

Stock Dividends

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

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

Stock dividends – however – refer to an allocation of additional shares to shareholders, with the term “dividend” actually misleading: Because the transaction's outcome (merely) results in an increase in the number of shares outstanding, with the (unchanged) equity position now divided by a larger number of shares.

Hence, a stock dividend will not alter a shareholder's economic position. Except, each shareholder will now have more shares in possession. And, as a consequence, the share price for a stock will decrease, reflecting the higher number of shares outstanding.

Should subsequent to a stock dividend transaction a shareholder actually require liquidity, then he has to sell shares. And, should he actually decide to cash in the amount of shares received in the course of the stock dividend transaction, then his 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).

From a company's perspective, on the other side, the additional, new shares issued in the course of a stock dividend do not raise any fresh capital. Instead, they 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 that the number of shares outstanding have increased.

In order to understand the purpose of stock dividends, one needs to take a closer look at the structure of a company's equity position: Latter 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 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). On the other hand, with no fresh capital raised, the additional paid in capital position will stay 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 remains the same).

Therefore: In the course of a stock dividend transaction a portion of the retained earnings (which are reduced) is transferred to the shareholders equity position (which is increased). Consequently, a stock dividend merely affects components within a firm's equity, with the overall equity position actually remaining unchanged.

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

PRE - STOCK DIVIDEND

POST - STOCK DIVIDEND

BALANCE SHEET

BALANCE SHEET

ASSETS

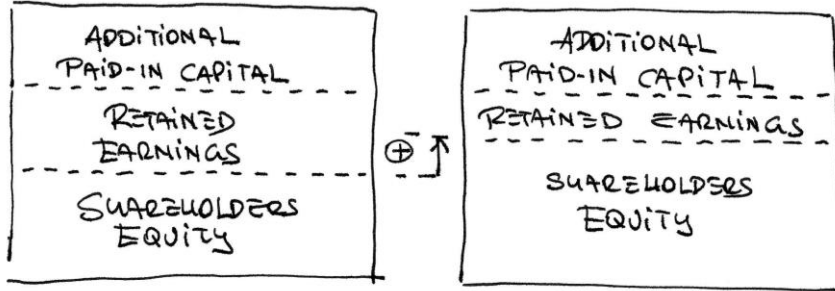
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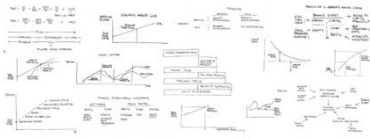
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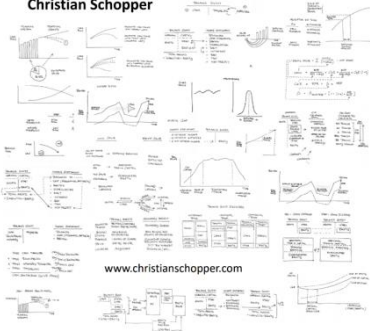


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