Plekhanov Russian Economic Academy

**The theme of the report:**

**“Going public and the dividend policy of the company.”**

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# Introduction

In this report we focus on the long-term financing by issuing shares and dividend policy of the company. We consider the institutional design of capital market, *Stock Market Exchange* and *Alternative Investment Market*; fundamental theories of paying dividend and factors which influence *Dividend Policy* of the companies.

The main objective of this report is to develop a better understanding of the problems faced by start-up firms seeking capital financing and paying percentage (dividends). In addition, we try to identify the consequences of shortcoming and overplus of the dividend payouts for value of corporation (for value of share) and individuals (shareholders).

The urgency of this question is obvious, because firms need capital to finance product-development or growth and must, by a lot of factors (interest rate, time period and etc), obtain this capital largely in the form of equity rather than debt. So the issuing of shares and dividend policy is one of the widest research overseas and I hope Russian economists don’t be backward in that list.

# I. ‘Going Public’ and the Securities Market

1. ***‘Going Public’***

Most private companies that experience the rapid growth have reached the stage when existing shareholders’ private resources are exhausted, retained profit is insufficient to cope with the rate of expansion, and further borrowing on top of your current amount of loans will probably be resisted by lenders until you have a more substantial layer of equity capital. One solution to this financial problem is to retain the services of a financial intermediary – usually a merchant bank – to find a few private individuals or financial institution such as an insurance company or an investment trust that is willing to subscribe more capital. This is known a *private placing.* And, of course, there are some advantages and disadvantages of going public.

##### Advantages

* access to the capital market and to larger amounts of finance becomes possible by having shares quoted on the Stock Exchange;
* institutions are more likely to invest on the public listed company, and additional borrowing becomes possible;
* shareholders will find it easier to sell their shares in the wider market;
* the company attains a higher financial standing;
* provides an opportunity for public companies to introduce tax-efficient employee share option scheme.

##### Disadvantages

* cost of a public flotation of shares are high – as much as 4% - 10% of the value of the issue;
* because outside shareholders are admitted, some control may be lost over the business;
* publicly quoted companies are subject to more scrutiny than private;
* the risk of being taken over by purchasing of company’s shares on the Stock Exchange;
* as the market tends to be influenced more by the short- then long-term strategy of listed companies, a company committed to a long-term plan may find its stock market performance disappointing.

The going public company is ***required***:

* minimum issued capital of ₤50.000;
* minimum market capitalization of ₤500.000;
* 25% of your equity shares available to the public;
* sign a Stock Exchange *listing* agreement, which binds you to disclose specified information about your company in future.
1. ***Types of Shares***

There are two main classes of shares are *ordinary* and *preference*

##### Ordinary shares (sometimes called ‘equity’ shares)

Those are the highest risk-takers shares in the company. This implies that the holder’s claims upon profit – for dividend, and assets – if the company is liquidated, are deferred to the prior rights of creditors and other security holders. However, the capital liability of ordinary shareholders is limited to the amount they have agreed to subscribe on their shares, therefore they cannot be called upon to meet any further deficiency that the company may incur. If the ordinary shares are the *voting (controlling shares)* but in some companies the significant proportion is held by the directors and the remainder are widely held by a large number of shareholders, so the directors may effectively control the company.

##### Preference shares

They also are the part of the equity ownership, attractive to risk-averse investors because of their fixed rate of dividend, which normally must be at a higher level than the rate of interest paid to lenders, because of the relatively greater risk of non-payment of dividend. Whilst they are part of the share capital, the holders are not normally entitled to a vote, unless the terms of issue specified overwise, and even then votes are usually only exercisable when dividends are in arrears. Preference shareholders have prior rights to dividend before ordinary shareholders, but it may be withheld if the directors consider there are insufficient resources to meet it. There is an implied right to accumulation of dividends if they are unpaid, unless the shares are stated to be non-cumulative. Payment of such arrears has priority over future ordinary dividends. And if the company goes into liquidation, preference shareholders are not entitled to payment of dividend arrears or of capital before ordinary shareholders, unless their terms of issue provide otherwise, which they usually do.

Companies have issued three varieties of preferences shares from time to time, to confer special rights; these are redeemable preferences shares, participating preferences shares and convertible preferences shares. *Redeemable preferences shares* are similar to loan capital in that they are repayable but they lack the advantage enjoyed by *loan* interest of being able to

charge dividend against profit for taxation purposes, *participating preferences shares* enjoy the right to further share in the profit beyond their fixed dividend, normally after the ordinary shareholders have received up to a state percentage on their capital, *convertible preferences shares* give the option to holders to convert their shares into ordinary shares at the specified price over a specified period of time.

1. ***The Stock Exchange and the Capital Market***

The *Capital Market* embraces all the activities of financial institution engaged in:

* the raising of finance for private and public bodies whether situated in UK or overseas (the primary market);
* trading the securities and other financial instruments created by the activity above (the secondary market).

The *Stock Exchange* plays a central role in this international market. It provides the primary facility fir marketing new issues of shares and other securities, and also a well-regulated secondary market in shares, British government and local authority stocks, industrial and commercial loan stocks and many overseas stocks that are included in its Official List. Nowadays it called the London Stock Exchange Ltd is an independent company with the Board of Directors drawn from the Exchange’s executive, and from the customer and user base.

The main participants on the Stock Exchange are Retail Service Providers (RSPs) and the stockbrokers. The function of *RSPs* is to provide a market in securities, which they have nominated, and to maintain two-way prices, i.e. lower price at which they are prepared to buy and a higher price at which thy will sell. And *stockbrokers* can act for client as agent only, when purchasing or sell securities on their behalf, in which case they deal with RSPs. And dual capacity *stockbrokers/dealers*, however they will buy and sell shares on their own account, and may act as both agent and principal in carrying out clients ‘buy’ and ‘sell’ instruction. Unfortunately the integration of the broking and dealing functions within the same financial grouping can give rise to conflict of interest, and this has made it essential to create a protective regulatory framework both within and between financial institutions.

But some companies are not suitable for a full Stock Exchange listing and the *Alternative Investment Market (AIM)*, setting up by the Stock Market Exchange in 1995, is a more suitable for unknown and risky companies.

Its main features are:

* no formal limit on company size;
* ₤500.000 capitalization (full listing ₤3-₤5 million);
* no minimum trading record (full listing five years);
* 10% of the equity capital must be in public hands (full listing 25%)
* no entry fee is required, but a annual listing fee of ₤2.500 in year 1, rising to ₤4.000 in year three is payable.
1. ***Procedure for an Issue of Securities***

All arrangements made by an Issuing House, which specialized in this work. The procedure would be probably as follows:

* an evaluation by the Issuing House of the company’s financial standing and future prospects;
* an assessment if the finance required, and advise regarding the most appropriate package to finance to meet the need;
* advice of the timing of the issue;
* agreement with the Stock Exchange on the method of issue (sale by tender, SE placing etc);
* completion of an underighting agreement;
* preparation of the prospectus and other documents required by the Stock Exchange in the initial application for the quotation;
* advertising the offer for sell and the publication of the prospectus;
* arrangements with the bankers to receive the amounts payable;
* the issue price of the share to be agreed at a level to ensure a success of the issue;
* final application for the Stock Exchange quotation, and signing of the listing agreement, which binds the company to maintain a regular supply of information to the Stock Exchange and shareholders.
1. ***Equity Share Futures and Options***

These are traded at the London International Futures and Options Exchange (LIFFE), which was established in 1982.

Both futures and options are used by investors for:

* *hedging* i.e. protecting against future capital loss in their investments;
* *speculation* i.e. gambling on forecasts of favorable movements in future Stock Market prices.

The main differences between futures and options is that futures contracts are *binding obligation* to buy or sell assets, whereas options convey *rights* to buy or sell assets, but not obligations. Futures are agreed, whereas options are purchase.

***Equity Share Futures***

The only equity futures dealt in on LIFFE are those based on the FTSE 100 and MID 250 Stock Indices.

Futures contracts may b used to protect an expected rise in the market before funds are available to an investor. For example, an investor expecting a large cash sum in three months’ time could protect his position by buying FTSE 100 Index futures contract now, and selling futures for a higher sum when the market rises. The profit made on the futures position would then compensate him for the higher price he has pay for his investments when the expected cash sum arrives.

***Equity Share Options***

An option is the right to buy or sell something at an agreed price (the exercise price) within a stated period of time. As applied to shares, a payment (a premium) is made through or to a stockbroker for a *call option*, which gives the *right to buy* shares by a future date; or for a *put option*, which gives the *right to sell* shares by future date. And the holder may exercise the option, or late it lapse. However the giver (the ‘writer’) of the option, i. e. the dealer to whom the premium has been paid, is obliged to deliver or buy the shares respectively, if the option holder exercises his rights.

*Traditional options* have been dealt in for over 200 years, and are usually written for a date three month’ hence, when either the shares are exchanged, or the option lapses. The disadvantage of the traditional option is that it cannot be traded before the exercise date, and it was because of this inflexibility that the *traded options market* was created in the UK in 1978.

Equity options were first traded on LIFFE in 1992, and currently (1997), options are available on 73 large companies’ shares. Because traded options cost much less then the underlying shares, an investor is able to back an investment opinion without risking too much money.

**II. Dividend Policy and Share Valuation**

## **Dividends as a Residual Profit Decision**

It would seem sensible for a company to continue to reinvest profit as long as projects can be found that yield returns higher than its cost of capital. In this way, the company can earn a higher return for shareholders than they can earn for themselves by reinvesting dividends. Such a policy can be optimal, however, only if the company maintains its target-gearing ratio by adding an appropriate proportion of borrowed funds to the retained earnings. If not, the company’s coast of capital would increase because of its disproportionate volume of higher-cost equity capital; this would be reflected share price.

***Activity:***

The LTD Company has the chance to invest in the five projects listed below:

|  |  |  |
| --- | --- | --- |
| **Projects** | **Capital outlay, ₤** | **Yield rate, %** |
| A | 70.000 | 18 |
| B | 100.000 | 17 |
| C | 130.000 | 16 |
| D | 50.000 | 15 |
| E | 100.000 | 14 |

The company cost of capital is 16% its optimal debt to net assets ratio is 30% and the current year’s profit available to equity shareholders is ₤350.000.

Required:

* State which projects would be accepted, and what is the total finance requires for those projects.
* Assuming that the company wishes to maintain its gearing ratio, how much of the required finance will be borrowed?
* How much of this year’s profit can be distributed?

The answers:

* *A*, *B* and *C*, with yield greater than or equal to the company’s cost of capital; total finance required ₤300.000.
* Amount to be borrowed: 30% of ₤300.000=₤90.000.
* This year’s profit: ₤350.000

*less*  amount to be reinvested ₤300.000-₤90.000: 210.000

Profit for distribution: 140.000

Company’s shareholders obtain the best of both words. They can invest the ₤140.000 received as dividends to earn a higher rate of return than the company could earn for them; and the ₤210.000 retained by the company is reinvested to shareholders’ advantage. Shareholders’ wealth is optimized, and the dividend paid is simply the residual profit after investment policy has been approved.

If companies look upon dividend policy as what remains after investments are decided then the search for an optimum dividend policy is pointless. Shareholders wanting dividends can always make them for themselves by selling some of their shares.

Further support for the ‘residual’ theory of dividends, and the argument that the change in dividend policy does not affect share values, was advanced by Modigliani and Miller in 1961. They contended that in a perfect market the increase in total value of a company after it has accepted an investment projects is the same, whether internal or external finance is used.

One deficiency in the Modigliani and Miller hypothesis, however, is that they ignore costs associated with an issue of shares, which can be quite considerable.

1. ***Costs Associated with Dividend Policy***

Capital floatation costs are a deterrent substituting external finance for retained earnings but there are other costs affected by the dividend decision.

If shareholders are left to make their own dividends by selling some shares, this involves brokerage and other selling costs that, on a small number of shares, can be extremely an economic. In addition, if they have to be sold during a period of low share price, capital losses may be suffered.

Another important factor is taxation. First, when the company distributes dividend it has to pay an advance installment of corporation tax (ACT), currently one quarter of the amount paid. But the offset against mainstream liability to pay corporation tax will be delayed by at least one year. Indeed, if the company does not currently pay this type of tax, the delay in setting off ACT will be even longer, and this will tend to restrain extravagant dividend distributions.

Second, from the investors’ viewpoint profitability invested retained earnings should increase share values, enabling shareholders to create their own dividends. Selling shares creates a liability to capital gains tax, currently 20%, 23% or 40%, but subject to a fairly generous exemption limit. By comparison, dividends in the hands of shareholders attract

higher rate of income tax (up to 40%). Thus higher-rate taxpayers may prefer comparatively low dividend payouts to minimize their tax burden.

Third, financial institutions confuse the taxation picture even more, through their major holdings in the shares of quoted companies. They are able to set off dividends received against dividends paid for tax purpose but some may be liable to capital gains tax if they sell shares to make dividends.

The effect of taxation on dividend decision is difficult to analyse. It may be argued that companies attract investors who can match their personal taxation regimes to company’s dividend policy, and that those who don’t join a particular ‘taxation club’ will invest elsewhere. If this were true, however, a change in company’s dividend policy would probably not find favour with its shareholders clientele. And would consequently affect share values, which seem to support the argument that dividend policy matters.

1. ***Other Arguments Supporting the Relevance of Dividend Policy.***

***Activity:***

As a potential investor, how would you react to the following questions?

1. Would you prefer cash dividends now, against the promise of future, perhaps uncertain, dividends?
2. Would you prefer a stable, growing dividend to one that fluctuates in sympathy with company’s investment needs?
3. If a company, in whose shares you invest, increases or decreases its dividend, would it change your personal investment policy?

In answer in question (a) you probably opted for cash now rather than cash you may never see. The future is uncertain and most people take much convincing that it is in their interests to postpone income. Although the equity shareholder by definition is the risk-bearer, he is also entitled to a reasonable resolution of dividend prospects to compensate for the additional risk he carries. An investor will almost certainty pay higher price for earlier rather than later dividends.

In question (b), in definition, a fluctuating dividend is more risky than a stable dividend. Investors will pay more for stability, especially if it is linked with steady growth. Research has shown that, in general, dividends follow a pattern of stability with growth. Maintenance

of the previous year’s dividend is the first consideration, with growth added when directors feel that a higher plateau of profitability has been consolidated.

As regards question (c), you would no doubt be very happy about an increase, and might even be prompted to buy more shares – thus helping to put the market price up. Conversely a decreased dividend would cause to review your investment, perhaps even to sell your shares to take advantage of better investment opportunities elsewhere. Investors tend to believe that dividend changes provide information regarding a company’s futures prospects, and they react accordingly.

1. ***Practical Factors Affecting Dividend Policy***

Whatever dividend policy is thought to be best for a company in theory, certain practical factors influence the decision.

***Availability of profit*** The Companies Act 1985 provides that dividends can only be paid out of accumulated *realized* profit *less* realized losses, whether these are capital of revenue. Previous or current years’ losses must be made good before a distribution can be made. If an asset is sold, any *realized* profit or loss arising can be distributed; but any profit or loss arising from revaluation of an asset cannot be distributed – unless and until the asset is sold.

***Availability of cash*** Profit may be earned during a year and yet it may hot be possible to pay a dividend because of lack of cash. This can arise for different reasons. It may already have been expected or be needed to replace fixed and working assets, perhaps at inflated prices. Large customers may not yet have paid their accounts or cash may be needed to repay a loan.

***Other restrictions*** The company’s articles association may limit the payment of dividends or a lender by insert into a loan agreement to restrict the level of dividends. A company’s dividend policy cannot be so outrageously different from policies followed by similar companies in the same industry; otherwise the market price of its shares could fall. Dividends may be restricted by government prices and incomes polices.

1. ***Alternatives to Cash Dividends***

In recent years companies have introduced more flexibility into their dividend policy by either:

* issuing shares in place of cash dividends (‘scrip’ dividend);
* repurchasing their shares.

***Script dividends*** Companies may give their shareholders the option to receive shares rather than cash. This has the effect of maintaining company liquidity, and enabling the company to increase earnings by investing the retained cash. However company has to pay ACT on the distribution, and the shareholders have to pay income tax.

Thus, the shareholders can increase his investment in the company, without expense associated with the public issue or a purchase on a stock market, but the same time retain the option to convert his shares into cash at a future date.

***Repurchasing shares*** Since 1981 companies have been allowed to purchase their own shares subject to certain restrictions, and the prior authorization of their shareholders. This is normally done by utilizing distributable profits, and the shares must be cancelled after purchasing.

Repurchasing of shares may be carried out for any of the following reasons:

* to repay surplus cash to shareholders;
* to increase gearing by reducing equity capital;
* to increase EPS by reducing the number of shares related to an unchanging level of profit, and hopefully, therefore, the value of each remaining share;
* to purchase the shares of a large shareholders.

#### Summary

In this report we have explored an important and long-standing issue in financial research: *how do corporations finance themselves, the shares issuing in the Stock Market Exchange and dividend policy of the companies*.

And the situation is that the rapidly expanding companies suffer from the retained profit insufficiency and one of the solutions of this financial problem is going public.

But it is not surprising that existing shareholders dig more deeply into company’s pocket by claiming dividends. And of course the public company is subject to more scrutiny than a private one.

Thus I think only when all other sources are exhausted your can dilute already existing shareholders’ control over the company. However corporations willingly make issues of shares and pay dividends. So how are their dividend, financial and investment policy reconciled? This question has exercised the minds of academics and financial managers in recent years without any completely satisfactory answer being produced.

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