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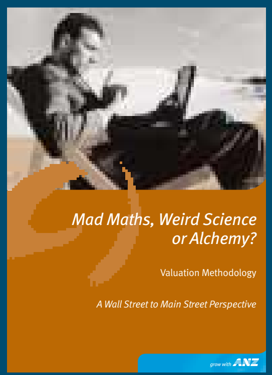

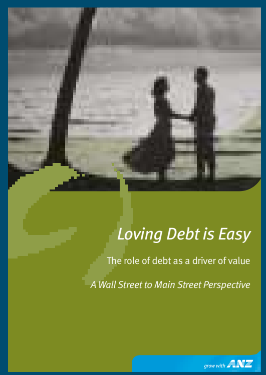

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Is your dividend policy liquidating your business?

Dividend policy and shareholder value

A Wall Street to Main Street Perspective

grow with ANZ

"The trouble is that high dividend distributions constrain good re-investment decisions as well as bad. The trade-off is often lower levels of investment, lower R&D, lower levels of risk taking, 'short-termism', and lower innovation etc."

Joseph Healy
Head of Private Equity
ANZ Investment Bank

Contents

There is an argument that dividends can be seen as an admission of failure by managers in their search for growth and that a dividend payment is a partial liquidation of the business.

In 1973, Joel Stern wrote an article[1] for the editorial page of The Wall Street Journal arguing for low dividends. The article attracted several strongly worded responses including one manager who wrote; "While Mr Stern is gambolling from pinnacle to pinnacle in the upper realms of the theoretical, those of us in financial management are down below slogging through the foothills of reality."[2]

Preface

When we published "Loving Debt is Easy", a commentary on how debt can be a driver of value, we promised to attempt to reconcile theory with the practice of dividend policy. This publication does that, highlighting aspects of current practice that would benefit from a rethink. Whilst this publication has a theoretical basis, we attempt to give it a practical slant so it is of use to our target audience – directors and senior executives, i.e. those responsible for shareholder value – in the "foothills of reality".

Generally speaking, our view is that the dividend policies of companies tend to destroy rather than add shareholder value in any meaningful way; policies are often driven by a perception that company performance, and hence value, is linked to the company's ability to pay a dividend. This perception is misplaced; it tends to "miss the boat" on what real drivers of value are.

Adding to this is the fact that, historically, dividend payout ratios have been high and there has been a reluctance to reduce dividends as this can be perceived as a sign of poor performance. Whilst we agree that reducing dividend levels in some circumstances can have negative impact, the reality is that previous dividend levels have no place as a basis for dividend policy.

These are broad areas of inefficiencies that are evident in the way companies form dividend policy, and consequently, how they manage capital. This publication expands on our view of these inefficiencies, and, as with our previous publications[3], our comments are driven by our desire to assist our customers in their quest for value. Whilst perhaps confrontational, we think there is a compelling case for a rethink on dividend policy. It is clearly impacting shareholder value – in the wrong direction.

After all, maximising shareholder value is the fundamental purpose of a business.

Introduction

Like debt policy, dividend policy is a much-neglected area of a firm's corporate finance policy. "Myopic thinking" and "market myths" influence it more than the pursuit of shareholder value. Consequently, a poorly thought through dividend policy can destroy shareholder wealth.[4]

Dividend policy must be tailored to synthesise with the strategic and financial economic characteristics of each company. This will be an ongoing process viewed through a "long term lens". In addressing dividend policy, the key issues should be:

› **Strategic Growth Options:** How do the company's growth options impact the ability to pay a dividend, particularly where growth returns are greater than dividend returns?

› **Residual Funds:** If there is a residual available after financing growth options, what portion of this should be paid out as a dividend?

› **Communicating the Story:** How will investors view a change in dividend policy and how compelling is the firm's strategic position?

Taxation consequences and transaction costs should also be taken into account.

Our research indicates that these issues are not being comprehensively addressed. Instead the mentality appears to be a "one-size-fits-all" one where maintaining high payouts is the driving focus. We also think that dividend policy is driven by "corporate myths" of which, we have identified four:

› **Dividends Maximise Shareholder Wealth:** On the contrary, only the realisation of growth options achieves this.

› **Short-Termism:** The argument that shareholder expectations force management to focus only on the next dividend payment is simply not supported by the evidence.

› **Agency Costs are Reduced:** In fact, by linking management rating and company performance to the ability to pay a constant or increasing dividend, shareholders risk higher agency costs in the form of dilution of wealth and an inability to convert growth options into real wealth.

› **Share Buy-Backs are Dividends in a New Guise:** Share buy-backs are not "dividends" in nature; they are more a tool for achieving a fundamental change to capital structure. Dividends cannot and should not attempt to play this role.

Before delving into the points above, our primer for provoking thought is:

With rational shareholders and having regard to growth options available to it, should a company pay a dividend even if it can comfortably do so and has done so regularly in the past.

Theories

Dividend Valuation Model ("DVM")

The DVM states that the value of equity is the present value of the future dividend stream discounted by investors' **expected** rate of return (investors may in practice also receive capital gains from selling shares but such capital gains reflect the next purchaser's expectations of the value of future dividends).

However the DVM makes assumptions which:

› for growth companies, are very difficult to make with any accuracy;

› may lead management into a dividend payment policy which does not maximise shareholder wealth given investment opportunities; and

› results in many shareholders facing higher taxation than may otherwise be necessary.

Other

There are several theories that explain the role of dividends: Taxation (Miller and Scholes, 1982); Litzenberger and Ramaswamy, 1979); Transaction costs (Pettit, 1977); Target Gearing (Feldstein and Green, 1983); Signalling future prospects (Bhattacharya, 1979; Miller and Rock, 1985); controlling for free cashflow agency costs (Jensen, 1986, Grossman and Hart, 1982); and Shareholder diversity (Bagwell-Judd, 1988).

Strategic **growth** options

Dividend policy, like all corporate finance initiatives, should necessarily evolve from a firm's strategic position, the nature of its core competencies, competitive advantages and the quality of management.

Our thinking goes like this:

As a starting point management must ask:

"Given our options for growth and our targeted capital structure, will there be funds available after we invest in EVA™[5] positive growth options?"

Growth options stem from a company's strategic position. Capital requirements and the important aspect of investment timing will also flow from the strategy. Thus, the question posed above is not a one-period question but one that needs to be posed in the context of the current **and** future capital expenditure programmes, for both maintenance capital expenditure and EVA™ positive projects.

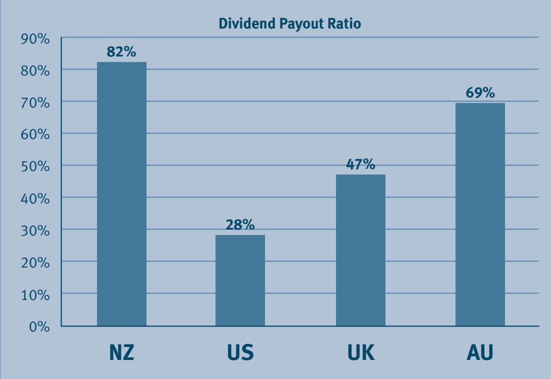
Linked to this is the issue of communicating strategy to the investor base. In the context of dividends, poor communication as to strategic growth options will not help a firm when it wants to make changes to dividend payout levels to fund growth. More on this later.

We haven't talked much in this section of dividend policy, but that's just the point! Dividend policy must be subservient to a company's strategic prospects and the consequential capital requirements. Whilst both should consider the implications of capital market inefficiencies, to put dividend policy ahead of these seriously risks starving growth channels. Moreover, in doing so the dividend payment amounts to a premature liquidation of the business!

Here's Some Evidence:

The vast majority of all publicly listed Australian and New Zealand companies making profits pay dividends, even though as a consequence some of those companies will have to either approach the capital markets to meet investment needs, or not make necessary investments!

Dividend Policy



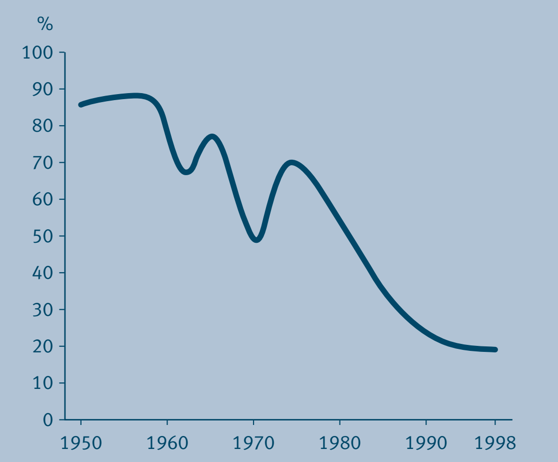
Paying a dividend is a major part of our corporate psyche and is based seemingly on the myth that firms that pay dividends create more shareholder wealth than those that don't – see our discussion of myths below.

We believe that dividend policy in Australia and New Zealand suggests we are under-investing by focusing on current consumption.

The US Experience

This situation is in stark contrast to the situation in the US,[6] where the number of dividend paying companies has reduced significantly since the 1950s!:

% of Companies Paying Dividends



Source: The Economist, 20 November 1999

What's behind this?

Despite US bosses being historically protective of dividend payouts, the real commitment has been towards investing in growth options. As a consequence, the current view is that paying dividends may just as easily signal an admission from the company it has run out of ideas on how to grow the business.

Perhaps this fictitious dialogue between an ANZ Corporate Banker (ANZ) and a CEO illustrates the point:

ANZ We can't help but observe that your company has significant growth opportunities, yet still maintains a high dividend pay-out ratio.

CEO Our shareholders expect a high dividend pay-out ratio; that is what the company has done for years. We have many loyal shareholders whose support depends on maintaining this ratio.

ANZ But you have a set of strategically consistent growth options with returns greater than your shareholders' required return on equity, and if you maintain a high dividend pay-out ratio, you may have to pass up on these options.

CEO The explanation is this; you must agree that shareholders value shares as the present value of future dividends.

Value of a share equals the present value of future dividends.

$$V = \frac{eps \times r \times (1+g)}{(R-g)}$$

V	Value per share
eps	Earnings per share
r	Pay-out ratio
g	Growth
R	Required return of equity
eps x r	Dividend per share

ANZ Yes that is correct, dividends represent actual cashflows to shareholders, and value is based on the present value of future cashflows.

CEO You will also agree that our current share price of $1.37 is based on our current dividend pay-out ratio.

$$\$1.37 = \frac{\$0.20 \times 80\% \times (1+3\%)}{(15\%-3\%)}$$

ANZ Yes, go on.

CEO If we cut our pay-out ratio from 80% to 50% in order to adopt future projects, our share price will drop to 86c destroying shareholder value.

$$\$0.86 = \frac{\$0.20 \times 50\% \times (1+3\%)}{(15\%-3\%)}$$

ANZ Hmmm, that's not quite right. By cutting your dividend your shareholders forego dividends now for higher dividends in the future. The lower pay-out ratio means funds available for investing in growth for the company will be higher as the new projects have a higher return on equity than your current business. As the future projects generate returns which are greater than the return required by your shareholders on their invested capital, cutting your dividend to take on future projects will create value for shareholders. That in turn will increase your share price from $1.37 to $1.54!

g	= (1- r) x ROE
ROE	Return on Equity
Status Quo Growth	3%=(1- 80%) x 15%
Growth under new Dividend Policy	8%=(1- 50%) x 16%

(note: assume return on project increases to 16% reflecting growth while required return on equity remains unchanged)

$$\$1.54 = \frac{\$0.20 \times 50\% \times (1+8\%)}{(15\% - 8\%)}$$

The acid test is: If a company has a range of attractive growth options, why doesn't management cut the dividend and invest that equity in those growth options? It is after all, the rational thing to do!

Residual funds

A dividend should be paid out only where, having exhausted investment in EVA™ positive growth, residual funds are available to pay a dividend. Where residual funds are not available, there is always the option of "financing" the dividend if doing so optimises capital structure. However, proceed with caution!

Don't get caught out by some of the traps inherent in financing a dividend payment:

› **Dilution:** Other than for optimising leverage, If management chooses to raise debt or equity to replace the dividend, then current shareholders' interests are diluted by introducing new claims on future cash flow, which is bad news if the company has good growth prospects;

› **Costs:** Raising debt and equity also makes a company incur transaction and interaction costs for unnecessary financing (cash paid out as a dividend could be used to reduce the firm's external financing requirements); and

› **Tax:** In certain circumstances, paying dividends forces investors to pay tax (i.e. where the dividends are not fully imputed, or, even if fully imputed, where the recipient is subject to tax at the top marginal rate) on dividends that might otherwise be deferred, or not paid at all were they to realise the same value as a capital gain by selling the shares (for shares held as capital assets).

Communicating the story

Our view is that many of the "market perception" issues upon which dividend policy appears to be based can be addressed by a proper communication to investors as to the firm's growth options and its underlying corporate strategy. Achieving this should, in theory, give shareholders an understanding as to what investment requirements there are and how this might affect dividend payments.

If properly presented to investors and the market, a cut in dividend can send a positive signal. A company would, however, have to convince the market that it has opportunities for making value-enhancing investments, and that it is using the cash saved to exploit those opportunities.

A positive market response is consistent with using retained earnings[7] to fund investment that the market views as capable of providing a return greater than the firm's cost of capital. Retained earnings are the least costly source of new financing. Funding opportunities from this source means companies avoid the costs of new equity (underwriting, dilution, after-market performance etc.) or debt raising (arranging, underwriting, covenants, financial distress etc.)[8]. These costs can be significant.

This is particularly the case for companies that have a close-to-optimum debt level or that wish to retain "headroom" in terms of debt capacity. These companies must issue new equity to fund any increase in dividends if investment opportunities are to be pursued. Bear in mind here our comments on the traps involved with financing dividend payments.

"Do not formulate dividend policy in an attempt to influence shareholders' returns. Instead, set dividend policy in the context of the company's own investment needs and financing options, and then carefully explain it to investors."

Bennett Stewart, The Quest For Value[9]

The **myths** of dividend policy

Introduction

Some of the arguments in favour of paying dividends (not that we necessarily agree with them) might be:

› Dividends in the hand allow shareholders to enjoy current consumption, diversify their portfolio and minimise transaction costs i.e. the cost of selling shares to satisfy their need for cash;

› Current dividends have a higher value than future capital gains or dividends, given the risk associated with the latter;[10]

› Maintaining dividend payout levels reduces agency costs through forcing firms as a consequence to seek outside capital to fund growth option projects; and

› Dividends contain signals or information about future prospects and as such give investors a steer as to how best to maximise wealth i.e. hold, buy, or sell (Bhattacharya 1979,[11] Miller & Rock 1985).

Whilst there is some theoretical support for these arguments, they may well conflict with maximising shareholder value! Moreover, we contend that they are often based on some of the myths that surround dividend policy.

Myth One

Paying Dividends is consistent with Maximising Shareholder Value.

Going back to basics, the value in a business comes from its competencies and assets, and the growth options embedded in them. To a lesser extent, value can be fostered through the manner in which the assets are financed.[12] Paying a dividend is only a consequence of revenue streams that a business' assets have delivered. It is essentially a liabilities side of the balance sheet matter. So it is totally implausible to think of dividends as being a source of **value** to shareholders. They never can be!

Dividend policy is purely a function of a firm's financing decision. It should have no impact on a firm's investment decisions, i.e. whether it will invest in a growth project or not. Its impact on a firm's value is confined to the value implications of optimising firm capital structure ie. the relevance of debt level to the firm's value.[13]

Rational shareholders will defer dividends today for bigger dividends later. If, instead of paying high dividends, managers are investing in EVA™ positive growth, shareholders will be motivated by the prospect of the greater wealth that will result. Shareholders who need income can simply sell shares. The value to the shareholder should be exactly the same (putting tax and transaction costs to one side).

Shares that go ex-dividend illustrate this. Their price falls by the amount of the dividend, never to regain that particular loss in value i.e. dividends gained are equal to capital gains lost. Modigliani and Miller (M&M) called this the **dividend irrelevance theorem**.[14]

Myth Two

Shareholder Expectation of Dividends Forces a Short-Termism on the Part of Management and Boards.

This myth assumes that financial markets seek regular dividend payments from current accounting profits. A focus on the next dividend payment and dividend expectations can result in a negative share price reaction when dividends are trimmed.[15]

This is inconsistent with the fact that shareholders want companies to invest in growth options to generate returns that are greater than the company's cost of capital.

It reflects to some extent the difficulty with dividends which is, once paid, there is an expectation they will continue to be paid, and at a growing rate. Thus management is reluctant to make adverse dividend changes. Management's concerns are validated by empirical evidence.[16]

However, there is no evidence that markets are short-term focussed. In fact, the valuation that markets give some high-tech stocks evinces the opposite; in present value terms, they demonstrate a preference for greater wealth tomorrow over less wealth today. After all, if a shareholder wants money, it can always sell shares.

Thus the market should not be concerned about a cut in dividend where the cut is funding investment in EVA™ positive projects. We think that an insistence on continuing or higher dividends reflects more a lack of confidence in management's ability to deliver growth than a reflection on the market per se. This may stem in part from management's inability to articulate the business' strategy or convince shareholders that it is value additive.

Myth Three

Agency costs are reduced and corporate governance enhanced by a commitment to a dividend policy.

The myth is that a commitment to a set dividend pay-out ratio is a ready and easy way for shareholders to monitor management and a check on governance standards. It is based on shareholder concerns about the cost of managers using surplus cash of the company to further their interests at the expense of shareholders' interests (agency cost), or invest in EVA™ negative initiatives.

This is based on the perceived information asymmetry between managers and shareholders. It drives investors to believe that managers have a tendency to give out good news quickly, and bad news slowly – news which they have but investors do not. Investors are, accordingly, suspicious of what managers have to say.

We believe, however, that commitment to a set dividend pay-out ratio can undermine corporate governance! It risks creating a single yardstick against which management-performance is measured which, if satisfied, can implicitly authorise management to pursue value destroying activities (e.g. Brierley Investments in recent times). Moreover, it can be elevated to be a determinant of investment policy, and may cause managers to make a dividend payment instead of investing in EVA™ positive projects. This is simply ludicrous!

In our view, the prominence of the corporate governance argument for paying dividends is attributable more to investors not having the time or resources to monitor their investments, particularly for investments in small-to-mid sized firms.[17] This can be no more than a litmus test of performance – so long as a dividend is paid (no lower than last year), then all is well. Who wants to see value measured by a litmus test?

Myth Four

Share Buy-Backs are Dividends in a New Guise.

Studies have proven share buy-backs are not replacing dividends.[18] Companies making buy-backs are in fact still paying dividends at a rate not affected by the fact that a buy-back is also being done or is available as an option. One study in particular found no evidence that companies stop paying dividends because they can buy back shares instead.[19]

An interesting observation is that whilst share buy-backs and dividends are mechanisms for making "distributions" to shareholders, it is not often that you see shareholders responding negatively if there is no share buy-back in an annual distribution. We would argue that share buy-backs are more a tool for addressing capital structure in a fundamental or meaningful way. On the other hand, dividends are, for historic reasons, seen as a weather-vein of financial performance, albeit that they too are a mechanism for altering capital structure. Our view is that dividends are a poor cousin when it comes to being used as a tool for addressing capital structure; share buy-backs tend to function more effectively in this realm.

Tax

No discussion on dividend policy would be complete without reference to tax. However, as with most tax topics, this area is worthy of a paper in its own right! Our comments here are essentially skin-deep and are given to complete our conversation.

Differential tax treatments between dividends and capital gains challenge the dividend irrelevance theorem. Specifically, if there is a difference in tax treatments with respect to how a shareholder accrues or receives value from their shareholding, it may be appropriate to take tax into account in formulating dividend policy. Present value of any future capital gains tax liability is another point in favour of considering tax in dividend policy.

The key question, as always, is what policy will best preserve shareholder value. Logically, the policy that results in less value passing to a party other than the shareholder (such as the Government) should be favoured where there is a legitimate choice.

In Australia and New Zealand dividends are subject to a different tax treatment in the hands of shareholders than applies for capital gains (depending, of course, on the circumstances of the particular recipient). But whether this translates to an economic difference depends chiefly on two factors: the recipient shareholder's tax rate; and the ability of the paying company to impute the dividend.

As a general proposition, when forming dividend policy, firms should consider tax differentials and the tax profile of their shareholders.[20] Where a firm has EVA™ positive growth options, even if it can fully impute its dividends, we suggest the company should invest in growth rather than pay out dividends.[21]

A final note on tax: provided dividend substitution rules are met, a share buy-back funded from paid-up capital can effect a tax-free distribution to shareholders. This, however, is a limited tool given that a buy-back made in substitution for a dividend will itself be treated as a dividend for tax purposes.

*Non-listed companies – **you are not off the hook!***

We have talked a lot in this publication about market perceptions and how dividend policy can be based on management views as to investor expectations. Hopefully we have already convinced you that this is a fundamentally wrong angle from which to approach dividend policy.

You might ask how relevant this commentary is to non-listed companies. Well, the answer is that it is totally relevant. The real issue is that dividend policy should be secondary to strategy and investment in growth options – that is something that non-listed companies cannot escape!

In fact, in some respects a non-listed company will have an easier road to the right dividend policy. When it comes to communicating the story, in the majority of cases, this will be a case of convincing a more closely held group of shareholders.

Moreover, if private company owners need cash then they would do well to consider raising funds for investment in growth or even a recapitalisation of the business.

Concluding remarks

Generally speaking, the dividend policies of Australian and New Zealand companies are not maximising shareholder value. A well-developed dividend policy that is driven by investment and strategic decisions will add to shareholder value; a dividend policy with a "myth-based" focus will destroy shareholder value.

Putting taxes to one side, so long as investment and borrowing policies are held constant, a firm's overall cashflows and value are the same regardless of dividend policy. Equally the risks borne by all the firm's shareholders are fixed by its investment and borrowing policies, and are unaffected by dividend policy.

Shareholders who look for constant or increasing dividends, where attractive investment opportunities exist, put at risk future dividends and incremental wealth. This arises as a consequence of the company having to either undertake additional borrowing – putting additional pressure on cashflows – or issuing equity – resulting in a transfer of ownership of the firm to new shareholders. We have pointed out the potential pitfalls in financing a dividend.

Where there are positive EVA™ investment opportunities open to a business, reinvesting funds available is the rational thing to do. Shareholders that need cash can sell their shares. Dividend payout can amount to a partial liquidation of the business. Moreover, by paying dividends and forsaking investment in growth,a company will risk being overtaken by its competitors and as a result de-leverage its ability to compete strategically. This will compound the erosion of shareholder value.

Dividend expectations once set are difficult to reduce. However, in efficient markets, i.e. those properly informed, dividends ought not to determine investor views as to shareholder wealth, so long as they understand the EVA™ positive investment opportunities. Skillful communication of the long-term strategy to shareholders is crucial.

Differentials between dividend and capital gain taxation may require that firms consider shareholder tax consequences when forming dividend policy.

A company should set its corporate finance policy to maximise shareholder value; paying dividends doesn't always support that objective.

We hope we have convinced you that there is a need to think about dividend policy within both financial and strategic contexts. For a deeper commentary, or if you would like us to review your dividend policy, call your ANZ corporate banker or someone from our private equity team.

Notes

1 The Wall Street Journal, "The Dividend Question", Stern, J., July, 16, 1973, p.13.

2 The letter was from A.J.Sandbuttle, SVP, Minnesota Light and Power and appeared in The Wall Street Journal on 20th August, 1973, p16.

3 The first publication on Valuation Methodology entitled Mad Maths, Weird Science or Alchemy? was followed by a second publication on Debt policy and Capital Structure entitled Loving Debt is Easy.

4 This is particularly the case in less efficient capital markets, because in theory (putting tax and transaction costs aside), it is the operating assets of the business which drive value not financing decisions. The extent to which dividends are paid, investment needs can be met either in the form of borrowings or through a rights issue. In shallow capital markets, however, the costs of this "recycling" of cash can be high.

5 EVA™ is a registered trade mark of Stern Stewart & Co.

6 The Economist (20th November 1999, p103) highlights that; in corporate America, paying dividends has gone out of fashion.

7 This is the so-called pecking order theory. Brealey defines dividend policy as a trade-off between retained earnings on the one-hand, and paying out cash and issuing new shares on the other. This trade-off may seem artificial at first, as firms don't raise new equity or take on new debt every time they make a dividend payment. Over time, however, many firms do go to the capital markets to "replace" cash that has been paid out.

8 Myers, in the The Capital Structure Puzzle, Journal of Finance, 1984, points out that if investment projects have to be financed by external funds, the information "asymmetry" between management and shareholders may lead to an underpricing of the new issue. Current shareholders would therefore suffer a loss of wealth if the investment turned out to be worth more than the market gave the company credit for in pricing the new shares. To avoid such a consequence, management ought to finance growth from internal funds. Given this logic, a dividend cut may be interpreted as a good signal.

9 B. Stewart, The Quest for Value: A Guide for Senior Management, Harper & Row, 1990.

10 Myron Gordon (1959).

11 S. Bhattacharya, "Imperfect Information, Dividend Policy, and the 'Bird in the Hand' Fallacy" The Bell Journal of Economics, 1979.

12 See our publication Loving Debt is Easy.

13 See our publication Loving Debt is Easy.

14 Merton H. Miller and Franco Modigliani, "Dividend Policy, Growth, and the Valuation of Shares." Journal of Business 34 (October 1961): 411–433.

15 Linter (1956) J. Linter "Distribution of Income of Corporations Among Dividends, Retained Earnings and Taxes", American Economic Review, Vol. 4, 1956, believed that management "manage" dividends progressively to show steady growth in line with perceived market expectations, that they should grow or at least not decrease; and that dividends should be viewed as an annuity.

16 Marsh (1992) concluded from research on 6,000 UK dividend announcements and abnormal stock price reaction: "the market interprets cuts as a powerful signal of bad news".

17 This is where the monitoring service that attaches to debt is beneficial to shareholders. See Loving Debt is Easy.

18 The Economist, 20th November, 1999, p103.

19 Professors French (MIT) and Fama (Univ. of Chicago).

20 Firms also have the option of paying dividends out as stock splits or bonus issues or giving shareholders a choice between a cash dividend or a stock dividend.

21 Miller (1985) argued that dividend policy should be cognisant of personal tax on dividends. Where dividends are taxed more highly than capital gains, then a company should cut dividends even if that reduces the stock price in the short term. A firm can address the personal taxation disincentive to dividends either by buying back stock or investing funds in a positive Net Present Value project thereby increasing shareholder wealth that way.