DIVIDEND POLICY

2017

General Thoughts on Dividends

FINANCIAL TIMES

28 April 2017 - **Russia demands big dividend payouts from state-owned companies**

- **Putin-backed move sparks rise in shares and is aimed at plugging holes in federal budget**

- Russia has demanded its state-owned companies pay out half of their profit in dividends this year, in a renewed attempt by the government to squeeze companies like Gazprom, Rosneft, Aeroflot and Alrosa to plug holes in the federal budget
- Shares in state-run companies soared on Friday morning after the decree, which will boost government coffers as well as those of private investors, was announced late on Thursday
- Russian president Vladimir Putin approved the plan “in general terms”, according to deputy prime minister Igor Shuvalov
- Gas monopoly Gazprom opened 3 per cent higher and federal power grid companies spiked more than 4 per cent in early trading in Moscow

Of Paper Profits …

FINANCIAL TIMES

15 May 2017 - **Putin comment on Gazprom raises questions about dividend**

- Russian gas monopolist Gazprom’s profit is mostly “on paper,” president Vladimir Putin said on Monday, raising questions about the company’s ability to pay dividends
- “Gazprom has large profits on IFRS. But it’s on paper. There isn’t a real cash flow,” Mr Putin said at the Belt and Road summit in Beijing
- Mr Putin implied the company would likely be exempt from a government decree mandating that all state-owned firms pay 50 per cent dividends
  - The company has previously asked for exceptions on the grounds that its large investment programme would force it to borrow to pay the compulsory dividend rate
- “So when the government makes a decision about this issue, it’s going to take the real situation into account, and not the company’s paper income,” he said
- Gazprom shares dropped 2.3 per cent on the Moscow exchange after Mr Putin’s comments

Dividend Strategy and the Life Cycle Model

	Cash availability	Profit availability	Dividend policy
Launch	No spare cash available All cash is needed for investment in developing the business	None. Probably making losses	Nil dividend payout
Growth	Cash is needed for development and investment in growing market share	May be profitable	Nil dividend payout is preferable. However, new shareholders might prefer a nominal payout
Maturity	The company is now cash positive and has fewer opportunities to invest in profitable growth	Profitable	A medium to high dividend payout is preferred
Decline	The company is cash positive, with no reinvestment potential	May be profitable	Full payout of available cash as dividend, even in excess of current profits

What Does a Dividend Change Signal?

Interpretation	Increase the dividend level	Decrease the dividend level
Good news	The company is prospering, and we can afford to pay out more of our profits without damaging our prospects	The company has changed its strategy and the directors see these very profitable investment opportunities, which will provide more shareholder value than will mere payment of dividends
Bad news	The directors have run out of ideas for profitable growth	Profits and cash flow are way down, and the company is facing trouble for the foreseeable future
	Signal for **advancing** one stage in the life cycle?	Signal for **moving back** one stage in the life cycle?

Example: Smoothing Dividends over a Period of Time

- A company is believed to be in its **mature** stage, …
- … and would like to pay out **max 50%** of annual profits as **dividends**

- **However**, the company's business model includes taking on large **contracts**, …
- … the profits of which can fall either side of a year end, …
- … significantly **affecting year-on-year profitability**

	Year 1	Year 2	Year 3	Year 4	Year 5
Profit after tax £ m	100	120	110	150	130
(a) Dividends using a 50% payout ratio	50	60	55	75	65
(b) Smoothed dividend policy	40	46	53	61	70

Perceived Volatility by Investor

Distribution of Economics - Stock Dividend and Buyback

Stock Dividend

- Dividend declared but no cash **paid out**
- Shareholders wanting cash can sell these new shares …
  - …however, causing dilution
- Stock dividend is effectively **retaining the cash in the business for reinvestment**
  - … and swapping retained earnings for shareholder equity

Share Repurchases (Buybacks)

- An alternative to a cash dividend is to repurchase own shares using excess cash
- Repurchased shares (Treasury stock) can later be **re-issued**, at an appropriate market price …
  - Tax and legal positions vary by country
  - E.g.: In the US buybacks have a tax advantage over dividend payment
- … or **cancelled**, resulting in re-levering the firm

Choosing between Dividends and Equity Repurchases

Net benefit of equity repurchases vs dividends depends upon the following:

Sustainability and Stability of Excess Cash Flow

- If the excess cash flows are temporary or unstable, firms should repurchase stock
- If they are stable and predictable, we would be more inclined to pay dividends, because they provide a stronger signaling benefit

Stockholder Tax Preferences

- If stockholders are taxed at much higher rates on dividends and, consequently are averse to dividends the firm will be better off repurchasing stock

Predictability of Future Investment Needs

- Firms that are uncertain about the magnitude of future investment opportunities should use equity repurchases as a way of returning cash to stockholders

Choosing between Dividends and Equity Repurchases (cont´d)

Net benefit of equity repurchases vs dividends depends upon the following (cont´d):

Undervaluation of the Stock

- If the stock remains undervalued, the remaining stockholders will benefit if managers buy back stock at less than true value
- Buyback may send a signal to financial markets that the stock is undervalued, and the market will react accordingly, by pushing up the price

Management Compensation

- Managers with significant option positions may be more likely to buy back stock than pay dividends

Example: Share Repurchase vs Special Dividend – Impact

Mega Cash Holding	
Pre-Transaction	
Excess Cash (m)	400,0
Interest	5,0%
Tax rate	33,3%
Payout Ratio	50,0%
Shares Outstanding (m)	500,0
Market Cap (m)	1.000,0
EPS	0,20
Share Price	2,0
P/E	10,0
Operating Profit	130,0
Interest Income	20,0
PBT	150,0
Tax	50,0
Net Income	100,0
Dividends	50,0
Retained Earnings	50,0

Mega Cash Holding	
Share Buyback	
Excess Cash (m)	0,0
Interest	5,0%
Tax rate	33,3%
Payout Ratio	50,0%
Shares Outstanding (m)	300,0
Market Cap (m)	600,0
EPS	0,29
Share Price	2,0
P/E	6,9
Operating Profit	130,0
Interest Income	0,0
PBT	130,0
Tax	43,3
Net Income	86,7
Dividends	43,3
Retained Earnings	43,3

Mega Cash Holding	
Special Dividend	
Excess Cash (m)	0,0
Interest	5,0%
Tax rate	33,3%
Payout Ratio	462,0%
Shares Outstanding (m)	500,0
Market Cap (m)	600,0
EPS	0,17
Share Price	1,2
P/E	6,9
Operating Profit	130,0
Interest Income	0,0
PBT	130,0
Tax	43,3
Net Income	86,7
Dividends	400,4
Retained Earnings	-313,7

Dividend Policy

Developing a Dividend Policy as Company Reaches Maturity

- **Increasing dividend payout ratio** signals **future growth prospects are not as exciting**
  - Company has ability to support consistent high level of dividends and cash required is also readily available
  - The reinvestment needs met from the lower retention ratio supplemented by raising a reasonable proportion of debt funding

- **P/E multiple will reduce** as market reassesses future growth potential
  - However, if substantial future growth expectations are allowed to be believed by shareholders for too long, share price may rise too high …

- **Need for reinvestment reduces** significantly just as the availability of finance increases substantially
  - Potential risk of retaining profits for which there is no profitable use, which can lead to a declining overall rate of return for the business
  - Alternatively, the company can start to diversify …
    - … which frequently destroys shareholder value

Growing Company – Base Parameters

Growing Company		
Corporate Parameters		
Share Price	125,0	
EPS	5,0	
Dividend	1,0	
Expected Growth (by shareholders)	15,0%	
Implied Corporate Parameters		
Dividend Payout Ratio	20,0%	
P/E	25,0	
Implied Shareholder View		
Share Price	125,0	
Total Yield	**15,8%**	
Dividend Yield	0,8%	1,0
Growth (Share Price)	15,0%	

$$P_0 = D_1/(K_e - g) \Longleftrightarrow K_e = D_1/P_0 + g$$

Growing Company – Growth Component of Share Price

Growing Company		
Corporate Parameters		
Share Price	125,0	
EPS	5,0	
Dividend	1,0	
Expected Growth (by shareholders)	15,0%	
Implied Corporate Parameters		
Dividend Payout Ratio	20,0%	
P/E	25,0	
Implied Shareholder View		
Share Price	125,0	
Total Yield	**15,8%**	
Dividend Yield	0,8%	1,0
Growth (Share Price)	15,0%	

Mature, Stable State Company Equivalent	
Corporate Parameters	
Steady State CoE (ie shareholder expectations)	10,0%
Implied Parameters	
P/E (inverse CoE; 1/CoE)	10,0

Parameter	Mature, Growing		Mature, Stable		Growth Element
Share Price	125,0		50		**75,0**
P/E	25,0		10,0		

Growing Company – Required Return on Re-Investment

Growing Company		
Corporate Parameters		
Share Price	125,0	
EPS	5,0	
Dividend	1,0	
Expected Growth (by shareholders)	15,0%	
Implied Corporate Parameters		
Dividend Payout Ratio	20,0%	
P/E	25,0	
Implied Shareholder View		
Share Price	125,0	
Total Yield	**15,8%**	
Dividend Yield	0,8%	1,0
Growth (Share Price)	15,0%	

Growing Company	
Return on Re-Investment	
Future Growth Expectations (by shareholders)	15,0%
Dividend Payout Ratio	20,0%
Implied Parameters	
Retention Rate	80,0%
Required Return on Re-Investment	**18,8%**

$$\begin{aligned} g &= \text{retention ratio} \times \text{return on reinvestment} \\ &= (1 - \text{payout ratio}) \times \text{return on reinvestment (ROR)} \end{aligned}$$

Growing Company – Change in Dividend Policy / Payout Ratio - Nil

Growing Company		
Corporate Parameters		
Share Price	125,0	
EPS	5,0	
Dividend	1,0	
Expected Growth (by shareholders)	15,0%	
Implied Corporate Parameters		
Dividend Payout Ratio	20,0%	
P/E	25,0	
Implied Shareholder View		
Share Price	125,0	
Total Yield	**15,8%**	
Dividend Yield	0,8%	1,0
Growth (Share Price)	15,0%	

Growing Company	
Alternative Scenario - Dividend Payout Ratio	
Dividend Payout Ratio	0,0%
Implied Parameters	
Delivered Growth Yield (by company)	18,8%
Expected Total Yield (by shareholders)	15,8%

Implied Shareholder View			
Total Yield	**15,8%**		
Dividend Yield	0,0%	0,0	
Growth (Share Price)	15,8%		
Share Price	**148,3**		

Previous Shareholder View (Growth)		
Total Yield	**15,8%**	
Dividend Yield	0,8%	1,0
Growth (Share Price)	15,0%	
Share Price	125,0	

$$K_e = D_1 / P_0 + g$$

Growing Company – Change in Dividend Policy / Payout Ratio - Full

Growing Company		
Corporate Parameters		
Share Price	125,0	
EPS	5,0	
Dividend	1,0	
Expected Growth (by shareholders)	15,0%	
Implied Corporate Parameters		
Dividend Payout Ratio	20,0%	
P/E	25,0	
Implied Shareholder View		
Share Price	125,0	
Total Yield	**15,8%**	
Dividend Yield	0,8%	1,0
Growth (Share Price)	15,0%	

Mature, Stable State Company Equivalent	
Corporate Parameters	
Steady State CoE (ie shareholder expectations)	10,0%
Implied Parameters	
P/E (inverse CoE; 1/CoE)	10,0

Mature, Stable State Company Equivalent	
Alternative Scenario - Dividend Payout Ratio	
Dividend Payout Ratio	100,0%
Implied Parameters	
Delivered Growth Yield (by company)	0,0%
Expected Total Yield (by shareholders)	10,0%

Implied Shareholder View			
Total Yield	**10,0%**		
Dividend Yield	10,0%	5,0	
Growth (Share Price)	0,0%		
Share Price	**50,0**		

Previous Shareholder View (Mature, Stable)		
Total Yield	**10,0%**	
Dividend Yield	10,0%	5,0
Growth (Share Price)	0,0%	
Share Price	?	

$$K_e = D_1/P_0 + g$$

The Logic of High Retention vs High Dividend Payout

High Retention

- In **theory** shareholders are **indifferent between dividends and capital growth**, …
- **… but** a **high retention** rate is **logical for** a **growth company**

- An increase in retention rate should **indicate higher future growth** expectations and …
- … the greater volatility associated with higher growth may **increase** the **risk perception** of investors

High Dividend Payout

- A high / full payout ratio indicated that **limited / no future growth** should be expected

- **Most / all of share-holder return** comes through **dividend** yield, and dividends are **likely to stay** at their current level
  - This potentially places the company in a **steady state** position

Mature Company – Base Parameters & Required Return on Re-Investment

Mature Company		
Corporate Parameters		
Share Price	100,0	
EPS	12,0	
Dividend	9,0	
Expected Growth (by shareholders)	2,0%	
Implied Corporate Parameters		
Dividend Payout Ratio	75,0%	
P/E	8,3	
Implied Shareholder View		
Share Price	100,0	
Total Yield	**11,0%**	
Dividend Yield	9,0%	9,0
Growth (Share Price)	2,0%	

Mature Company	
Return on Re-Investment	
Future Growth Expectations (by shareholders)	2,0%
Dividend Payout Ratio	75,0%
Implied Parameters	
Retention Rate	25,0%
Required Return on Re-Investment	**8,0%**

$$P_0 = D_1/(K_e - g) \Longleftrightarrow K_e = D_1/P_0 + g$$

$$\begin{aligned} g &= \text{retention ratio} \times \text{return on reinvestment} \\ &= (1 - \text{payout ratio}) \times \text{return on reinvestment (ROR)} \end{aligned}$$

Mature Company – Change in Dividend Policy / Payout Ratio - Full

Mature Company		
Corporate Parameters		
Share Price	100,0	
EPS	12,0	
Dividend	9,0	
Expected Growth (by shareholders)	2,0%	
Implied Corporate Parameters		
Dividend Payout Ratio	75,0%	
P/E	8,3	
Implied Shareholder View		
Share Price	100,0	
Total Yield	**11,0%**	
Dividend Yield	9,0%	9,0
Growth (Share Price)	2,0%	

Mature Company	
Alternative Scenario - Dividend Payout Ratio	
Dividend Payout Ratio	100,0%
Implied Parameters	
Delivered Growth Yield (by company)	0,0%
Expected Total Yield (by shareholders)	12,0%

Implied Shareholder View				Previous Shareholder View		
Total Yield	**11,0%**			**Total Yield**	**11,0%**	
Dividend Yield	11,0%	12,0		Dividend Yield	9,0%	9,0
Growth (Share Price)	0,0%			Growth (Share Price)	2,0%	
Share Price	**109,1**			Share Price	100,0	

$$K_e = D_1/P_0 + g$$

Mature Company – Change in Dividend Policy / Payout Ratio - Half

Mature Company		
Corporate Parameters		
Share Price	100,0	
EPS	12,0	
Dividend	9,0	
Expected Growth (by shareholders)	2,0%	
Implied Corporate Parameters		
Dividend Payout Ratio	75,0%	
P/E	8,3	
Implied Shareholder View		
Share Price	100,0	
Total Yield	**11,0%**	
Dividend Yield	9,0%	9,0
Growth (Share Price)	2,0%	

Mature Company	
Alternative Scenario - Dividend Payout Ratio	
Dividend Payout Ratio	50,0%
Implied Parameters	
Delivered Growth Yield (by company)	4,0%
Expected Total Yield (by shareholders)	11,0%

Implied Shareholder View				Previous Shareholder View		
Total Yield	**11,0%**			**Total Yield**	**11,0%**	
Dividend Yield	7,0%	6,0		Dividend Yield	9,0%	9,0
Growth (Share Price)	4,0%			Growth (Share Price)	2,0%	
Share Price	**85,7**			Share Price	100,0	

$$K_e = D_1/P_0 + g$$

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