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Dividend policy

Dividends and earnings

- Companies pay a fraction of their earnings as dividends to its owners
- The remainder is kept by the company (retained earnings) and increases its equity
- Retained earnings can be used to finance further investments
- Dividends are a source of income for equity owners

Balancing income and investment

- Companies need to balance providing an income to owners with making additional investments
- Additional investments would lead to higher profits in the future and higher future dividends
- As future investments are dependent on retained earnings, we will see how dividends can be used to signal information to the market

Increasing equity and retained earnings

- Retained earnings are not the only source to increase investments, companies can also raise additional equity
- We will see how companies would optimally balance dividends and raising additional equity in the market
- Companies might also retain too much earnings such that not all can be invested and we will look at the impact this has on company values

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Dividend irrelevance and moral hazard

Dividends do not matter without moral hazard

- We have seen that the dividends paid are irrelevant for the value of the company as long as future investments are profitable
- If investments are not profitable or retained earnings can be diverted to benefit managers, dividends should be increased

? Even if managers cannot divert earnings for their own benefit, when would shareholders prefer high dividends?

! If the company has only low-value investments available and shareholders have better investments available to them, they would prefer a return of funds to make such investments

Asymmetric information between shareholders and managers

- Companies have better information about future prospects than outside investors
- If dividends affect their ability to make investments, they might use dividends strategically to maximize company value
- Investors can observe dividend decisions and might be able to infer from that the prospects of the company

Signalling with dividends

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Dividends revealing company prospects

- Dividends can signal the prospects of a company as the impact of high dividends is more severe if these prospects are less good
- The information obtained from the dividend decision will then affect the company value as its type is revealed

? A company pays a high dividend, does it then always follow that it has good prospects?

! It can signal good prospects, but might also be the result of reducing moral hazard if the company does not have many good investment projects

Summary

- Dividends can serve as a signal about the prospect of a company
- Dividends can also be used to reduce moral hazard, but this implies no good investment opportunities or managers taking advantage of their decision-making power
- Without these effects, dividends are not relevant for company value as the earnings paid out can be recovered through raising additional equity

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