business model. Instead, this is foremost, because substantial disruptions will be caused by dividend-focused shareholders seeking to exit their engagement. This could subsequently result in larger share packages changing hands, possibly even for a steep discount. Besides, investors focused on net present value-related valuations may fear a deterioration of the amount, quality and momentum of future expected cash flows and earnings. Thereby their concern is foremost in regards to a significant decrease of the residual value component.

A prudent dividend policy is ideally long-term focused and sets a framework of how much of a firm´s earnings shall be paid out to shareholders. Whilst theory suggests that it should be irrelevant to investors whether yields earned come from share price accretion or dividend payments, reality suggest otherwise, not least amid their different tax treatment in most jurisdictions.

SHAREHOLDER EXPECTATIONS
TAX TREATMENT
LEGAL REQUIREMENTS
COVENANTS
GROWTH MOMENTUM
CAPITAL STRUCTURE
INVESTMENT REQUIREMENTS
⋮

$\Rightarrow$ DIVIDEND POLICY