Dividend Policy

A firm´s dividend policy subsumes guidelines 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. Actually, in the past cash dividends were the principle indicator of a company´s financial health, long before laws required firms to disclose detailed financial information.

Whereby, loss-making firms 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 sufficiently available, dividends can be paid. Once this position is used up, no longer.

Whilst the availability of retained earnings is a condition to pay dividends, the availability of cash is actually not. Hence, if a firm lacks liquidity to cover dividend payments, then the required funds have to be raised, via loans or bonds, for instance.

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 more mature stage in their life cycle. Firms in their startup and growth phase rather tend to withhold cash to support and fund their respective growth strategies: In these stages cash requirements are driven by a firm´s capital expenditure programs as well as investments in working capital (i.e. increase inventory and receivables). – Once a firm reaches an advanced or later stage in its life cycle, though, also extraordinary or special dividends could be considered and paid, even exceeding earnings. In taking such step, retained earnings – having no more strategic relevance any longer - would be reduced, along with the firm´s total equity position. Hence, the purpose and rationale of paying extraordinary dividends is to hand back part of the equity capital to shareholders, as far as this is not required any longer. (Same can be achieved via share buybacks, by the way).

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

Therefore, formulating a dividend policy is striking a balance between a corporate´s life cycle-driven requirements with reward expectations by investors: For instance, certain groups of a firm´s shareholders, such as pension funds or life insurance companies, may have to make regular payments to their clients and stakeholders. Hence, these institutions rely on stable and regular dividend income. - On the other hand, investors in growth stories are lesser interested in dividend payments, their rather prefer share price increases instead.

Cutting or cancelling dividend payments can severely impact a firm´s share price, not least due to large share packages changing hands, by times even for steep discounts: On the one hand, shareholders relying on dividend income may simply seek to exit and divest. Other investor clusters may be concerned as well, though: A change in dividend policy could signal that a firm faces difficulties in pursuing its business model short- / medium-term. Therefore, investors with a focus on net present value-related valuations may fear a deterioration of the amount, quality and momentum of future expected cash flows and earnings. Their concern regards a perhaps significant decrease in the firm´s residual value.

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

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