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Dividends and Dividend Policy

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Learning Objectives

By the end of this chapter, participants will be able to:

- Define dividends and dividend policy
- Explain the importance of dividend decisions
- Identify different forms of shareholder distributions
- Explain the dividend-payment process
- Calculate dividend per share and payout ratios
- Distinguish dividends from retained earnings
- Explain major dividend-policy theories
- Apply residual dividend policy
- Evaluate stable and constant-payout policies
- Explain stock dividends and stock splits
- Evaluate share-repurchase decisions
- Identify factors affecting dividend decisions
- Assess dividend policy and organizational value
- Recommend a sustainable dividend policy

Chapter Roadmap

This chapter covers:

1. Meaning of dividends
2. Sources and forms of dividends
3. Dividend-payment process
4. Dividend measures
5. Dividend-policy objectives
6. Factors affecting dividends
7. Dividend-policy theories
8. Residual dividend policy
9. Stable and constant-payout policies
10. Stock dividends and stock splits
11. Share repurchases
12. Dividends, growth and value
13. Practical dividend decisions

SECTION

Introduction to Dividends

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What Is a Dividend?

A dividend is a distribution of company earnings or accumulated reserves to shareholders.

Dividends may be distributed through:

- Cash
- Additional shares
- Property or assets
- Special distributions
- Share repurchases

What Is Dividend Policy?

Dividend policy is the framework a company uses to determine:

- How much profit to distribute
- How much profit to retain
- When dividends will be paid
- Which form of distribution will be used
- Whether dividend payments should remain stable
- How shareholder expectations will be managed

The Central Dividend Decision

Management must decide whether earnings should be:

Distributed to Shareholders

Through dividends or repurchases.

Retained in the Business

- Expansion
- New projects
- Debt repayment
- Working capital
- Asset replacement
- Reserves and contingencies

Dividend Policy as a Financing Decision

Dividend policy affects financing because retained earnings are an important source of equity capital.

Higher dividends generally mean	Lower dividends generally mean
• Lower retained earnings • Greater need for external financing	• Higher retained earnings • Greater internal financing capacity

Dividend Policy as an Investment Decision

Profits should be retained when the company has investments expected to earn more than shareholders' required return.

Profits may be distributed when:

- Attractive investments are unavailable
- Internal funds exceed financing requirements
- Shareholders can earn better returns elsewhere

Dividend Policy as a Shareholder Decision

Shareholders may prefer dividends because they provide:

- Current income
- Predictable cash flow
- Reduced uncertainty
- Evidence of profitability
- Confidence in management
- Funds for consumption or reinvestment

Why Dividend Policy Matters

Dividend policy may affect:

- Shareholder satisfaction
- Share price
- Internal financing
- Capital structure
- Liquidity
- Cost of capital
- Market expectations
- Growth capacity
- Financial flexibility

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Sources of Shareholder Return

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Total Shareholder Return

Shareholder return generally comes from:

1. Dividend income
2. Capital gains or losses

Total Shareholder Return
= Dividend Yield + Capital-Gain Yield

Dividend Income

Dividend income is the cash or other benefit distributed to shareholders.

It provides a return without requiring the investor to sell shares.

Capital Gain

A capital gain occurs when:

Selling Price > Purchase Price

A company that retains earnings successfully may increase share value through future growth.

Dividend Yield

$$\text{Dividend Yield} = \text{Annual Dividend per Share} \div \text{Market Price per Share} \times 100$$

Dividend-Yield Example

Assume:

- Annual dividend per share: ETB 6
- Market price per share: ETB 80

$$\text{Dividend Yield} = (6 \div 80) \times 100$$

Dividend Yield = 7.5%

Capital-Gain Yield

$$\text{Capital-Gain Yield} = (P_1 - P_0) \div P_0 \times 100$$

Where:

- P_0 = beginning share price
- P_1 = ending share price

Total-Return Example

Assume: Beginning price ETB 80 | Ending price ETB 88 | Dividend ETB 6

Dividend yield = 6 ÷ 80 = 7.5%
Capital-gain yield = (88 – 80) ÷ 80 = 10%

Total return = 7.5% + 10% = 17.5%

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Types of Dividends

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Major Forms of Dividends

Companies may distribute value through:

- Cash dividends
- Stock dividends
- Property dividends
- Special dividends
- Liquidating dividends
- Share repurchases

Cash Dividend

A cash dividend is a direct cash payment to shareholders. It is the most common form of dividend.

Cash dividends reduce:

- Cash balances
- Retained earnings
- Total shareholders' equity

Regular Cash Dividend

A regular dividend is paid according to an established schedule. It may be:

- Monthly
- Quarterly
- Semiannual
- Annual

Regular dividends create shareholder expectations.

Interim Dividend

An interim dividend is paid before the company’s final annual results are approved.

It is usually based on:

- Interim profit
- Current cash flow
- Management expectations
- Available distributable reserves

Final Dividend

A final dividend is normally recommended after annual financial results are completed.

Depending on governance arrangements, it may require:

- Board recommendation
- Shareholder approval
- Confirmation of distributable profit
- Review of liquidity

Special Dividend

A special dividend is a non-recurring distribution. It may be paid when the company has:

- Exceptional profits
- Excess cash
- Asset-sale proceeds
- Unusually strong liquidity
- Limited investment opportunities

Property Dividend

A property dividend distributes assets other than cash. Examples include:

- Shares in another company
- Products
- Securities
- Physical assets

Property dividends are less common and may involve valuation and tax complexity.

Liquidating Dividend

A liquidating dividend represents a return of invested capital rather than a normal distribution of earnings.

It may occur when:

- Operations are being closed
- A business unit is sold
- Capital requirements decline
- Assets are permanently reduced

Stock Dividend

A stock dividend distributes additional shares to existing shareholders.

A 10% stock dividend provides
10 additional shares for every 100 shares owned

Cash Dividend vs Stock Dividend

Cash Dividend	Stock Dividend
Distributes cash	Distributes additional shares
Reduces liquidity	Preserves cash
Provides immediate income	Increases number of shares
Reduces retained earnings	Transfers equity accounts
May affect share price directly	Adjusts value per share

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Dividend Payment Process

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Major Dividend Dates

The dividend-payment process normally includes:

1. Declaration Date →
2. Ex-Dividend Date →
3. Record Date →
4. Payment Date

Declaration Date

The declaration date is the date on which the board formally announces:

- Dividend amount
- Record date
- Payment date
- Eligible class of shares
- Form of distribution

After declaration, the dividend may become a legal obligation.

Ex-Dividend Date

The ex-dividend date is the date from which a purchaser of the share is no longer entitled to the declared dividend.

An investor buying on or after the ex-dividend date normally does not receive the upcoming dividend.

Record Date

The record date determines which registered shareholders are entitled to receive the declared dividend.

The company reviews its shareholder register on this date.

Payment Date

The payment date is the date on which the company distributes the dividend to eligible shareholders.

Payments may be made through:

- Bank transfer
- Cheque
- Broker account
- Dividend-reinvestment plan
- Electronic-payment system

Theoretical Ex-Dividend Price

Ignoring taxes and market movements, the share price may decline by approximately the dividend amount on the ex-dividend date.

Example: Cum-dividend price ETB 100 | Dividend ETB 5

Ex-dividend price = 100 − 5 = ETB 95

Dividend-Process Timeline

1. Declaration Date
2. Ex-Dividend Date
3. Record Date
4. Payment Date

The exact sequence and timing depend on market rules and company procedures.

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Dividend Measures

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Dividend per Share (DPS)

DPS = Total Common Dividends
÷ Number of Common Shares

DPS measures the dividend allocated to each common share.

DPS Example

Assume: Total common dividends ETB 12 million | Common shares 2 million

$$\text{DPS} = 12{,}000{,}000 \div 2{,}000{,}000$$

$$\text{DPS} = \text{ETB } 6$$

Earnings per Share (EPS)

$$EPS = \text{Profit Available to Common Shareholders} \div \text{Weighted Average Common Shares}$$

EPS represents profit attributable to each common share.

Dividend Payout Ratio

$$\text{Payout Ratio} = \text{Dividends} \div \text{Net Income to Common Shareholders} \times 100$$

It may also be calculated as:

$$\text{Payout Ratio} = (\text{DPS} \div \text{EPS}) \times 100$$

Payout-Ratio Example

Assume: EPS ETB 15 | DPS ETB 6

$$\text{Payout Ratio} = (6 \div 15) \times 100$$

Payout Ratio = 40%

Retention Ratio

The retention ratio measures the proportion of earnings retained.

$$b = 1 - \text{Dividend Payout Ratio}$$

$$b = 1 - 0.40 = 60\%$$

Retained Earnings

Retained Earnings for the Period
= Net Income – Dividends

Retained earnings increase internal equity financing.

Dividend-Cover Ratio

Dividend Cover = EPS ÷ DPS

It shows how many times earnings cover the dividend.

Dividend-Cover Example

Assume: EPS ETB 15 | DPS ETB 6

$$\text{Dividend Cover} = 15 \div 6$$

$$\text{Dividend Cover} = 2.5 \text{ times}$$

Interpreting Dividend Cover

Higher cover may indicate

- Greater dividend security
- More retained earnings
- Stronger capacity to absorb profit declines

Very high cover may indicate

- Strong growth investment
- Excessive retention
- Limited shareholder distributions

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Objectives of Dividend Policy

Major Dividend-Policy Objectives

A sound dividend policy should aim to:

- Reward shareholders
- Support growth
- Maintain liquidity
- Preserve financial stability
- Minimize financing costs
- Communicate confidence
- Maintain flexibility
- Support long-term value creation

Balancing Current Income and Growth

Dividend policy balances:

Current Shareholder Income	Future Shareholder Wealth
Through dividend payments.	*Through retained earnings and business growth.*

Maintaining Dividend Stability

Companies often seek stable dividends because stability may:

- Reduce shareholder uncertainty
- Attract income-oriented investors
- Build market confidence
- Reduce negative signaling
- Support long-term planning

Maintaining Financial Flexibility

The company should avoid dividends that:

- Create cash shortages
- Require unnecessary borrowing
- Prevent investment in valuable projects
- Weaken debt-service capacity
- Reduce emergency reserves

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Factors Affecting Dividend Policy

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Major Influencing Factors

Dividend decisions are influenced by:

- Profitability
- Cash flow
- Liquidity
- Investment opportunities
- Growth stage
- Debt obligations
- Legal restrictions
- Tax considerations
- Shareholder preferences
- Market expectations

Profitability

Dividends are commonly associated with profit. However, high accounting profit does not automatically mean high dividend capacity.

Management must also consider:

- Cash availability
- Debt commitments
- Capital expenditure
- Working-capital requirements

Cash Flow

Dividends normally require cash. A company may report profit but have limited cash because of:

- High receivables
- Large inventories
- Capital expenditure
- Debt repayment
- Delayed customer payments

Liquidity Position

Before declaring dividends, management should assess:

- Cash balance
- Cash-flow forecast
- Working-capital needs
- Debt-service requirements
- Emergency reserves
- Seasonal cash demands

Investment Opportunities

Companies with many positive-NPV projects may retain more earnings.

Companies with few attractive opportunities may distribute more earnings.

Organizational Life Cycle

Start-Up / Growth

- High investment requirements
- Limited dividends
- Greater earnings retention

Mature Stage

- Stable cash flows
- Lower reinvestment needs
- Greater dividend capacity

Declining Stage

- Limited growth opportunities
- Potentially high distributions
- Possible capital returns

Earnings Stability

Companies with stable earnings may maintain higher and more predictable dividends.

Companies with volatile earnings may:

- Use lower dividends
- Build larger reserves
- Apply flexible payout policies
- Avoid commitments they cannot maintain

Debt Obligations

Debt agreements may restrict dividends through:

- Maximum payout limits
- Minimum retained earnings
- Minimum liquidity ratios
- Minimum interest coverage
- Maximum leverage ratios
- Prohibition during default

Legal Restrictions

Dividend payments may be restricted when:

- Distributable profits are unavailable
- Capital would be impaired
- The company is insolvent
- Payment would create insolvency
- Regulatory capital would fall below required levels

Access to Capital Markets

Companies with strong access to external financing may distribute more profit because they can raise funds when needed.

Companies with limited access may retain more earnings.

Cost of External Financing

External financing may involve:

- Interest costs
- Flotation costs
- Legal fees
- Underwriting fees
- Registration costs
- Information requirements

High external-financing costs encourage greater retention.

Shareholder Preferences

Shareholders may differ in their preference for:

- Current income
- Capital gains
- Stable dividends
- Tax efficiency
- Long-term growth
- Low-risk investments

Tax Considerations

Dividend and capital-gain taxation may influence shareholder preferences.

Investors may prefer the return form with:

- Lower tax rate
- Later tax payment
- Greater flexibility
- Lower transaction cost

Inflation

Inflation may increase:

- Asset-replacement costs
- Working-capital requirements
- Financing needs
- Nominal accounting profits

Companies should avoid distributing amounts needed to maintain operating capacity.

Control Considerations

Retaining earnings may reduce the need to issue new shares.

This can help existing owners avoid:

- Ownership dilution
- Reduced voting control
- New shareholder influence

Market Expectations

Unexpected dividend changes may affect investor confidence.

A reduction may signal

- Financial weakness
- Cash-flow problems
- Lower future earnings

An increase may signal

- Strong confidence
- Improved cash flow
- Limited investment opportunities

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Dividend-Policy Theories

Major Dividend Theories

Important theories include:

- Dividend irrelevance theory
- Bird-in-the-hand theory
- Tax-preference theory
- Signaling theory
- Clientele-effect theory
- Agency-cost theory
- Life-cycle theory
- Residual dividend theory

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Dividend Irrelevance Theory

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Modigliani–Miller Dividend Irrelevance

The dividend-irrelevance theory argues that, under perfect-market assumptions, dividend policy does not affect company value.

Value depends on:

- Investment decisions
- Operating cash flows
- Business risk

Not on how earnings are divided between dividends and retention.

Irrelevance Assumptions

The theory assumes:

- No taxes
- No transaction costs
- No flotation costs
- Perfect information
- Rational investors
- Fixed investment policy
- No difference between dividends and capital gains

Homemade Dividends

If a company does not pay dividends, an investor can create cash by selling some shares.

If the company pays more dividends than desired, an investor can reinvest the cash.

This is known as a homemade-dividend strategy.

Limitations of Dividend Irrelevance

In reality:

- Taxes exist
- Transaction costs exist
- Information is unequal
- Investors have different preferences
- Dividends may signal information
- External financing is costly
- Agency conflicts exist

Therefore, dividend policy may matter in practice.

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Bird-in-the-Hand Theory

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Bird-in-the-Hand Theory

This theory suggests that investors may prefer certain current dividends to uncertain future capital gains.

A dividend received today may be valued more highly than a possible future gain.

Investor Preference for Certainty

Current dividends may reduce uncertainty because:

- Cash is received immediately
- Future growth is uncertain
- Share prices can decline
- Management may misuse retained funds
- Investment opportunities may fail

Implication of Bird-in-the-Hand Theory

If investors strongly prefer current dividends:

- Higher dividends may reduce perceived risk
- Required return may decline
- Share value may increase

This conclusion remains debated.

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Tax-Preference Theory

Tax-Preference Theory

Tax-preference theory suggests investors may prefer capital gains when dividends are taxed more heavily or earlier.

Capital gains may provide:

- Tax deferral
- Control over realization timing
- Potentially lower tax rates
- Greater reinvestment flexibility

Tax Effects on Dividend Preference

Investor preference depends on:

- Dividend tax rate
- Capital-gain tax rate
- Tax-exempt status
- Holding period
- Personal tax situation
- National tax rules

Tax-Exempt Investors

Some investors may be less concerned about dividend taxation. Examples may include:

- Pension funds
- Charitable institutions
- Certain institutional investors
- Tax-exempt accounts

These investors may prefer stable dividend income.

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Signaling Theory

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Dividends as Signals

Management may possess information that outside investors do not have.

Dividend changes may communicate management's expectations about:

- Future earnings
- Cash flow
- Financial strength
- Growth prospects

Dividend Increase Signal

An increased dividend may signal:

- Confidence in future cash flow
- Sustainable profitability
- Lower financial uncertainty
- Strong liquidity

However, it may also suggest fewer growth opportunities.

Dividend Reduction Signal

A dividend reduction may signal:

- Weak earnings
- Cash-flow pressure
- High debt obligations
- Financial distress

It may also reflect a rational decision to fund valuable investments.

Why Companies Avoid Dividend Cuts

Companies may avoid increasing dividends unless they believe the increase can be maintained.

Dividend cuts can:

- Damage credibility
- Reduce investor confidence
- Increase share-price volatility
- Attract negative market interpretation

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Clientele Effect

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Dividend Clientele

The clientele effect suggests that different groups of investors prefer different dividend policies. Examples include:

- Retirees preferring income
- Growth investors preferring retention
- Tax-sensitive investors preferring capital gains
- Institutions preferring stable payouts

Company Dividend Clientele

A stable policy attracts investors who value

- Regular income
- Low uncertainty
- Predictability

A low-payout policy attracts investors seeking

- Growth
- Capital appreciation
- Tax deferral

Implication of Clientele Effect

Changing dividend policy may cause:

- Some shareholders to sell
- New shareholders to buy
- Temporary price pressure
- Changes in investor composition

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Agency-Cost Theory

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Dividends and Agency Problems

Managers control company resources but may not always use retained funds in shareholders' best interests.

Excess cash may encourage:

- Unnecessary expansion
- Managerial benefits
- Wasteful expenditure
- Low-return projects
- Excessive acquisitions

Dividends as a Control Mechanism

Paying dividends reduces cash under management control.

This may:

- Reduce waste
- Require external-financing scrutiny
- Improve discipline
- Reduce agency costs
- Return surplus funds to owners

Limitation of High Dividends

Excessive dividends may:

- Reduce valuable investment
- Increase borrowing
- Raise flotation costs
- Weaken liquidity
- Reduce financial flexibility

Agency control must be balanced against investment needs.

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Life-Cycle Theory

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Dividend Life-Cycle Theory

Dividend policy may change as the company develops.

Young Company

- High growth
- Limited free cash flow
- Low or no dividends

Mature Company

- Stable profit
- Strong cash flow
- Higher dividends

Growth-Stage Dividend Policy

Growth companies often retain earnings because:

- Investment needs are high
- External financing is expensive
- Cash flows are uncertain
- Internal capital supports expansion

Mature-Stage Dividend Policy

Mature companies may distribute more because:

- Growth slows
- Cash flow becomes stable
- Investment requirements decline
- Retained cash may exceed productive needs

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Residual Dividend Policy

What Is Residual Dividend Policy?

Residual dividend policy distributes dividends only after financing the equity portion of all acceptable investment projects.

Dividends are treated as the residual amount.

Residual-Policy Steps

1. Determine the capital budget
2. Identify the target capital structure
3. Calculate equity financing required
4. Use retained earnings to finance equity needs
5. Distribute remaining earnings as dividends

Residual Dividend Formula

Residual Dividend =
Net Income – Equity Portion of Capital Budget

The result cannot normally be below zero.

Residual-Policy Example

Assume: Net income ETB 24m | Capital budget ETB 20m | Target equity weight 60%

$$\text{Equity financing} = 20 \text{ million} \times 60\%$$

= ETB 12 million

Calculate Residual Dividend

Residual Dividend = 24 million – 12 million

= ETB 12 million

Residual Payout Ratio

$$\text{Payout Ratio} = (\,12 \text{ million} \div 24 \text{ million}\,) \times 100$$

$$= 50\%$$

Residual Dividend per Share

Assume 1.2 million shares:

$$DPS = 12{,}000{,}000 \div 1{,}200{,}000$$

DPS = ETB 10

Advantages of Residual Policy

- Supports positive-NPV investments
- Maintains target capital structure
- Minimizes external equity financing

- Reduces flotation costs
- Links dividends with financing needs
- Supports long-term value creation

Limitations of Residual Policy

- Dividends may fluctuate significantly
- Shareholders may dislike uncertainty
- Dividend changes may send misleading signals
- Planning investor income becomes difficult
- Market confidence may be affected

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Stable Dividend Policy

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Stable Dividend per Share

Under a stable-dividend policy, the company aims to maintain a regular dividend per share.

Dividends may increase gradually as sustainable earnings rise.

Advantages of Stable Dividends

- Predictable shareholder income
- Positive market confidence
- Reduced uncertainty
- Attractive to income-oriented investors
- Lower risk of negative signaling
- Easier financial planning

Limitations of Stable Dividends

- May create pressure during weak years
- May require borrowing
- May reduce investment capacity
- Creates strong expectations
- Dividend cuts become difficult

Dividend Smoothing

Dividend smoothing means adjusting dividends gradually rather than matching every short-term earnings change.

Management may:

- Maintain dividends during temporary profit declines
- Increase dividends only after sustained growth
- Avoid reacting to one-time profits

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Constant-Payout Policy

Constant-Payout Ratio

Under a constant-payout policy, the company distributes a fixed percentage of earnings.

$$\text{Dividend} = \text{Net Income} \times \text{Target Payout Ratio}$$

Constant-Payout Example

Assume: Net income ETB 30 million | Target payout ratio 40%

$$\text{Dividend} = 30 \text{ million} \times 40\%$$

$$= \text{ETB } 12 \text{ million}$$

Advantages of Constant Payout

- Links dividends to profitability
- Prevents excessive distributions
- Protects the retention ratio
- Simple to understand
- Maintains proportional sharing

Limitations of Constant Payout

Because earnings fluctuate:

- Dividends fluctuate
- Shareholder income becomes uncertain
- Negative signaling may occur
- Dividend stability is reduced

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Low Regular Dividend Plus Extra

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Low Regular Plus Extra Policy

The company pays:

- A low, sustainable regular dividend
- An additional dividend when earnings and cash flow are strong

Advantages

This policy provides:

- Minimum predictable income
- Flexibility
- Protection during weak years
- Ability to distribute exceptional earnings
- Reduced pressure to maintain high dividends

Communication Requirement

The extra dividend should be clearly identified as non-recurring.

Otherwise, shareholders may expect it to continue.

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Stock Dividends

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Meaning of Stock Dividend

A stock dividend increases the number of shares held by each shareholder without distributing cash.

Ownership percentages normally remain unchanged.

Stock-Dividend Example

An investor owns 1,000 shares. The company declares a 10% stock dividend.

$$\text{Additional shares} = 1{,}000 \times 10\% = 100$$

New total = 1,100 shares

Effect on Shareholder Wealth

Immediately after a stock dividend:

- The shareholder owns more shares
- Each share may be worth less
- Total ownership percentage is unchanged
- Total economic wealth may remain unchanged

Reasons for Stock Dividends

Companies may use stock dividends to:

- Preserve cash
- Reward shareholders
- Increase shares in circulation
- Reduce market price per share
- Signal confidence
- Adjust equity-account balances

Limitations of Stock Dividends

- They do not provide immediate cash
- Administrative costs may arise
- Share price may decline proportionately
- Investors may misunderstand the effect
- No economic value is automatically created

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Stock Splits

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What Is a Stock Split?

A stock split increases the number of shares and proportionately reduces the price per share.

A two-for-one split provides
two shares for every existing share.

Two-for-One Split Example

Before Split

- Shares owned: 500
- Price per share: ETB 200
- Total value: ETB 100,000

After Split

- Shares owned: 1,000
- Approx. price: ETB 100
- Total value: ETB 100,000

Reasons for Stock Splits

- Reduce share price to a preferred trading range
- Increase affordability
- Improve marketability
- Increase number of shares
- Communicate management confidence
- Broaden investor participation

Reverse Stock Split

A reverse split reduces the number of shares and increases the price per share.

A one-for-five reverse split converts
five old shares into one new share.

Reasons for Reverse Splits

- Increase low share price
- Meet listing requirements
- Improve market perception
- Reduce administrative costs
- Decrease number of small shareholders

A reverse split does not automatically improve company value.

Stock Dividend vs Stock Split

Stock Dividend	Stock Split
Additional shares distributed	Existing shares divided
Retained earnings may be reclassified	Usually no retained-earnings transfer
Often smaller percentage	Often larger change
May resemble a dividend	Mainly changes share structure
Preserves cash	Preserves cash

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Share Repurchases

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What Is a Share Repurchase?

A share repurchase occurs when a company buys back its own shares.

The shares may be:

- Cancelled
- Held as treasury shares
- Used for employee compensation
- Reissued later

Repurchase Methods

Companies may repurchase shares through:

- Open-market purchases
- Fixed-price tender offers
- Dutch auctions
- Direct negotiation
- Targeted repurchases

Reasons for Share Repurchases

- Return excess cash
- Reduce shares outstanding
- Offset employee-share issuance
- Adjust capital structure
- Signal undervaluation
- Increase financial leverage
- Provide flexible distributions

Repurchase Example

Assume: Shares outstanding 1,000,000 | Market price ETB 50 | Budget ETB 10m

Shares repurchased = 10,000,000 ÷ 50 = 200,000

Remaining shares = 800,000

Repurchase Effect on EPS

Assume net income remains ETB 8 million.

Before Repurchase	After Repurchase
EPS = 8,000,000 ÷ 1,000,000 = ETB 8	*EPS = 8,000,000 ÷ 800,000 = ETB 10*

Higher EPS does not automatically mean greater economic value.

Advantages of Repurchases

- Flexible compared with regular dividends
- May signal undervaluation
- Reduces shares outstanding
- May improve per-share indicators
- Allows shareholders to choose whether to sell
- Can adjust capital structure

Risks of Repurchases

- Shares may be repurchased at excessive prices
- Cash reserves may become insufficient
- Debt may increase
- Investment opportunities may be sacrificed
- EPS may improve without operating improvement
- Management incentives may influence timing

Dividends vs Repurchases

Cash Dividends	Share Repurchases
Paid to all eligible shareholders	Cash received by selling shareholders
Create strong recurring expectations	More flexible
Reduce cash and retained earnings	Reduce cash and shares outstanding
Provide regular income	May create capital gains
Difficult to reduce	Can be varied more easily

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Dividends and Growth

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Retention and Growth

Retained earnings can support growth through:

- New investment
- Capacity expansion
- Product development
- Technology
- Market expansion
- Debt reduction

Sustainable Growth Rate

$$g = b \times ROE$$

Where:

- g = sustainable growth rate
- b = retention ratio
- ROE = return on equity

Sustainable-Growth Example

Assume: Payout ratio 40% | Retention ratio 60% | ROE 18%

$$g = 0.60 \times 18\%$$

$$g = 10.8\%$$

Effect of Higher Payout

If payout increases:

- Retention declines
- Internal financing declines
- Sustainable growth may decline
- External financing may increase

Unless operational profitability or leverage changes.

Retention Is Valuable Only When Productive

Retaining earnings creates value only when the funds earn at least the shareholders’ required return.

If retained funds earn poor returns:

- Value may decline
- Agency costs may increase
- Shareholders may prefer distributions

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Dividends and Stock Value

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Dividend Discount Model

For a constant-growth company:

$$P_0 = D_1 \div (k_e - g)$$

- D_1 = expected next dividend
- k_e = required return
- g = dividend-growth rate

Dividend Policy and Valuation

Dividend policy may affect:

- Current dividend
- Future growth
- Required return
- Investor expectations
- External financing needs

Increasing dividends may raise current income but reduce future growth.

Dividend-Growth Trade-Off

A High Payout Provides

- Greater current dividends
- Lower retained earnings
- Potentially lower growth

A Low Payout Provides

- Lower current dividends
- Greater retained earnings
- Potentially higher growth

The key issue is whether retained earnings generate adequate returns.

Value-Neutral Illustration

Assume: EPS ETB 20 | Payout ratio 50% | Dividend ETB 10 | Retention ETB 10

A lower payout is not automatically better unless the retained amount creates sufficient future value.

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Dividend Policy and Capital Structure

Dividend Policy and External Financing

When dividends exceed internally available funds, the company may need:

- Additional debt
- New equity
- Asset sales
- Reduced investment
- Lower working capital

Dividend Policy and Debt

High dividends may increase debt because retained earnings are reduced.

This may affect:

- Interest expense
- Credit rating
- Financial leverage
- Debt-service coverage
- Financial flexibility

Dividend Policy and Equity Issuance

Paying dividends while issuing new shares may create:

- Flotation costs
- Ownership dilution
- Mixed market signals
- Higher financing costs

Management should evaluate whether such a policy is economically justified.

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Dividend Decisions under Uncertainty

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Dividend-Stress Testing

Before approving dividends, evaluate scenarios such as:

- Revenue decline
- Profit decline
- Delayed receivables
- Interest-rate increase
- Currency depreciation
- Major capital expenditure
- Unexpected emergency
- Debt covenant pressure

Dividend Capacity Analysis

A dividend-capacity review should assess:

- Distributable profit
- Operating cash flow
- Free cash flow
- Cash balance
- Debt service
- Capital expenditure
- Working-capital requirements
- Legal restrictions
- Forecast liquidity

Free Cash Flow to Equity

A simplified measure is:

$$\text{FCFE} = \text{Net Income} + \text{Depreciation}$$
$$- \text{Capital Expenditure} - \Delta\,\text{Working Capital} + \text{Net Borrowing}$$

FCFE indicates cash potentially available to common shareholders.

Dividend Safety Indicators

Useful indicators include:

- Payout ratio
- Dividend cover
- Free-cash-flow coverage
- Interest coverage
- Debt-service coverage
- Cash balance
- Earnings stability
- Dividend history

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Developing a Dividend Policy

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Elements of a Dividend Policy

A formal dividend policy may define:

- Target payout ratio
- Minimum dividend
- Payment frequency
- Conditions for increases
- Conditions for suspension
- Liquidity requirements
- Debt-covenant requirements
- Approval authority
- Communication procedures

Dividend-Approval Questions

Before approval, the board should ask:

1. Is the company profitable?
2. Is cash available?
3. Are legal requirements satisfied?
4. Can debt obligations be met?
5. Are valuable investments fully financed?
6. Is the dividend sustainable?
7. What signal will the decision send?

Characteristics of a Sound Policy

A sound dividend policy should be:

- Sustainable
- Transparent
- Consistent
- Flexible
- Strategically aligned
- Legally compliant
- Financially affordable
- Clearly communicated

SECTION

Practical Exercise

Develop a Dividend Recommendation

Participants will:

- Calculate EPS
- Calculate residual dividends
- Calculate DPS
- Calculate payout and retention ratios
- Estimate sustainable growth
- Assess liquidity
- Compare alternative policies
- Recommend a dividend decision

Exercise Scenario

A company reports:

- Net income: ETB 24 million
- Common shares: 1.2 million
- Capital budget: ETB 20 million
- Target debt ratio: 40%
- Target equity ratio: 60%
- Return on equity: 18%
- Cash balance: ETB 15 million
- Minimum required cash reserve: ETB 5 million

Step 1 — Calculate EPS

$$EPS = 24{,}000{,}000 \div 1{,}200{,}000$$

EPS = ETB 20

PRACTICAL EXERCISE

Step 2 — Determine Equity Requirement

Capital budget: ETB 20 million | Target equity portion: 60%

$$\text{Equity requirement} = 20 \text{ million} \times 60\%$$

$$= \text{ETB } 12 \text{ million}$$

Step 3 — Calculate Residual Dividend

Residual Dividend = 24 million – 12 million

= ETB 12 million

Step 4 — Calculate DPS

$$DPS = 12{,}000{,}000 \div 1{,}200{,}000$$

DPS = ETB 10

PRACTICAL EXERCISE

Step 5 — Calculate Payout Ratio

$$\text{Payout Ratio} = (10 \div 20) \times 100$$

$$= 50\%$$

Step 6 — Calculate Retention Ratio

$$b = 1 - 0.50$$

$$b = 50\%$$

Step 7 — Estimate Sustainable Growth

$$g = b \times ROE = 0.50 \times 18\%$$

$$g = 9\%$$

PRACTICAL EXERCISE

Step 8 — Assess Cash Availability

Cash balance ETB 15m – Minimum reserve ETB 5m

Available cash = ETB 10 million

The proposed cash dividend is ETB 12 million — there may be a liquidity shortfall of ETB 2 million.

Liquidity Interpretation

Although the residual-dividend calculation supports ETB 12 million, the company currently has only ETB 10 million above its minimum reserve.

Management should assess:

- Expected operating cash inflows
- Timing of capital expenditure
- Debt-service obligations
- Working-capital requirements
- Whether part of the dividend should be delayed

Alternative 1 — Full Residual Dividend

Pay ETB 12 million. Possible consequences:

- Maintains 50% payout ratio
- Requires additional cash inflow or financing
- May reduce liquidity
- Supports shareholder income

Alternative 2 — Cash-Limited Dividend

Pay ETB 10 million.

$$\text{DPS} = 10{,}000{,}000 \div 1{,}200{,}000 = \text{ETB } 8.33$$

$$\text{Payout Ratio} = (\,10 \div 24\,) \times 100 = 41.67\%$$

Alternative 3 — Regular Plus Extra

The company may:

- Pay a sustainable regular dividend
- Delay an additional distribution
- Declare an extra dividend after cash improves
- Protect minimum liquidity

Group Recommendation

Each group should present:

1. Recommended total dividend
2. Dividend per share
3. Payout ratio
4. Retention ratio
5. Sustainable-growth implication
6. Liquidity impact
7. Financing impact
8. Communication message to shareholders

SECTION

Chapter Review

Common Dividend-Policy Mistakes

- Declaring dividends based only on accounting profit
- Ignoring cash-flow requirements
- Paying dividends while valuable projects remain unfunded
- Treating dividend increases as temporary
- Ignoring shareholder expectations
- Paying dividends through excessive borrowing
- Ignoring debt covenants
- Assuming stock dividends create immediate wealth
- Repurchasing shares at excessive prices
- Failing to stress-test dividend capacity

Dividend-Policy Checklist

Before approving a dividend, confirm:

- Distributable profit exists
- Cash is available
- Working capital is sufficient
- Debt service can be met
- Legal requirements are satisfied
- Investment needs are funded
- Target capital structure is maintained
- Dividend is sustainable
- Market communication is clear
- Stress tests are acceptable

Knowledge Check

1. What is a dividend?
2. What is dividend policy?
3. How is DPS calculated?
4. What does the payout ratio measure?
5. How does the retention ratio affect growth?
6. What is residual dividend policy?
7. Why do companies smooth dividends?
8. What is the clientele effect?
9. How does a stock dividend differ from a cash dividend?
10. Why might a company repurchase shares?

Knowledge Check — Answers

1. A distribution of earnings or resources to shareholders
2. The framework determining distributions and retained earnings
3. Total common dividends divided by common shares
4. The proportion of earnings distributed
5. Greater retention may increase sustainable growth
6. Dividends are paid after financing acceptable investments
7. To provide stability and reduce negative signals
8. Different investors prefer different payout policies
9. A stock dividend distributes shares rather than cash
10. To return cash, adjust capital structure or reduce shares

Action Plan

Evaluate one company's dividend policy by identifying:

- Earnings per share
- Dividend per share
- Payout ratio
- Retention ratio
- Dividend yield
- Dividend cover
- Free cash flow
- Investment requirements
- Debt restrictions
- Sustainable-growth rate
- Recommended dividend policy

Chapter Summary

- Dividends distribute company value to shareholders.
- Policy determines the balance between distribution and retention.
- Cash dividends provide income but reduce liquidity.
- Retained earnings finance investment and growth.
- Profit does not always mean cash is available.
- Dividend stability may reduce investor uncertainty.
- Residual policy prioritizes investment and capital structure.
- Constant-payout links dividends directly with earnings.
- Stock dividends and splits rarely create automatic value.
- Repurchases provide a flexible alternative to dividends.
- Dividend policy may communicate information to investors.
- Sustainable policy balances shareholders, growth and risk.

KEY MESSAGE

Dividend policy is not simply a decision about how much cash to distribute.

It is a strategic decision connecting:

Profitability › Cash Flow › Investment Opportunities › Capital Structure › Shareholder Expectations › Sustainable Growth › Organizational Value

THANK YOU

Questions and Discussion

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A sound dividend policy rewards shareholders without weakening the company's ability to invest, meet its obligations and remain financially resilient. Sustainable distributions are built on real cash flow, disciplined investment decisions and a clear balance between current income and long-term value creation.