

The Rationale of Stock Dividends

Stock dividends have nothing in common with the concept of cash dividends. Instead, the foremost purpose of stock dividends is strengthening a firm's credit standing.

The term dividends usually refers to cash dividends. They compensate shareholders for their investment in a firm. Thereby, cash leaves the company, ending up in the pocket of the investor, who is free to decide what to do with it.

Stock dividends – however – refer to an allocation of additional shares to shareholders, whereby already the term “dividend” in this context seems misleading: The result of the transaction is an increase of the number of shares outstanding, with the equity position now divided by a larger number of shares.

Should subsequently to a stock dividend a shareholder require liquidity and decide to cash in all or part of the shares received, then that shareholder's stake or relative share in the company would be diluted. Hence, to avoid this, a shareholder would need to hang on to the newly received shares (and surrender any cash income).

As a result, a stock dividend will not alter the economic position of a shareholder in the company. Except, each 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

position of a shareholder nor that of the company itself. The only difference between pre- and post-transaction is the number of shares outstanding.

To appreciate the purpose of stock dividends, one needs to take a closer look at the structure of a company's equity position: This can be decomposed into shareholders equity, additional paid in capital, and retained earnings. Now, with no funds raised, a stock dividend does not increase the overall equity, it remains the same, as it was pre-transaction. However, as the number of shares outstanding increase, so does the sub-position shareholders equity (equaling the number of shares outstanding multiplied with the face value of each share). And with no fresh capital raised, also the additional paid in capital stays the same. - In consequence, it is the retained earnings position which will have to decrease to compensate for the increased shareholders equity position (so that the overall equity position can remain unchanged).

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 within a firm's equity are affected, not the equity position as such, though.

Hence, the rationale of a stock dividend is in strengthening a firm's shareholders equity position. But this has important consequences, as dividends are ultimately paid from the firm's retained earnings position. Now reduced, this implicitly also reduces a firm's flexibility in paying dividends, especially extraordinary (perhaps excessive) dividends. Whereby this restriction is, suffice to say, ultimately to the benefit of creditors: They are given extra comfort, as a firm's asset pool cannot be reduced as easily any longer, for example by paying extraordinary dividends to shareholders. – In conclusion: Stock dividends are ultimately to the benefit of creditors and may be seen as a means of a credit enhancement.

PRE - STOCK DIVIDEND

POST - STOCK DIVIDEND

BALANCE SHEET

BALANCE SHEET

ASSETS

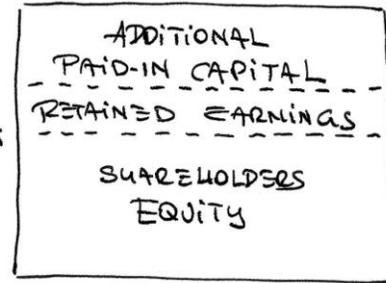
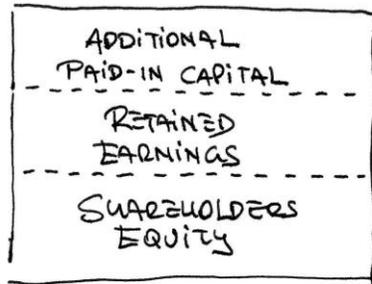
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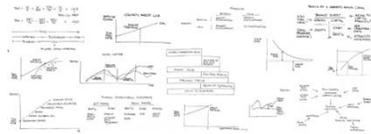
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