

SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION

MBA FA ~~202~~

SUBJECT NAME: FUNDAMENTALS OF FINANCIAL MANAGEMENT

UNIT-V

TOPIC NAME: WALTER'S MODEL

WALTER'S MODEL

Walters Model

- Walter's model supports the doctrine that dividends are relevant. The investment policy of a firm cannot be separated from its dividends policy and both are, according to Walter, interlinked. The choice of an appropriate dividend policy affects the value of an enterprise.

Walter's theory on dividend policy believes in the relevance concept of a dividend.

According to this concept, a dividend decision of the company affects its valuation.

The companies paying higher dividends have more value as compared to the companies that pay lower dividends or do not pay at all.

Walter's theory further explains this concept in a mathematical model.

Crux of Walter's Model

Prof. James E Walter formed a model for share valuation that states that the dividend policy of a company has an effect on its valuation.

He categorized two factors that influence the price of the share viz. dividend payout ratio of the company and the relationship between the internal rate of return of the company and the cost of capital.

RELATION OF DIVIDEND DECISION AND VALUE OF A FIRM

According to Walter's theory, the dividend payout in relation to (Internal Rate of Return) 'r' and (Cost of Capital) 'k' will impact the value of the firm in the following ways:

- Relationship between r and k Increase in Dividend Payout Decrease in Dividend Payout
- $r > k$
 - Value of the firm decreases Value of the firm increases
- $r < k$
 - Value of the firm increases Value of the firm decreases
- $r = k$
 - No change in the value of the firm No change in the value of the firm

Assumptions of the Model:

Walter's model is based on the following assumptions:



▪ Internal Financing:

All the investments are financed by the firm through retained earnings. No new equity or debt is issued for the same.



▪ Constant IRR and Cost of Capital:

The internal rate of return (r) and the cost of capital (k) of the firm are constant. The business risks remain same for all the investment decisions.



▪ Constant EPS and DPS:

Beginning earnings and dividends of the firm never change. Though different values of EPS and DPS may be used in the model, but they are assumed to remain constant while determining a value.



▪ 100% Retention/ Payout:

All the earnings of the company are either reinvested internally or distributed as dividends.



▪ Infinite Life:

The company has an infinite or a very long life

Valuation
Formula and
its
Denotations:
Walter's
formula to
calculate the
market price
per share (P)
is:

$$P = D/k + \{r^*(E - D)/k\}/k,$$

- P = market price per share
- D = dividend per share
- E = earnings per share
- r = internal rate of return of the firm
- k = cost of capital of the firm

The mathematical equation indicates that the market price of the company's share is the total of the present values of:



- An infinite flow of dividends, and



The formula can be used to calculate the price of the share if the values of other variables are available.



- An infinite flow of gains on investments from retained earnings.

▪ Growth Firm:

- Growth firms are characterized by an internal rate of return $>$ cost of the capital i.e. $r > k$.
- These firms will have surplus profitable opportunities to invest.
- Because of this, the firms in growth phase can earn more return for their shareholders in comparison to what the shareholders can earn if they reinvested the dividends.
- Hence, for growth firms, the optimum payout ratio is 0%.

▪ Normal Firm:

- Normal firms have an internal rate of return $=$ cost of the capital i.e. $r = k$.
- The firms in normal phase will make returns equal to that of a shareholder.
- Hence, the dividend policy is of no relevance in such a scenario.
- It will have no influence on the market price of the share.
- So, there is no optimum payout ratio for firms in the normal phase. Any payout is optimum.

▪ Declining Firm:

- Declining firms have an internal rate of return $<$ cost of the capital i.e. $r < k$.
- Declining firms make returns that are less than what shareholders can make on their investments.
- So, it is illogical to retain the company's earnings.
- In fact, the best scenario to maximize the price of the share is to distribute entire earnings to their shareholders.
- The optimum dividend payout ratio, in such situations, is 100%.

Criticism of Walter's Model

Walter's theory is critiqued for the following unrealistic assumptions in the model:

■ No External Financing:

- Walter's assumption of complete internal financing by the firm through retained earnings is difficult to follow in the real world.
- The firms do require external financing for new investments.

■ Constant r and k :

- It is very rare to find the internal rate of return and the cost of capital to be constant.
- The business risks will definitely change with more investments which are not reflected in this assumption.

Summary

- Though Walter's theory has some unrealistic assumptions,
- it follows the concept that the dividend policy of a company has an effect on the market price of its share.
- It explains the impact in the mathematical terms and finds the value of the share.