A Study on Dividend Policy and Its Impact on the Shareholders’ Wealth in Trading Organizations

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ABSTRACT:

The study titled ‘A Study On Dividend Policy And Its Impact On The Shareholders Wealth In Trading Organization’ focuses on dividend policy and its impact on the wealth of shareholders in the trading industry. For the purpose of this study, a trading company and three of its shareholders’ companies were selected and the dividend policies of these companies were analyzed. This was a descriptive study and the period of study was during the years 2015 to 2017. The tools used for analysis are Dividend per Share, Earnings per Share, Payout ratio and Gordon’s model. At the end of this study, it was found that the dividend policy is relevant in maximising the shareholders’ wealth. Also, many companies were not in a position to declare dividend due to retention for future purposes. It was also found that when the cost of capital decreases, the rate of return increases and this influences the market price per share.

Keywords: Dividend Policy, Market price per share (MPS), payout ratio, Dividend Per Share (DPS), Earnings Per Share (EPS) , Cost of equity

INTRODUCTION:

In today’s world, finance has an important place. The management of any company has to take decisions in various areas requiring concern. One such area is to maximise the wealth of shareholders and for this, dividend policy plays a major role. The shareholders’ wealth can be maximised if the market price of the company’s shares increases and for this to happen, the management should chalk out an appropriate dividend policy. Dividend decision is an important decision which a company has to make. The company must decide whether it should pay the dividend to its shareholders or retain the entire earnings with itself for future purpose. For joint – stock companies, dividend payment is not considered as an expense but as a division of profits after tax to their shareholders. When a company sees that
there are good investment opportunities, it must try to retain the profits to itself and go for reinvestment. But at the same time, it should see that at the end it does not result in reduction in the value of the company’s stock because of non-payment of dividend. So, the finance manager must choose an optimal dividend decision. A dividend decision is said to be optimal only when the shareholders’ wealth increases along with the value of the firm. The relevance theory of dividend supports the factors that have an impact on the market price per share namely – cost of equity, dividend and growth rate. One of the important contributions from relevance theory is the Gordon’s model. According to Gordon, the value of a share reflects the value of the future dividends accruing to that share. Hence, the dividend payment and its growth are relevant in valuation of shares.

OBJECTIVES OF THE STUDY:

- To study the impact of dividend policy on the wealth of shareholders
- To find the impact of cost of equity and growth rate on market price per share

LITERATURE REVIEW

Asquith, P., & Mullins Jr, D. W. (1983) conducted a study to investigate the impact of dividends on the shareholders’ wealth by studying 168 firms that either pay their dividend for the first time or those who initiate dividends after a ten year break and the effect of subsequent increase in dividends. The results found showed that a subsequent increase in dividend had a positive impact on the wealth of shareholders. Black, F., & Scholes, M. (1974) also conducted a research to find the effects of dividend yield and dividend policy on common stock prices and returns and concluded that it is not possible to determine or show that the expected returns coming out on a high yield stocks differ from the expected returns coming out on a low yield stocks, let it be before or after taxes. Also, it is not possible to determine the effect of a change in policy over the stock's price.

Baker, H. K., & Powell, G.E.(1999) conducted a study to know the views of managers on dividend policy and also the relationship between dividend policy and value of a firm. A mail survey sent to 603 chief financial officers of U.S firms found that most of them agreed that dividend policy affects the value of the firm. Also, the managers were also
concerned regarding the continuity of dividends when setting dividend payments.

There was also research done to find the determinants of dividend policy. The size of a firm and its profitability also has an influence in the dividend payout decision of a firm. In a study conducted during the period of 1999 – 2003 at Gulf Co-operation Council (GCC) country stock exchanges, Al-Kuwari, D. (2009) found that the dividend payout was heavily influenced with firm size and its profitability. Also, the firms listed in the GCC alter their dividend policies frequently. According to Adaoglu, C.(2000), the earnings of the corporations had a huge influence in determining the amount of cash dividends.

La Porta, R., et al (2000) for their research on agency problems and dividend policies around the world conducted an experiment on a section of 4000 employees selected from 33 countries to test the two agency models of dividend – the outcome model and the substitute model. The test results supported the “outcome model” which says that dividends are paid because of the pressure instilled by the minority shareholders. According to Alli, K. L., (1993) managerial consideration affects a firm’s payout especially for the firms that maintain a stable dividend policy.

Also the firms that have financial flexibility pay high dividends to their shareholders.

In different countries, the policy followed for dividend is also different. Andres, C., et al (2009) analysed the dividend policy of German firms and found that Germans pay out lower proportion of dividend from their cash flows but higher compared to other countries in terms of profit. Also, Germans determine dividend payout based on their cash flows and not on published earnings. The dividend policies of German firms were found to be more flexible. Denis, D. J., & Osobov, I. (2008) conducted a study with countries like US, UK, Canada, Japan, Germany and France as samples to understand the determinants of dividend policy. They found out that most of the countries were driven by the failure of newly listed firms in initiating dividends. Also, abandonment of dividend was considered economically unimportant in most of the countries except Japan.

The preference of shareholders also has an impact on the dividend policy. This was verified by Brennan, M. J., & Thakor, A. V. (1990). They state that for small distributions, the shareholders prefer a dividend payment as compared to large distributions for which the shareholders prefer an open market stock repurchase.
Mancinelli, L., & Ozkan, A., (2006) conducted a study to know the relationship between ownership structure of firms and their dividend policy by using a sample of 139 Italian companies. The results of the study concluded that if the voting rights increase for the largest shareholder, then the firms will be making a lower dividend policy. Bradley, M., et al (1998) conducted a study on dividend policy and its relationship with cash flow uncertainty. A sample of REITs from 1985 to 1992 was used. It was found that firms with high expected cash flow volatility had lower payout ratios as compared to firms with less cash flow volatility as measured by property diversification and leverage.

RESEARCH METHODOLOGY

The research design used for this study is descriptive research. The sources of data used for this study is secondary data which includes annual reports, published articles and internet sources. The study covers a period of 3 years ranging from 2015 to 2017 of the company Sicagen India (company 1) and 3 of its shareholders’ companies namely Mercantile Ventures (company 2), SPIC Ltd (company 3) and Sical Logistics (company 4). The tools used for analysis includes Dividend Per Share, Earnings Per Share, Payout ratio and Gordon’s model through which the market price and the value of the firms were found.

DATA ANALYSIS & INTERPRETATION

The 4 companies’ dividend policy and its payout ratio is found here.

Table 1: Analysis of dividend & payout ratios

<table>
<thead>
<tr>
<th>Company</th>
<th>Years</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>DPS</td>
<td>EPS</td>
<td>PAYOUT</td>
</tr>
<tr>
<td>Company 1</td>
<td></td>
<td>0.6</td>
<td>0.77</td>
<td>77.9</td>
</tr>
<tr>
<td>Company 2</td>
<td></td>
<td>Nil</td>
<td>1.90</td>
<td>Nil</td>
</tr>
<tr>
<td>Company 3</td>
<td></td>
<td>Nil</td>
<td>0.86</td>
<td>Nil</td>
</tr>
<tr>
<td>Company 4</td>
<td></td>
<td>Nil</td>
<td>4.89</td>
<td>Nil</td>
</tr>
</tbody>
</table>

(Source: Annual Reports)
From table 1, it is found that the dividend per share for all 3 years were constant for company 1. Only the earnings per share were changing due to profits of the company. Also, when the profits were less in one year, the payout was more in order to satisfy the shareholders. So change in profit influences the earnings per share which in turn influences the dividend payout ratio. The other companies who have good earnings per share did not declare dividends due to accumulated losses and reserves for future purposes.

**Table 2: Analysis of relationship between cost of equity & growth rate on market price of Company 1**

<table>
<thead>
<tr>
<th>Year</th>
<th>Cost Of equity (Ke) (In %)</th>
<th>Growth Rate (g) (in %)</th>
<th>Market Price per share (MPS in Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>5.6</td>
<td>0.15</td>
<td>12.20</td>
</tr>
<tr>
<td>2016</td>
<td>4.7</td>
<td>1.14</td>
<td>16.70</td>
</tr>
<tr>
<td>2017</td>
<td>3.5</td>
<td>1.19</td>
<td>25.65</td>
</tr>
</tbody>
</table>

The market price per share is determined based on the tool used for this study - Gordon’s model. From the table 2, it is found that in the first year, the cost of equity was more for company 1 and so the growth rate was less. This influenced the market price which became low. In the second year, the market price increased slightly due to a slight decrease in cost of equity. Whereas in the third year, the market price per share increased due to decrease in cost of equity and increase in the growth rate. It is found that when cost of equity was less the growth rate was more and so the market price per share is also increased. But when the cost of equity increases, the market price per share gets decreased. This shows the relationship between the cost of equity and growth rate on the market price per share of a company’s stock.

**DISCUSSION:**

The relation between cost of equity and growth rate was analysed for this study to find the impact of dividend on the shareholders’ wealth. Taking into account the analysis of 3 years, in the first year, the cost of equity was high at 5.6 %. In the next year, it was 4.7 % followed by 3.5% in the current year. The change in cost of equity impacted the growth rate of the company, thereby affecting its market price per share and its dividend payout. Thus, it was proved that there is a relationship between cost of equity and
growth rate on the market price of a company’s shares, which in turn influences the dividend payout thereby impacting the shareholders’ wealth.

CONCLUSION

Dividends are important for any investors. The decision regarding payout and retention is all the more crucial for any finance manager. The reduction in the cost of equity and increase in the growth rate helps a company to improve considerably their market price per share and earnings per share. This increase in market price per share will help in increasing the wealth of shareholders. From the analysis, we can come to the conclusion that the relevance theory of dividend policy is relevant for valuation of a company’s shares which helps in increasing the wealth of shareholders.

REFERENCES:


