Dividend Policy

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

Dividends are cash distributions to a firm´s shareholders paid from its earnings. They matter to investors, especially to those seeking long-term stable cash income, such as insurance companies or pension funds. No surprise that cash dividends were in the past considered as the principle indicator of a company´s financial health, long before laws required firms to disclose financial information.

Whereby, a loss-making firm can actually also pay dividends, as - technically - dividends are paid from and subsequently reduce a company´s retained earnings within its equity position: As long as retained earnings are still sufficiently available, dividends can be paid. Once this position is used up, no longer.

Whilst the availability of retained earnings to pay dividends is a 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, via loans or bonds.

A sound dividend policy has shareholder expectations in mind as well as a firm´s funding requirements. - Typically, dividends are paid by companies which have reached a rather mature stage in their life cycle. In earlier stages, such as in the startup and growth phases, firms aim to withhold cash to support and fund their respective growth strategies: Cash requirements in these stages are mostly due to sizable capital expenditure programs as well as investments in working capital (i.e. increase inventory and receivables). – In contrast, in well-advanced stages in a firm´s life cycle, also extraordinary or special dividends could be considered and paid, even exceeding earnings. In taking such a step, retained earnings – of no more strategic relevance any longer - would be reduced, along with the firm´s total equity position. In this case, the purpose of paying extraordinary dividends is to hand back part of the equity capital to shareholders, as far as this is not required any longer. (The same purpose can also be achieved via share buybacks, though).

Investors in mature firms are typically foremost focused on a company´s dividend yield, calculated as the stock´s cash dividend paid divided by the share price. This is not least due to mature or declining companies often confronted with a deceleration of their respective share prices: Hence, an increasing portion of yield to shareholders will be derived from cash dividends.

Therefore, in formulating a dividend policy, striking a balance between a corporate´s life cycle-driven requirements whilst also having a profound understanding of shareholders´ reward expectations is key: For example, some shareholders may have to make regular payments to their clients and stakeholders, such as pension funds or life insurance companies. These institutions rely on stable and regular dividend income. - On the other hand, investors in growth stories are lesser interested in dividend payments, preferring share price increases instead.

Cutting or cancelling dividend payments can severely impact a firm´s share price: To start with, shareholders relying on dividend income may seek to exit their investment. But also other investors clusters may be concerned, as the firm signals it may be confronted with difficulties in pursuing its business model short- / medium-term. For instance, investors foremost focused on net present value-related valuations may fear a deterioration of the amount, quality and momentum of future expected cash flows and earnings. Hence, their concern is a potentially significant decrease in the firm´s residual value. – As a result, large share packages may be changing hands, perhaps even for steep discounts.

Therefore, a prudent dividend policy is ideally long-term focused and sets a reliable framework of how much of a firm´s earnings shall be paid out to shareholders. Whilst theory suggests that investors are indifferent whether yields earned originate from share price accretion or dividend payments, reality proves otherwise, not least amid different tax treatments in major jurisdictions.

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