



IRRELEVANCE OF DIVIDEND

- According to professors **Soloman, Modigliani and Miller, dividend policy** has no effect on the share price of the company.
- There is no relation between the dividend rate and value of the firm. Dividend decision is irrelevant of the value of the firm.
- Modigliani and Miller contributed a major approach to prove the irrelevance dividend concept.

MODIGLIANI AND MILLER'S Approach

- According to MM, under a perfect market condition, the dividend policy of the company is irrelevant and it does not affect the value of the firm.
- "Under conditions of perfect market, rational investors, absence of tax discrimination its dividend policy may have no influence on the market price of shares".
- MM approach is based on the following important assumptions:
- 1. Perfect capital market.
- 2. Investors are rational.
- 3. There are no tax.
- 4. The firm has fixed investment policy.
- 5. No risk or uncertainty.

MODIGLIANI AND MILLER'S Approach

• MM approach can be proved with the help of the following formula:=

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

- Where,
- Po = market price of the share at the beginning of period
- Ke = Cost of equity capital.
- D1 = Dividend to be received at the end of period one.
- P1 = Market price of the share at the end of period one.

 P_1 can be calculated with the help of the following formula. $P_1 = P_0 (1 + K_e) - D_1$

MODIGLIANI AND MILLER'S APPROACH: CRITICISM

- MM approach assumes that tax does not exist. It is not applicable in the practical life of the firm.
- MM approach assumes that, there is no risk and uncertain of the investment. It is also not applicable in present day business life.
- MM approach does not consider floatation cost and transaction cost. It leads to affect the value of the firm.
- MM approach assumes that, investor behaves rationally. But we cannot give assurance that all the investors will behave rationally.

RELEVANCE OF DIVIDEND: Walter's Model

According to this concept, dividend policy is considered to affect the value of the firm.

Prof. James E. Walter argues that the dividend policy almost always affects the value of the firm. Walter model is based in the relationship between the following important factors:

Rate of return I

Cost of capital (k)

According to the Walter's model, if r > k, the firm is able to earn more than what the shareholders could by reinvesting, if the earnings are paid to them.

The implication of r > k is that the shareholders can earn a higher return by investing elsewhere.

If the firm has r = k, it is a matter of indifferent whether earnings are retained or distributed.

ASSUMPTIONS

- Walters model is based on the following important assumptions:
- The firm uses only internal finance. (retained earning)
- The firm does not use debt or equity finance.
- The firm has constant return and cost of capital.
- The firm has 100 recent payout.
- The firm has constant EPS and dividend.
- The firm has a very long life.

WALTER MODEL

- Where,
- P = Market price of an equity share
- D = Dividend per share
- r = Internal rate of return
- E = Earning per share
- Ke = Cost of equity capital

Κ

CRITICISM OF WALTER'S MODEL

- Walter model assumes that there is no extracted finance used by the firm. It is not practically applicable.
- There is no possibility of constant return. Return may increase or decrease, depending upon the business situation. Hence, it is applicable.
- According to Walter model, it is based on constant cost of capital. But it is not applicable in the real life of the business.

GORDON'S MODEL

- Myron Gorden suggest one of the popular model which assume that dividend policy of a firm affects its value, and it is based on the following important assumptions:
- The firm is an all equity firm.
- The firm has no external finance.
- Cost of capital and return are constant.
- The firm has perpectual life.
- There are no taxes.
- Constant relation ratio (g=br).
- . Cost of capital is greater than growth rate (Ke>br).

GORDON MODEL

Gordon's model can be proved with the help of the following formula:

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

Where,

- P = Price of a share
- E = Earnings per share

1 - b = D/p ratio (i.e., percentage of earnings distributed as dividends)

 K_e = Capitalization rate

br = Growth rate = rate of return on investment of an all equity firm.

CRITICISM OF GORDON'S MODEL

- Gordon model assumes that there is no debt and equity finance used by the firm. It is not applicable to present day business.
- Ke and r cannot be constant in the real practice.
- According to Gordon's model, there are no tax paid by the firm. It is not practically applicable.

GORDAN'S REVISED MODEL

- Gordon revised his basic model to consider risk &uncertainty.
- He suggested that even r=k, dividend policy affects the value of shares on account of uncertainty of future.
- Investors are rational &they want to avoid risk
- They prefer near dividend than future dividend
- "bird in the hand is better than in bush"