DIVIDENDS AND SHARE BUYBACKS

The Rationale of Stock Dividends

Stock Dividends have nothing in common with the concept of (cash) dividends, but are actually implemented to strengthen a firm´s credit standing.

Dividends usually refer to cash dividends: They matter to investors, especially to those seeking a long-term stable cash income, such as insurance companies or pension funds. And it is also no surprise that cash dividends were in the past considered as the principle indicator for the financial health of a company, long before laws required firms to disclose financial information.

Stock dividends – however – are an allocation of additional shares to shareholders, whereby in this context the term dividend is actually misleading. – Now, in the case of a cash dividend a shareholder is compensated for an investment in cash. This cash leaves the company, ending up in the pocket of the investor, who is free to decide what to do with it.

In the case of a stock dividend, however, the shareholder receives one (or several) additional share(s). To start with, this results in the number of shares outstanding to increase. And, if a shareholder required cash, all or part of the newly received shares would have to be sold. Thereby, the shareholder´s stake or relative share in the company would be diluted. To avoid this, the shareholder would therefore need to hang on to the newly received shares. – As a consequence, a stock dividend will not alter the economic position of a shareholder in the company. It´s just that the shareholder will now have more shares in possession. And the share price for each stock will decrease accordingly, reflecting the higher number of shares outstanding.

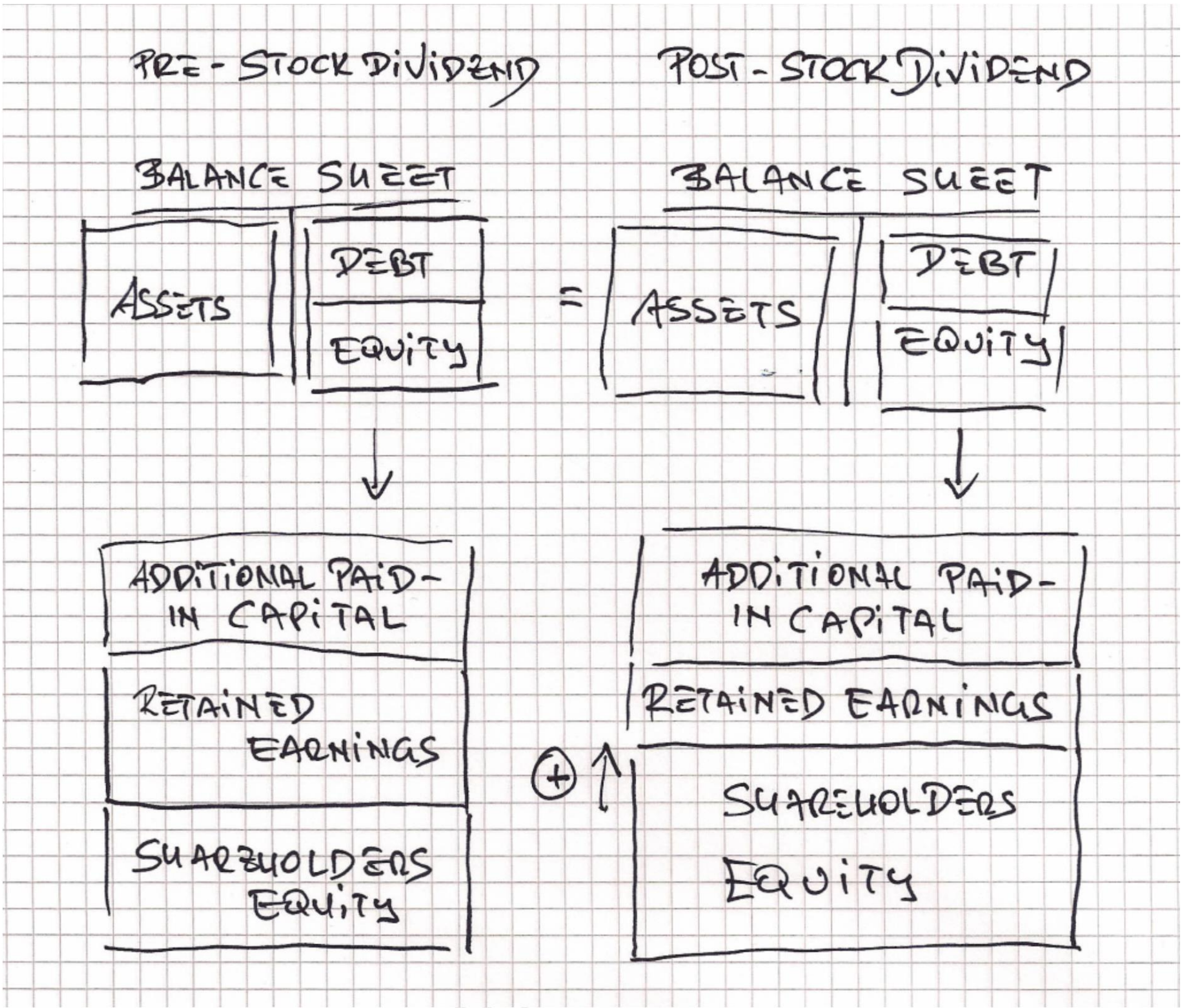
From a company´s perspective the new shares issued in the course of a stock dividend do not raise any fresh capital. Instead, these newly created shares are merely “given away” to shareholders.

Therefore, as an interim result, one may conclude that a stock dividend neither alters the economic or commercial position of a shareholder nor that of the company itself.

To better understand the rationale of stock dividends, one needs to take a closer look at the composition of the equity position of a company: This position can be de-composed into the shareholders equity; the additional paid in capital; and the retained earnings. Now, as no funds are raised, a stock dividend does not increase the overall equity, which remains at the same amount. However, as the number of shares outstanding increase, so does the shareholders equity (equaling the number of shares outstanding multiplied with the face value of a share). And, with no fresh capital raised, the additional paid in capital will also stay constant. - In consequence, it is the retained earnings which will have to decrease to compensate for the higher shareholders equity (and so that the overall equity position can remain constant).

Therefore: A stock dividend transfers a portion of the retained earnings (which are reduced) to the shareholders equity position (which is increased). Consequently, a stock dividend is a transaction whereby only components of the equity are affected without changing the amount of the equity as such.

Hence, the rationale of a stock dividend is in strengthening a firm´s shareholder equity. And, this has actually important consequences: Dividends are ultimately paid from the firm´s retained earnings position. Now, a reduction of this position automatically reduces a firm´s flexibility in paying dividends, especially of paying special or extra dividends. And this, suffice to say, is ultimately to the benefit of creditors: They are given comfort in regards to ultimately being able to get hold of a pledged asset pool which now cannot be reduced that simply, for example by paying extra dividends to shareholders. – Therefore: Stock dividends are ultimately to the benefit of creditors.


PRE - STOCK DIVIDEND
POST - STOCK DIVIDEND
BALANCE SHEET
BALANCE SHEET
ASSETS
DEBT
EQUITY
=
ASSETS
DEBT
EQUITY
ADDITIONAL PAID-IN CAPITAL
RETAINED EARNINGS
SHAREHOLDERS EQUITY
ADDITIONAL PAID-IN CAPITAL
RETAINED EARNINGS
+
SHAREHOLDERS EQUITY