Unit III
Dividend Decisions

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Programme/Class: Degree	Year:First	Semester: Second
Course/ paper-4 (B)		
Course Code: F010201T	**Course Title: Business Finance**	

Course outcomes:

The aim of the course is to build knowledge and understanding of Business Finance among the student. The course seeks to give detailed knowledge about the subject matter by instilling them basic ideas about Business Finance. The outcome of the course will be as follows –

To provide knowledge about business finance and investment decisions.
To provide knowledge about financing and dividend decision.
To give an overview about working capital.

Credits: 3	Compulsory
Max. Marks: 25+75	Min. Passing Marks:

Unit	Topics	No. of Lectures Total=30
I	Introduction to Finance: Finance functions, objectives of financial management- Profitability vs. Shareholder wealth maximization. Time Value of Money – Compound interest and terminal values, Present values, relationship between present value and Discount rate, present value and future value of an annuity, amortizing a loan Valuation of bonds. Calculating return from stocks investment, perpetual dividend growth model	10
II	Nature of Capital Budgeting decisions, Payback, NPV, IRR and ARR methods and their practical applications. Financing Decision: Making capital structure decisions- concept of leverage, operating, financial and combined leverage, EBIT-EPS Analysis, cash flow ability to service debt, Pecking order of financing	7
III	Procedural and regulatory aspect of paying dividend Concepts of Relevance and Irrelevance of dividend Walter's Model, Gordon's model. Passive and residual Dividend policy Factors affecting dividend policy, alternative forms of dividend- bonus, stock split , share-buy back	7
IV	Concepts of working capital, operating cycle concept, estimating working capital requirements, Approaches to the financing of current Assets, sources of short-term financing, cost of alternative sources of financing working capital Contents of an Annual Report and Financial Ratio analysis.	6

Suggested Readings:

1. Maheshwari S.N., Financial Management
2. Khan and Jain, Financial Management
3. Singh H.K., Business Finance

Dividend

- Dividend is a distribution to shareholders out of profits or reserves available for this purpose.
- That portion of profit (after tax) which is distributed among the owners / shareholders of the firm.
- Dividend is that part of the net earnings of a corporation that is distributed to its stockholders.
- It is a payment made to the equity shareholders for their investment in the company.
- Dividend is a reward to equity shareholders for their investment in the company.

Dividend

- A reward, cash or otherwise, that a company gives to its shareholders. Dividends can be issued in various forms, such as cash payment, stocks or any other form.

- A company’s dividend is decided by its board of directors and it requires the shareholders’ approval.

- However, it is not obligatory for a company to pay dividend. Dividend is usually a part of the profit that the company shares with its shareholders.

https://economictimes.indiatimes.com/definition/dividend

Dividend

- However, companies may decide to retain their accumulated profits to reinvest in the business or reserve it for future use. Further, announcements about dividend income declaration mostly accompany a significant change in the company's stock value

Dividend

- The dividend payable to the preference shareholders is usually fixed by the terms of the issue of preference shares.
- But the dividend on equity shares is payable at the discretion of The Board of Directors of the company.
- For payment of dividends, a company must earn distributable profits from which the actual payment of dividends will be made.
- Retentions are used to finance capital projects and redeem shares and debentures.

Kinds of Dividend

- **Interim dividend:-** Is a dividend which is declared between two annual general meetings. The Board of Directors may from time to time pay to the members such interim dividend as appears to it to be justified by the profits of the company.

- The directors must take into consideration the future prospects of the profits e.g., orders in hand, any seasonal element in business before declaration of interim dividend otherwise it may be considered payment out of capital. Cash resources, likelihood profitability of the company must also be taken into consideration while deciding to declare an interim dividend.

Kinds of Dividend

- **Final Dividend -** At the end of the accounting period, the accounts of the company are prepared to ascertain the amount of profit earned by the company. The directors, taking into consideration the financial position of the company's future prospects, provision for resources, etc., decide to recommend to the shareholders at the annual general meeting the dividend to be paid to the shareholders.

Kinds of Dividend

- **Dividend on Preference Shares:** The articles of association of a company empower the directors to declare and pay both interim and final dividend on preference shares. Holders of preference shares are entitled to receive dividend before any dividend is paid to the equity shareholders as per the terms of the issue.

Determinants of Dividend Policy

- Dividend policy determines the division of earnings between payments to shareholders and reinvestment in the firm. Retained earnings are one of the most significant sources of funds for financing corporate growth, but dividends constitute the cashflows that accrue to shareholders. Determinants of Dividend Policy are as:

Firm's transcation costs

- The costs incurred in raising new capital are called 'flotation costs' and it is ranging as high as 10% of the amount raised. The flotation costs associated with raising new funds give firms an incentive to avoid paying dividends.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Dividend Clientele

- Firms with different dividend policies will appeal to different kinds of investors with each group constituting a different dividend clientele.
- A dividend clientele is a group of investors favouring a particular kind of dividend policy.
- Low and zero tax payers appear to prefer high payout ratios, while high taxation groups prefer low dividends and expect to realize benefits through capital gains.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Dividend Payout Ratio

- Determination of dividend payout ratio is one of the major financial decisions effecting the firm's wealth as well as market price of the share. Dividend payout ratio represents the percentage of dividend declared and paid out of the earnings per share.

Dividend per share/Earnings per share

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Dividend Payout Ratio

- Dividend payout indicates the extent of the net profits distributed to the shareholders as dividend. A high payout ratio signifies a liberal distribution policy drives down the cash resources available with the company.
- A low payout ratio indicates conservative distribution policy, which enables the firm to accumulate internal resources for future capital expenditure, growth and diversification, which will result in long-run capital appreciation of share price and maximization of firm's wealth. A low dividend payout will cause to depress the market price of the share.
- The management should strike a balance between current dividends and future growth and should ascertain an optimum dividend payout ratio.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Dividend Cover

- The dividend cover is calculated as follows:

Profit after tax /Dividend

- This ratio indicates the number of times the dividends are covered by net profit. This highlights the amount retained by a company for financing its future operations.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Dividend Signaling

- Increase in the dividend is often accompanied by an increase in the price of the stock, while a dividend cut generally leads to a stock price decline.
- The companies, in practice appear to place great emphasis on last year's dividend when deciding the current year's dividend.
- Dividends tend to be more stable than earnings. changes in dividend policy may convey information to the stock market.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Dividend Signaling

- An increase in dividends is likely to be interpreted as 'good news and a cut as bad news.
- The complete skip-off of a dividend is likely to be regarded as very bad news.
- The companies use this information channel to inform the investors.
- According to the dividend signalling hypothesis, dividend changes provide an effective way of allowing management to convey believable information to the market about the firm's expected future cashflows. By conveying the favourable information to the market in a believable way, the dividend decision may effect the value of the firm.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Liquidity

- In order to pay dividend, a company requires cash and, therefore, the availability of cash resources within the company will be a factor in determining dividend payments.

- The liquidity position of the company will influence the dividend payout of a particular year. Before paying dividend the company should consider its financial commitments in repayment of loans and provide sufficient funds for meeting working capital requirements.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Rate of Expansion

- The rate of asset expansion needs to be taken into account. The more rapid the rate at which the firm is growing, the greater will be its needs for financing asset expansion. The greater the future need for funds, the more likely the firm is to retain earnings rather than pay them out.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Stability of Earnings

- The stability of earnings also effects the decision. If earnings are relatively stable, a firm is better able to predict what its future earnings will be.
- A stable firm is, therefore, more likely to pay out a higher percentage of its earnings than is a firm with fluctuating earnings.
- The unstable firm is not certain that in subsequent years the hopes for earnings will be realized, so it is more likely to retain a high proportion of earnings.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Stability of Dividends

- The stability of dividends ensures the consistency of future stream of income to the shareholders Small shareholders generally do not prefer variability in their future earnings in the form of dividends, they require a stable dividend policy.

- The stability of dividends signals the efficient and profitable working of the company, increases the marketability of company's securities, increases the stock market price of the share, help in raising funds for future investment proposals, Stability of dividends increases the investors' confidence in company's performance.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Contractual Constraints

- When the company obtained loan funds from debenture holders or term lending institutions, the terms of issue or contract of loan may contain restrictions on dividend payments designed to ensure that the firm will have enough funds to meet its obligations to the loan providers.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Cost of Financing

- The cost external financing will have impact on the dividend payout of a company. In situation the external funds are costlier, a firm may resort to low dividend payout and use the funds for financing its business

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Degree of Control

- The management who wish to maintain close control over the firm will not much depend on the external sources of finance, and they maintain a low dividend payout policy and the funds generated from operations would be used for working capital and capital investment needs of the firm.

- The use of retained earnings to finance new projects preserves the company's ownership and control.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Capital Market Access

- A firm intends to raise further funds from the capital market for its expansion and diversification projects, to attract the funds from the capital market, it has to maintain a liberal dividend policy. The investment decisions of a general investor will be influenced by the firm's dividend policies.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

State of Economy

- When state of economy is uncertain, both political and economic, the firm may maintain a low dividend payout policy, to withstand to the business risks.
- The capital market conditions, rate of inflation, monetary and fiscal policy of the government will also influence the dividend policy.
- In case of high inflation conditions, the fixed assets are generally replaced with the retained earnings rather than raising external finances.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Dividend Policy

Constant Dividend Payout Policy

- This method is also known as 'constant payout ratio method. This concept of stability of dividends means 'always paying a fixed percentage of the net earnings every year.

- Under this method, if earnings vary, the amount of dividends also varies from year to year. The dividends varies from year to year, if earnings vary.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Constant Dividend Payout Policy

- In this kind of a policy, instead of fixing the amount of dividend as constant, firms fix a percentage of earnings as dividend payout ratio.
- This means that a certain percentage of earnings say 25% or 30% of earnings are paid as dividend and the remaining are retained with the company for future investments. In this way, the shareholders are assured with a certain percentage of earnings as dividends.
- With changes in the earnings, the shareholders receive earnings as a percentage of the same. This is a most acceptable policy as the shareholders are sure about the payment of dividend.

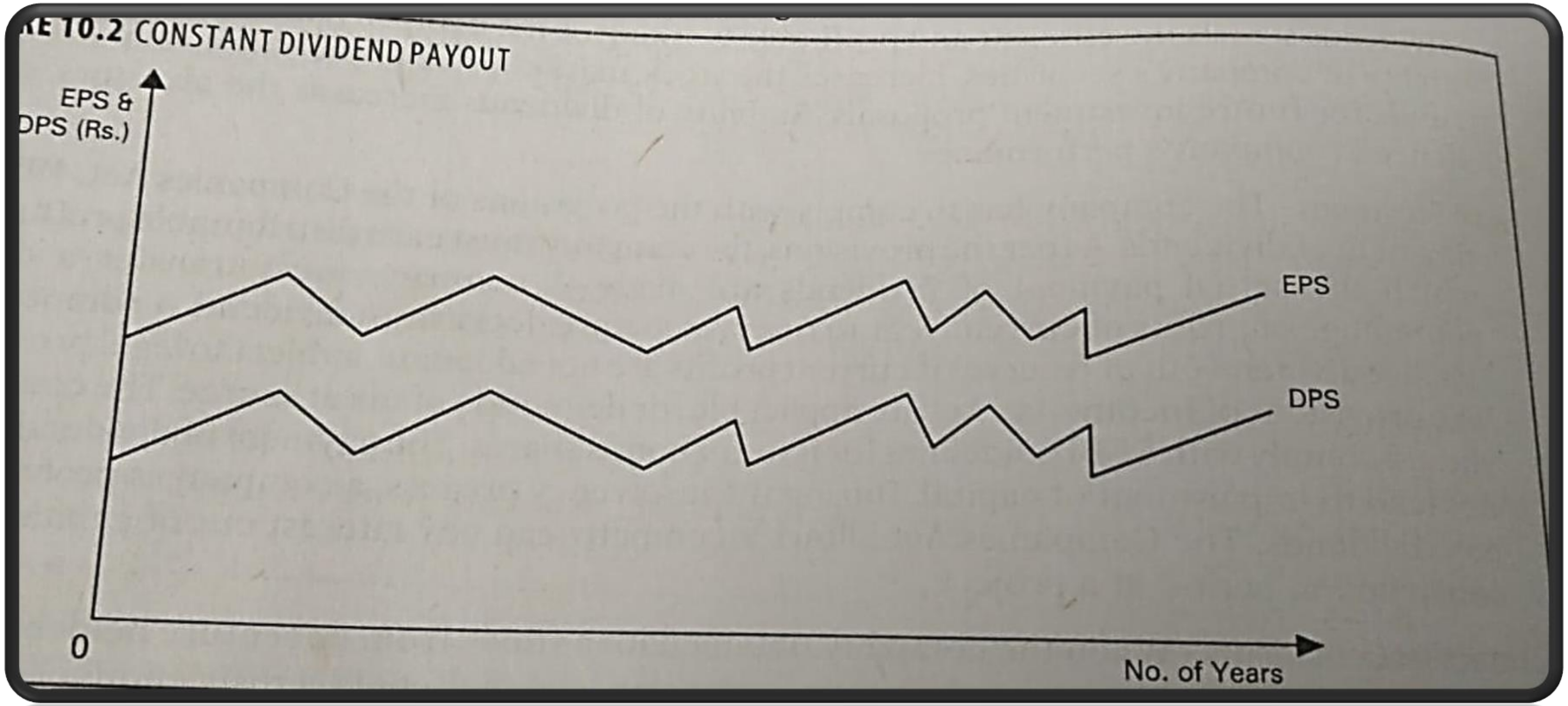
Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Constant Dividend Payout Policy

- The dividend policy is entirely based on company's ability to pay under this policy. The company follows a regular practice of retained earnings.
- For most firms, earnings are quite volatile, fluctuating with changes in the economy and firm's own special circumstances.
- Very few firms select this method. The relation between earnings per share and dividend per share under this policy is shown in figure

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Constant Dividend Payout Policy



Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Constant Dividend Payout Policy

- Dividend Payout Ratio = Dividends per Share / Earnings per Share

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Dividend Policies

- Constant Dividend per share : Shareholders are given fixed amount of dividend irrespective of actual earnings. The amount of dividend may increase or decrease later on depending upon the financial health of the company but it will be maintained for a considerable period.

- To maintain a constant dividend amount, it is necessary to create a reserve like Dividend Equalisation Reserve Fund earmarked by marketable securities for accumulation of surplus earnings and to use for paying dividends in bad years.

- This policy treats common shareholders at par with preference shareholders without giving them any preferred opportunities within the firm. It is preferred by persons and institutions that depend on dividend income to meet thing and operating expenses.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Constant Dividend per share

- This is one form of a dividend policy followed by companies where the company fix a constant amount as Dividend and pay it yearly to their shareholders. Despite increase or decrease in the earnings, the dividend is paid at a fixed rate every year.
- A fluctuation in the earnings does not affect the dividend policy of the firm. This does not mean that the dividend remains constant throughout, but they remain same for a few years and they are changed from time to time.
- This policy is most suitable for those firms whose earnings are fluctuating and who do not want to pass it on to their shareholders. So those type of companies choose a constant dividend per share to their shareholders.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

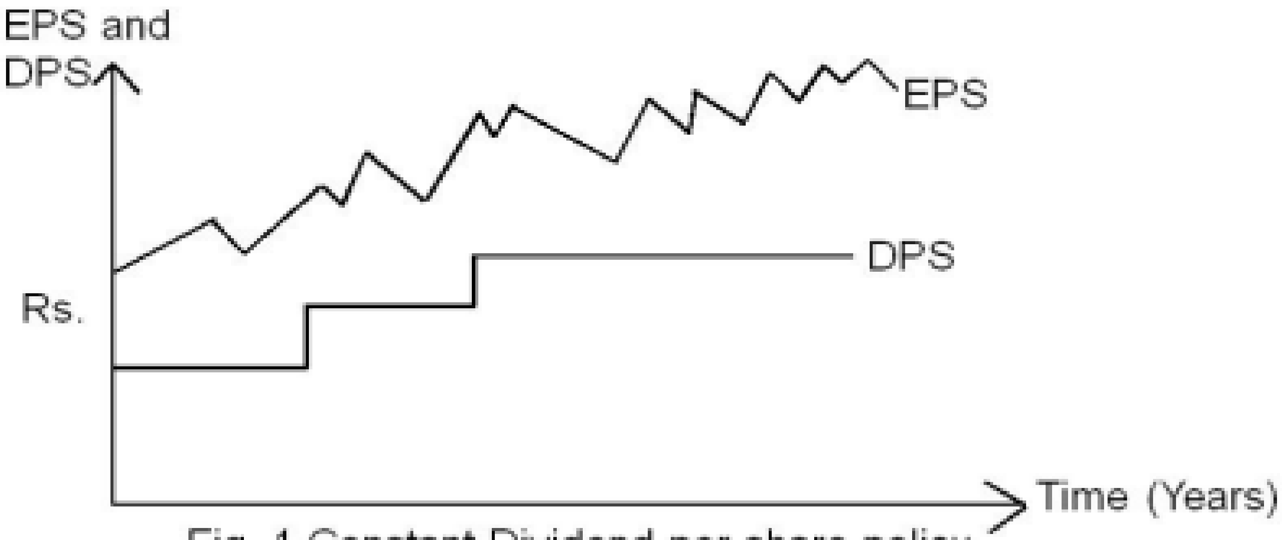


Fig. 1 Constant Dividend per share policy

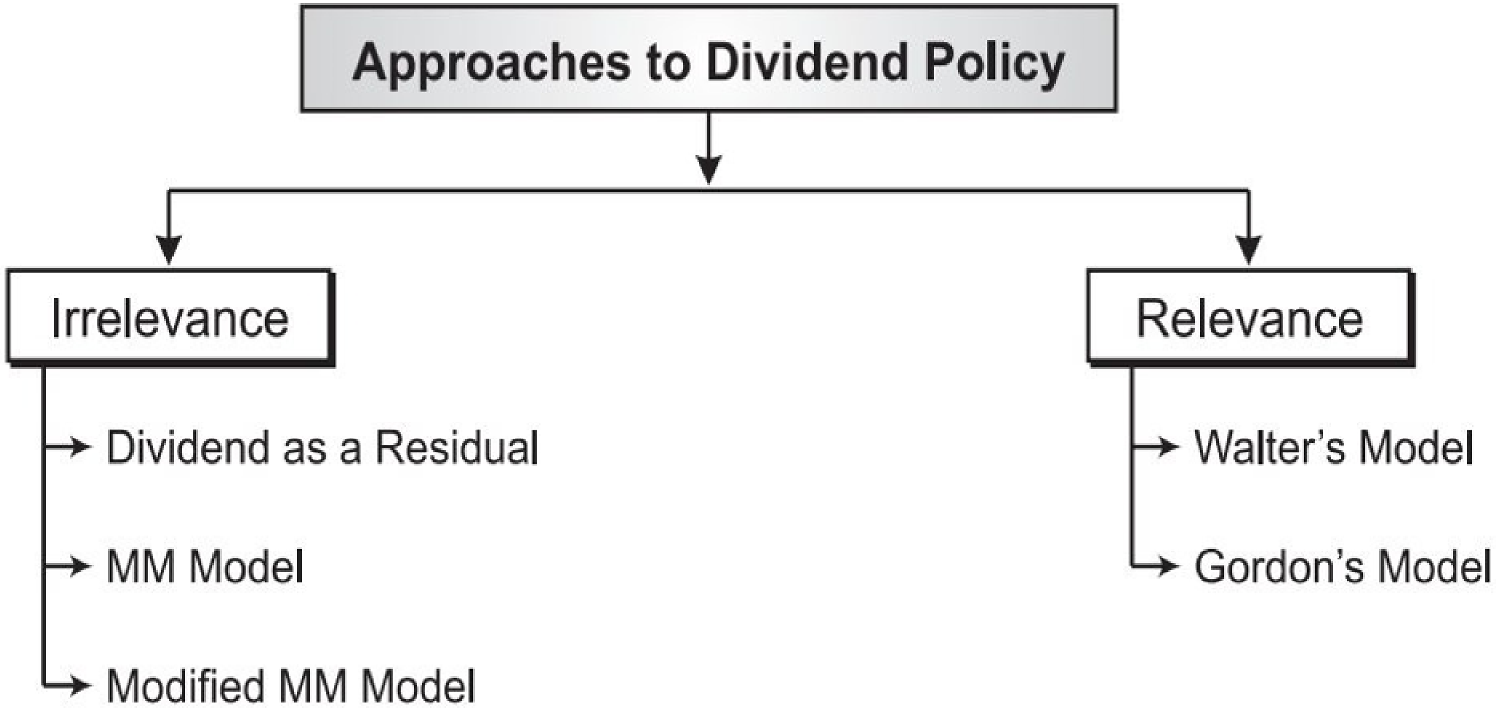
Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Assumptions

- No Debt: The model assumes that the company is an all equity company, with no proportion of debt in the capital structure.
- No External Financing: The model assumes that all investment of the company is financed by retained earnings and no external financing is required.
- Constant Cost of Capital: The model is based on the assumption of a constant cost of capital (k), implying the business risk of all the investments to be the same.
- Perpetual Earnings: Gordon's model believes in the theory of perpetual earnings for the company.
- Corporate taxes: No Corporate taxes Exist.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Approaches of Dividend Policy



Residual Theory

- Dividend decision has no effect on the wealth of the shareholders or the prices of the shares, and hence it is irrelevant so far as the valuation of the firm is concerned.

- This theory regards dividend decision merely as a part of financing decision because the earnings available may be retained in the business or for re-investment.

- But if the funds are not needed in business then it may be distributed as dividend. It means, in each period a firm has to decide whether to retain its earnings or to distribute part or all of them to shareholders as cash dividend.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Residual Theory

- As long as there are investment opportunities, firm will retain the earnings to finance these projects, otherwise will be distributed to shareholders.
- In the words of J.C. Van Horne, if the dividend policy is strictly a financing decision then the payment of dividends is a passive residual.
- The passive residual nature, and wide fluctuations makes dividend policy irrelevant and investor become indifferent between dividend pay-out and retention of earnings.
- On the contrary, investors opt to take dividend if the firm's rate of return is below than expectations or below the market level. If firm's rate of return is more than expected or above market average rate of return, a shareholder will prefer to retain the earnings. Thus, a firm should retain the earnings if it has profitable investment opportunities otherwise it should pay them as dividends.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

MODIGLIANI and MILLER (M.M) HYPOTHESIS

- Modigliani – Miller theory was proposed by Franco Modigliani and Merton Miller in 1961. MM approach is in support of the irrelevance of dividends i.e. firm's dividend policy has no effect on either the price of a firm's stock price.

- According to this approach, the market price of a share is dependent on the earnings of the firm on its investment and not on the dividend paid by it. Earnings of the firm which affect its value, further depends upon the investment opportunities available to it.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

MODIGLIANI and MILLER (M.M) HYPOTHESIS

- The dividend policy is immaterial and is of no consequence to the value of the firm. What matters, on the other hand, is the investment decisions which determine the earnings of the firm and thus affect the value of the firm.

MODIGLIANI and MILLER (M.M) HYPOTHESIS

- This model state that the effect of dividend is neutralized by issue of new securities. In simple words, a payment of dividend increases the market value of share, but on the same time it reduces the balance of funds available to a firm as retained earnings.
- In order to meet the requirement of future needs of funds, firm will make a fresh issue which result into increase in total number of shares available in the market, and reduce the market price of the share. Thus, dividend has no effect on wealth of the shareholders.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

MODIGLIANI and MILLER (M.M) HYPOTHESIS

- MM model suggest that the sum of the discounted value per share after financing and dividends paid is equal to the market value per share before the payment of dividends.
- In other words, the stock's decline in the market price because of external financing offsets exactly the payment of the dividend. Thus, the shareholders are at indifferent point either to get dividend or increase value through retained earnings.

Assumption

- Perfect Capital Markets - This theory believes in the existence of ‘perfect capital markets’. It assumes that all the investors are rational, they have access to free information.
- There are no flotation or transaction costs and brokerage fees
- No large investor can influence the market price of the share.
- There are no personal or corporate income tax.
- Securities are divisible and can be split into any fraction

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Assumption

- Fixed Investment Policy - The company does not change its existing investment policy. It means whatever may be the dividend payment, the company will make investment as it has already decided upon.
- No Risk of Uncertainty - All the investors are certain about the future market prices and the dividends. This means that the same discount rate is applicable for all types of stocks in all time periods.
- All investor can lend or borrow at the same rate of interest.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

The Critics of MM model

(i) The assumption of perfect capital market is theoretical in nature as the perfect capital market is never found in practice.

(ii) No flotation cost and no time lag assumptions are also unrealistic. In reality, the fact is otherwise and companies have to incur expenses in raising fresh equity capital from the market and that too requires a time gap to fulfil a lot of legal formalities for raising capital, etc.

The critics of MM model

(iii) The assumption of no transaction costs is imaginary. Some brokerage or commission etc. is payable by the investors whenever they decide in future to encash future capital gain arising out of bonus shares. Hence, the investors may prefer current dividend.

(iv) Assumption of no tax is also questionable. There is generally a difference in tax rate applicable to dividend incomes and capital gains in the hands of the shareholders.

The MM-Model sets the relationship of present value of share in respect of dividend pay-out at the end of financial year, and requirement of additional funds, as shown below :

$$P_0 = \frac{(D_1 + P_1)}{(1 + k_e)}$$

Where,

P_o = Market price per share at the beginning of the period, or prevailing market price of a share

D_1 = Dividend to be received at the end of the period.

P_1 = Market price at the end of the period

K_e = Cost of equity capital, or rate of capitalization.

From the above equation, the present value of share at the end of the period can be computed as

$$P_1 = P_o (1 + K_e) - D_1$$

Relevance

- Another school of thought supports dividend relevance.
- They advance argument in favour of dividend relevance.
- According to this approach, the current dividend payments reduce investors uncertainty, therefore, investors will discount the firm's earnings at a lower rate.
- Thereby placing a higher value of the firm's stock.
- On the other hand, if dividend is not paid, investors uncertainty will increase, raising the required rate of return and lowering stock value.

Walter's Approach

- Dividend decisions are relevant and affect the value of the firm. Prof. Walter's model is based on the relationship between the firms's

(i) Return on investment (rate of return). i.e. r. and

(ii) Cost of capital or the required rate of return, i.e., k

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Walter's Approach

- According to Prof. Walter, If r > k i.e., if the firm earns a higher rate of return on its investment than the required rate of return, the firm should retain the earnings. Such 'firms are termed as **growth firm** and the optimum pay-out would be zero in their case.

- In case of declining firms which do not have profitable investments, i.e., where r < k, the shareholders would stand to gain if the firm distributes its earnings. For such firms, the optimum pay-out would be 100% and the firms should distribute the entire earnings as dividends.

- In case of **normal firms** where r = k, the dividend policy will not affect the market value of shares as the shareholders will get the same return from the firm as expected by them. For such firms, there is no optimum dividend payout and the value of the firm would not change with the change in dividend rate.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Assumption of Walter's Model

- ❖The investments of the firm are financed through retained earnings only and the firm does not use external sources of funds.
- ❖The internal rate of return (r) and the cost of capital (k) of the firm are constant.
- ❖There is no change in EPS and DPS.
- ❖The firm has a infinite life and going concern.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Criticism of Walter's Model

- The basic assumption that investments are financed through retained earnings only is seldom true in real world. Firms do raise funds by external financing.

- The internal rate of return, i.e. r, also does not, remain constant.

- As a matter of fact, with increased investment the rate of return also changes.

- The assumption that cost of capital (k) will remain constant also does not hold good. As a firm's risk pattern does not remain constant, it is not proper to assume that k will always remain constant.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Formula

Walter's Model proposes the following formula to compute the market price per share.

$$P = \frac{D + r\frac{(E-D)}{K_e}}{K_e}$$

Or,
$$P = \frac{D}{K_e} + \frac{r(E-D)/K_e}{K_e}$$

Where,

P = Market price of the equity share

D = Dividend per share

r = Internal rate of return , rate of return on investment

E = Earnings per share

K_e = Cost of equity capital , Rate of capitalization, discount rate

$\frac{D}{K_e}$ = Present value of future dividends

If r/Ke is greater than 1, lower dividend will maximize the value per share and vice versa.

Numerical

Calculate the prevailing market price of a share using Walter Model from the following Information:

Rate of Return on Investment	: 10%
Capitalization Rate	: 8%
EPS	:Rs. 5
DPS	: Rs. 4

Gordon Growth Model

- The Gordon Growth Model, also known as the dividend discount model, measures the value of a publicly traded stock by summing the values of all of its expected future dividend payments, discounted back to their present values. It essentially values a stock based on the net present value (NPV) of its expected future dividends.

Gordon's Model

- Dividend policy of a firm is relevant and can affect the value of a firm. Like Walter's Model value of the firm under this method also depends upon reinvestment rate (r) and shareholder's expectations (Ke). ◦

- This is based on the premise that the investors are generally risk averse and prefer to have current income i.e. dividend. Hence there is a direct relationship between dividend policy and the value of a firm

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Formula of Gordon's Model

$$P = \frac{E\,(1-b)}{k_e - br}$$

- P = Market price of equity share.
- E = Earnings per share.
- b = Retention ratio.(1 – payout ratio)
- r = Rate of return on investment.
- k_e = Cost of equity capital.
- br = Growth rate of the firm.
- Hence, value of firm = N × P
- Where, N = No. of outstanding equity shares.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Example

- Cost of equity is 11%; rate of return on investment is 12%; and earning per share is Rs 15. Calculate price per share by 'Gordon Model' if dividend payout ratio is 10% and 30%.

Example

Solution: According to Gordon's Model:

$$P = \frac{E(1 - b)}{k_e - br}$$

- **P** = Market price of equity share.
- **E** = Earnings per share.
- **b** = Retention ratio (1 - payout ratio).
- **r** = Rate of return on investment.
- k_e = Cost of equity capital.
- **br** = Growth rate of the firm.

When **D/P Ratio** is 10%:

$$P = \frac{15(1 - 0.90)}{0.11 - (0.90 \times 0.12)} = \frac{1.5}{0.002} = Rs750$$

When **D/P Ratio** is 30%:

$$P = \frac{15(1 - 0.70)}{0.11 - (0.70 \times 0.12)} = \frac{4.5}{0.026} = Rs173.08$$

Example of a Bonus Issue

- Suppose a company declares a **1:2 bonus issue**, which means shareholders will receive 1 additional share for every 2 shares they hold.
- If a shareholder owns **200 shares**, they will receive **100 additional shares** as a bonus, bringing their total holding to **300 shares**. However, the total value of their investment remains the same initially, as the share price will adjust accordingly.

Bonus Shares

- Issue of shares at no cost to current shareholders in a company, based upon the number of shares that the shareholder already owns.
- No new funds are raised with a bonus issue. While the issue of bonus shares increases the total number of shares issued and owned, it does not increase the net worth of the company.
- Although the total number of issued shares increases, the ratio of number of shares held by each shareholder remains constant.

Bonus Shares

- A **Bonus Issue**, also known as the **Capitalization of Profits**, is a method through which a company distributes its accumulated profits or reserves to its existing shareholders in the form of additional shares, instead of paying cash dividends. These additional shares are issued **free of cost** to shareholders in proportion to their existing holdings.

Bonus Shares

- The term **Capitalization of Profits** refers to the process of converting a company's retained earnings, reserves, or surplus profits into **paid-up capital** by issuing bonus shares. Instead of distributing profits as dividends, the company reinvests them in the business, strengthening its equity base.
- This process does not involve any cash outflow from the company. Instead, it results in an increase in the company's **share capital** while reducing the amount available in reserves.

Bonus Shares

- If the subscribed and paid-up capital exceeds the authorised share capital as a result of bonus issue, a resolution shall be passed by the company at its general body meeting for increasing the authorised capital. A return of bonus issue along with a copy of resolution authorising the issue of bonus shares is also required to be filed with the Registrar of Companies.

ADVANTAGES OF BONUS SHARES FROM INVESTOR’S POINT OF VIEW

1. The investor doesn’t need to pay any tax upon receiving the bonus shares.
2. It is specifically beneficial for the investors who believe in the long-term story of the company and want to increase their investment in the same.
3. Issuing additional shares and using cash for the business growth of the company increases the investor’s belief in operations of the company.
4. If the company starts paying the cash dividend in the future, the investor receives more because he holds a number of shares in the company due to past policy of paying a stock dividend.

DISADVANTAGES OF BONUS SHARES FROM INVESTOR’S POINT OF VIEW

1. Not all investors may be interested in receiving the shares as a dividend; some may want liquidity for fulfilling other objectives. When such investors sell their bonus shares for generating liquidity, their stake in the company is reduced.

2. The stock dividend doesn’t give any extra wealth to the shareholders because share price drops by a proportionate amount to keep the market capital of the company same as before.

ADVANTAGES OF BONUS SHARES FROM COMPANY'S POINT OF VIEW

1. Bonus issue allows the company to conserve cash for reinvesting back into the business.

2. It has a signaling effect and gives a positive sign to the market that company believes in its long-term growth story.

3. Sometimes, the company may not be in a position to pay any cash, so bonus issue is the only means to satisfy the shareholders' desire for a dividend.

4. Increasing the number of outstanding shares through a bonus issue increases the participation of smaller investors in the company's shares and hence enhances the liquidity of the stock.

DISADVANTAGES OF BONUS SHARES FROM COMPANY’S POINT OF VIEW

1. Bonus issue increases the number of outstanding shares of the company and this will decrease the future EPS and cash dividend yield. This can have a negative impact on the market’s perceived value of the company.

2. The company doesn’t receive any cash upon issuing bonus shares. So, the company’s ability to raise money by follow-on offerings is reduced.

3. The cost of administering a Bonus Share Plan is more than that of paying a cash dividend. This cost can add up over the years if the company keeps on issuing bonus shares.

Stock Split

- A stock split is the division of a share into two or more parts. Stock split adds no value but increases the number of shares in the ratio of the split. By splitting of shares the capital of the company does not increase, but the capital is only redistributed by increased number of shares.

- A stock split is a decision by the company's board of directors to increase the number of outstanding shares of a company without changing the shareholders equity. A stock split is usually done by companies that have seen their share price increase to levels that are either too high or are beyond the price levels of similar companies in their sector.

Stock Split

- The basic objective is to make shares seem more affordable to small investors even though the underlying value of the company has not changed. Stock splits help to make shares more affordable to small investors and provide greater marketability and liquidity in the market.
- When the market price of a share is very higher, the subdivision is better device to reduce the market value per share and to increase the liquidity of the share. With subdivision more shares will be in floating, thereby, increase the liquidity of share. It also facilitate the small investors to hold the shares.

Reverse Stock Split

- The reverse stock split is just opposite to stock split. A reverse stock split is done by consolidating the existing number of shares into a share with a bigger nominal value. It causes a reduction in number of shares and an accompanying increase in the share price. A reverse stock split is usually done by companies that have seen their share price fall below their face value. Reverse splits occur when a company wants to raise the price of their stock, so it no longer looks like a 'penny stock.

Share Buy-Back

- Buy back of shares is a method of financial engineering.
- It can be described as a procedure which enables a company to go back to the holders of its shares and offer to purchase the shares held by them.
- Buy back helps a company by giving a better use for its funds than reinvesting these funds in the same business at below average rates of return or going in for unnecessary diversification or buying growth through costly acquisitions.
- When a company has substantial cash resources, it may like to buy its own shares from the market particularly when the prevailing rate of its shares in the market is much lower than the book value or what the company perceives to be its true value.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Share Buy-Back

- Naturally, the market price of equity goes up. The reduction in share capital strengthens the promoter's control and enhances the equity value for shareholders.
- The main aim of shares repurchase might be reduce the number of shares in circulation in order to improve the share price, or simply to return to shareholders resources no longer needed by the company.
- The shares repurchase may be by way of purchase from the open market or by general tender offer to all shareholders made by the company to repurchase a fixed amount of its securities at pre-stated price.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Impact of Buyback Decision

(a) Decreased number of shares in the market.

(b) Decreased number of shareholders.

(c) Increased debt-equity ratio.

(d) Increased earnings per share.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Methods of Buy Back

- **Tender Offer Method :** In this method, it is the company which fixes and announces a price (which will be at a premium over the prevalent market price in order to act as an incentive to the shareholders to offer their shares for buyback and also to signify in its opinion, the correct share valuation) at which it is prepared to buyback a fixed number of shares determined by it from its shareholders.

- If the number of shares offered for buyback by the shareholders at this price exceeds the total number of shares determined by the company to be bought-back, then shares shall be bought from each shareholder proportionately. In this method, it is permissible for the promoters to offer their shares for buyback provided specified disclosures.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Open Market Repurchase through Stock Exchanges

- Open Market Repurchase through Stock Exchanges: This is the most commonly practiced method of buyback of shares. In this method, the company buys shares through the stock exchanges for cancellation till it reaches the maximum number of shares it had originally started out to buyback and cancel. In this method, the price is market determined i.e. prevalent share price on the stock exchange. This method does not enable the company to directly signal any undervaluation in the share price which the tender method permits. By its very nature also, this method does not permit any payment of premium over the market price for buy-backs. However, it is the most easy method to implement since the company makes use of the established stock exchange mechanism to buy shares which are then cancelled by it.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Open Market Repurchase through Book Building

- **Open Market Repurchase through Book Building**

Under this method, the shareholders are invited to quote a range of prices and the number of shares at each price level that they would be interested in offering for buyback. Based on this information provided by all the quoting shareholders, a common price and the respective number of shares there against quoted by all the shareholders. Aggregate of which will equal the total number of shares that the company would like to buyback, will decide the price and the number of shares to be bought-back from the participating shareholders.

Source: Kishore, R. M. (2009). *Financial Management: Comprehensive Text Book with Case Studies*. Taxmann.

Thank You