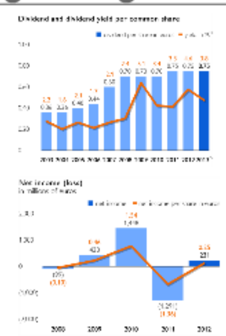
Strides Arcolab Limited's Dividend Pay-Out Decision

Dividends

A distribution of a portion of a company's earnings to its shareholders, in the form of

- Cash
- Stock
- Property

Signalling Theory



Based on the idea of asymmetry information

Announcements of dividends - indicator of the firm's future prospects

- Increase - strong - higher earnings
- Decrease - weak - investment or lower earnings

"A manager who has good investment opportunities is more likely to "signal" than one who doesn't because it is in his or her best interest"

Evidence

- Not conclusive
- Miller and Rock (1985) suested that dividends announceents convey information to investors.
- Earlier studies by Bhattacharya and others - stock prices increase with dividend increases and vice versa
- Watt (1973), Godenes (1978), Penman (1983) and Benartz, Michaely and Thaler (1997) show dividends have no effect on earning.
- Healy and Palepu (1998) have shown that dividend signaling does occur when companies either increase or decrease
- Some studies show that companies announce large dividends when future prospects are good
- HOWEVER, studies also show that is the case due to good past financial records

INVESTMENT DECISIONS

BIRD-IN-HAND THEORY

CLIENTELE EFFECT

AGENCY THEORY

Dividends used to monitor and control agency problems, instead of signal information.
A firm with excess cash may distribute dividends in order to avoid agency problems.

- Financial cost will be lower than agency
- Firms with increased agency problems will pay high dividends

On the other hand:

Dividend payouts signal that managers are meeting their main objective of increasing shareholder wealth.

DIVIDEND IRRELEVANCY MODEL (M&M)

The theory states that:

CONCLUSION

Changes in dividends can be used to signal asymmetric information such as:

- expected future cash flow
- investment activity

Bird in hand theory suggests shareholders prefer dividends to capital gains

HOWEVER

Changes in dividends can also be used:

- as a solution to reduce agency problems
- to cater to different classes of investors

THE END!

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- Low tax bracket ---high dividend pay out
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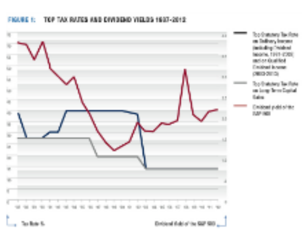
Dividend levels may be used to attract different kinds of investors

- e.g institutional investors



Signalling Theory

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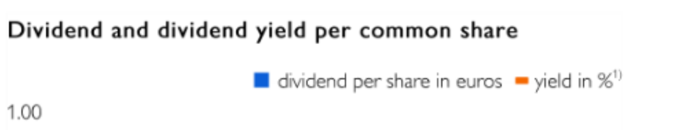
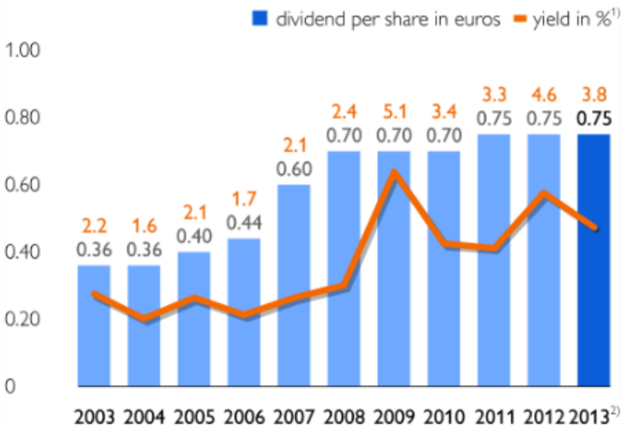


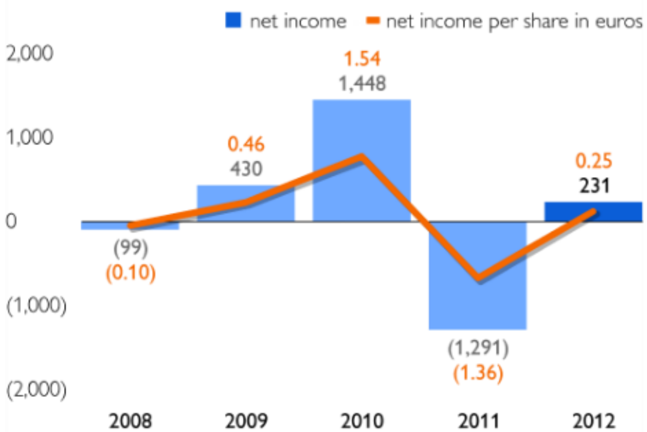
Based on the idea of asymmetry information

Signalling Theory

Dividend and dividend yield per common share



Net income (loss)
in millions of euros



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INVESTMENT DECISIONS

A firm's revenue should also be used on growth and investments of the company.

Constant high dividends should raise concerns regarding the firm's investment decisions.

- Overlooking potential positive NPV projects
- Not enough funds to invest in potential NPV projects

Consequently may have an adverse effect on future performance.

On the other hand, paying low dividends may have negative connotations but these firms may just be taking on more positive NPV projects.

Farma (1974) found investment and dividends decision were independent. However, misconceptions are still rife.

Table I Level of importance attached to factors influencing dividend policy by managers of Indonesian firms

		Level of importance					*Rank*			
F no.	*Factor*	*None 0*	*Low 1*	*Mod 2*	*High 3*	*Mean*	*IDX*	*NYSE*	*NASDAQ*	*TSX*
1	Stability of earnings	0.0	7.7	17.3	75.0	2.67	1	6	2	2
3	Level of current earningsa	0.0	11.5	15.4	73.1	2.62	2	1.5	3	4
4	Level of expected future earnings[a]	0.0	13.5	15.4	71.2	2.58	3	1.5	4	1
11	Liquidity constraints such as the availability of cash	0.0	7.7	28.8	63.5	2.56	4	8	14	5
5	Concern about affecting the stock price	1.9	9.6	21.2	67.3	2.54	5	4	5	7
14	Needs of current shareholders such as the desire for current income	1.9	9.6	30.8	57.7	2.44	6	10	9	9
2	Pattern of past dividends	0.0	17.3	28.8	53.8	2.37	7	3	1	3
10	Projections about the future state of the economy	3.8	11.5	32.7	51.9	2.33	8	18	18	17
20	Investment considerations such as the availability of profitable investment opportunities	3.8	13.5	32.7	50.0	2.29	9	7	15	11
13	Desire to pay out, in the long run, a given fraction of earnings	3.8	21.2	38.5	36.5	2.08	10	9	7	6
21	Signaling incentives such as using dividend changes to convey information to financial markets	13.5	21.2	32.7	32.7	1.85	11	NA	16	16
7	Availability of alternative sources of capital	17.3	23.1	25.0	34.6	1.77	12	NA	17	15
6	Current degree of financial leverage	13.5	32.7	21.2	32.7	1.73	13.5	NA	10	8
16	Preference to pay dividends instead of undertaking risky reinvestments	11.5	28.8	34.6	25.0	1.73	13.5	19	20	21
15	Contractual constraints such as dividend restrictions in debt contracts	13.5	30.8	28.8	26.9	1.69	15	15	21	20
19	Financing considerations such as the cost of raising external funds (debt and equity)	13.5	28.8	36.5	21.2	1.65	16	12	19	14
12	Desire to conform to the industry's dividend payout ratio	15.4	32.7	36.5	15.4	1.52	17	14	13	18
8	Expected rate of return on the firm's assets	23.1	30.8	30.8	15.4	1.38	18	13	11	10
9	Desire to maintain a target capital structure	17.3	44.2	28.8	9.6	1.31	19	11	6	13
18	Legal rules and constraints such as paying dividends that would impair capital	17.3	50.0	25.0	7.7	1.23	20	16	12	19
22	Stockholder characteristics such as the marginal tax rates of the firm's current shareholders	36.5	32.7	21.2	9.6	1.04	21.5	17	22	22
17	Desire to avoid giving a false signal to investors by changing the dividend	40.4	23.1	28.8	7.7	1.04	21.5	5	8	12

Notes: This table presents the survey responses for 52 dividend-paying Indonesian firms on the importance of 22 factors in determining the respondent firms' dividend policy. The rankings are based on a four-point importance scale were none=0, low = 1, moderate = 2, and high = 3, and are listed in declining order of the means of the Indonesian firms. Baker and Powell (2000) and Baker *et al.* (2001) provide the rankings for the NYSE and NASDAQ firms, respectively, and Baker *et al.* (2007) supply the rankings for the TSX-listed (Canadian) firms; [a]Baker and Powell (2000) combine these two factors into a single factor (i.e. level of current and expected future earnings)

BIRD-IN-HAND THEORY

Developed by Myron Gordon and John Lintner:

Investors prefer dividends to capital gains because:

- Risk of unpredictability of future cash flow
- Reduces cost of capital
- Credit Agencies prefer high-dividend paying firms

Evidence

Support for Bird-in-hand theory

- Graham and Dodd - a dollar of dividends has four times impact on stock price (Graham and Shapiro (1961), Lintner (1962) and Walter (1963)). HOWEVER, limited support from empirical evidence.

- Gordon (1959) found that dividends had a greater impact on share value than retained earnings did.
  - Stocks with high dividend payout ratio have higher market price and hence firm's value.

- M&M argue that firm's risk is based on risky operating cash flow, not earnings distribution.

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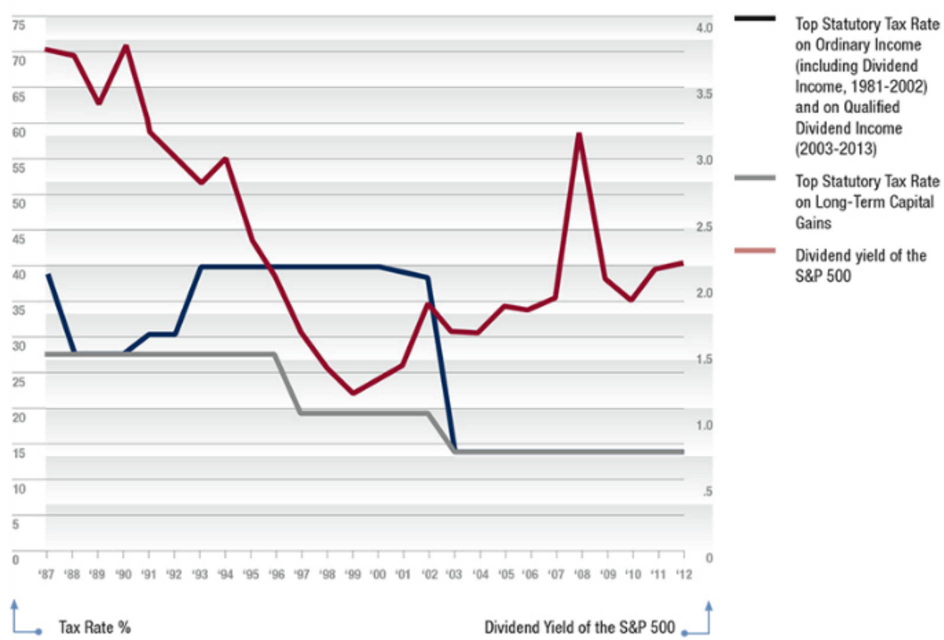
FIGURE 1: **TOP TAX RATES AND DIVIDEND YIELDS 1987-2012**



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DIVIDEND IRRELEVANCY MODEL (M&M)

The theory states that:

- dividends are irrelevant conditions that markets should meet
- investors are not concerned with a company's dividend policy since they can sell a portion of their portfolio of equities if they want cash.
- Issuance of dividends should have little to no impact on stock price.
- state dividends have no bearing on shareholder wealth because cost of capital and share price are independent - therefore shareholders are indifferent capital gains and dividends.
  - Dividends can be made through 'homemade dividends'
  - Firm's value dictated by investment decisions
  - Not bothered by changes in dividend payout ratios and information they may convey

Evidence

Ball et al (1979) found that numerous conditions upon the theory made it hard to test