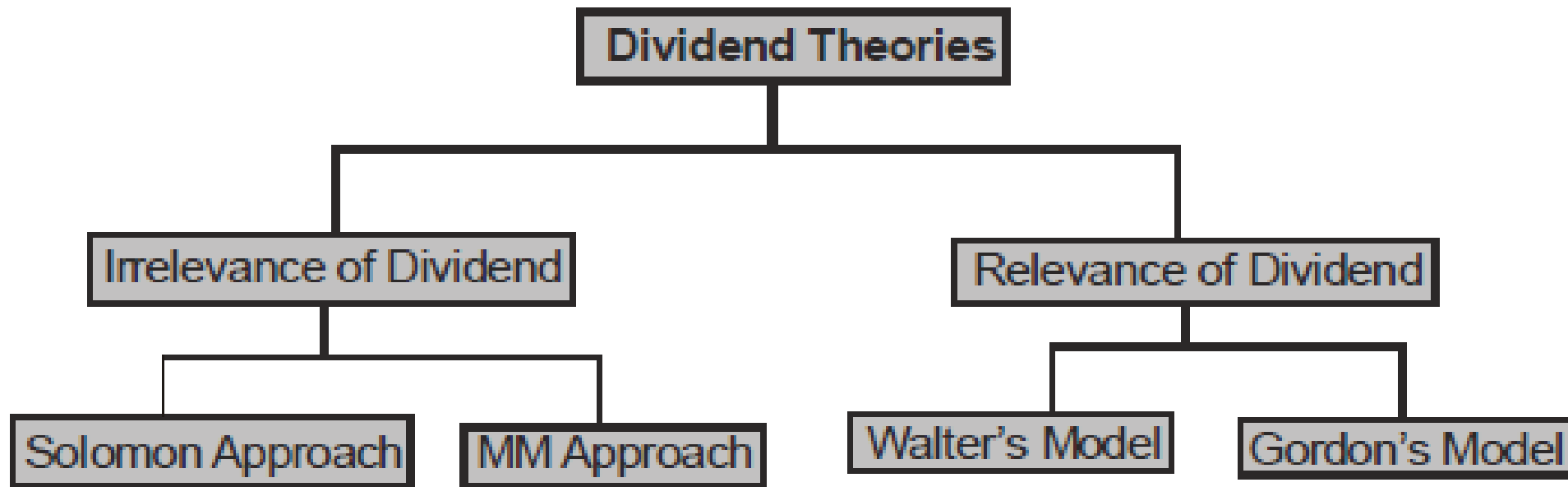


DIVIDEND POLICY

DIVIDEND THEORIES



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,
- P_0 = market price of the share at the beginning of period
- K_e = Cost of equity capital.
- D_1 = Dividend to be received at the end of period one.
- P_1 = 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 r

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 indifference 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 percent 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

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

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 Gordon 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 perpetual life.
- There are no taxes.
- Constant relation ratio ($g=br$).
- Cost of capital is greater than growth rate ($K_e > br$).

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.
- K_e 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”