Andreas Krause

Signalling with dividends

- We can now investigate how companies can overcome adverse selection in that investors cannot distinguish between companies that have good prospects through highly profitable investments and companies that do not have such investments available.
- One way companies could achieve that is through their dividend payments and use this decision as a signal to investors about their quality.

Dividends and future investments

- Managers of companies are better informed about the future prospects of companies than outside investors
- If managers pay out higher dividends, they retain less earnings and can make less future investments
- This would negatively impact the value of companies
- If future earnings are high, this impact would be less pronounced
- Companies might use their dividends to signal their confidence in the companies prospects

Dividends and future investments

→ We will first make the connection between dividends and investments.

- Typically, managers have better information about the prospects of a company than investors. This is because they have better access to information, much of which could not be disclosed for reason of competition.
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  - If managers pay out high dividends, they reduce the amount of equity the company has and thus the funds available.
  - With less funds available, the company can make less investments.
- Making less investments would impact the company value negatively.
- With higher future earnings the impact on the company value would be less pronounced as they would be able to generate sufficient profits to maintain their investments, despite paying out high dividends.
- It is therefore that paying high dividends might be used as a signal that the company has such profitable investment opportunities and can afford to pay high dividends.

→ We will now explore in more detail how this signalling might work.

Company value

- Managers care about the current value as assessed by outside investors and the future value of the company, which will be revealed fully after investment
- Assume that a company paying high dividends is seen as having good future prospects and those paying low dividends as having less well prospects
- A company will have a current value to outside investors consisting of its dividend and the value of future inferred retained earnings that are invested
- The value of the company in the future will be the return on the actually retained earnings
- $\Pi_M^{ij} = \gamma \left(d_j + (1+R)\left(E_j - d_j\right)\right) + (1-\gamma)\,(1+R)\left(E_i - d_j\right)$

Company value

→ We will first look at the company value from the perspective of

- Assume managers obtain a bonus that depends on the value of the company now,
  - but also in the future once the future investment they can make is revealed.
- We assume that is the company is paying a high dividend, then it will be seen as having good future prospects,
  - while paying low dividends is seen as having low prospects.
- The current value of the company is determined by the dividend the company pays
  - and the future inferred earnings, which are based on the investment return of the inferred investment amount. This inference will be high if the dividend is high and low if the dividend is low.
- The future value will depend on the return the company can earn based on the actual state of the company, thus the equity that is actually available after the dividend has paid. γ denotes the relative importance of current and future values to the manager.
- *Formula*

→ The manager's remuneration will now be based on this value and therefore he will seek to choose the dividend payment that gives him the highest payment, which is the highest value as described here.

High future earnings

- High dividends:
  $\Pi_M^{HH} = \gamma\left(d_H + (1+R)\left(E_H - d_H\right)\right) + (1-\gamma)(1+R)\left(E_H - d_H\right)$
- Low dividends: $\Pi_M^{HL} = \gamma\left(d_L + (1+R)\left(E_L - d_L\right)\right) + (1-\gamma)(1+R)\left(E_H - d_L\right)$
- Company pays high dividends if $\Pi_M^{HH} \geq \Pi_M^{HL}$

$\Rightarrow\ d_H - d_L \leq \frac{\gamma(1+R)(E_H - E_L)}{\gamma R + (1-\gamma)(1+R)}$

High future earnings

→ Let us now assume that the manager knows that the prospects of the company will be good and hence high future earnings are obtained.
- If he pays a high dividend, the value will be given by this *formula*.
- If he pays a low dividend, the value will be given by this *formula*.
- He will pay a high dividend if the value of the company is higher than with a low dividend.

⇒ This condition can be solved for this *formula*.
→ We have thus established the condition that ensures the company with good prospects chooses the high dividend.

Low future earnings

- High dividends:
  $\Pi_M^{LH} = \gamma\left(d_H + (1+R)\left(E_H - d_H\right)\right) + (1-\gamma)(1+R)\left(E_L - d_H\right)$
- Low dividends: $\Pi_M^{LL} = \gamma\left(d_L + (1+R)\left(E_L - d_L\right)\right) + (1-\gamma)(1+R)\left(E_L - d_L\right)$
- Company pays low dividends if $\Pi_M^{LL} \geq \Pi_M^{LH}$

$\Rightarrow\ d_H - d_L \geq \frac{(2\gamma-1)(1+R)(E_H-E_L)}{\gamma R+(1-\gamma)(1+R)}$

Low future earnings

→ Let us now assume that the manager knows that the prospects of the company will be low and hence low future earnings are obtained.
- If he pays a high dividend, the value will be given by this *formula*.
- If he pays a low dividend, the value will be given by this *formula*.
- He will pay a low dividend if the value of the company is higher than with a high dividend.

⇒ This condition can be solved for this *formula*.
→ We have thus established the condition that ensures the company with bad prospects chooses the low dividend.

Signalling the company's prospects

- Both conditions can be fulfilled simultaneously
- $\frac{(2\gamma-1)(1+R)(E_H-E_L)}{\gamma R+(1-\gamma)(1+R)} \leq d_H - d_L \leq \frac{\gamma(1+R)(E_H-E_L)}{\gamma R+(1-\gamma)(1+R)}$

$\Rightarrow$ Companies can signal through high dividends that their prospects are good

Signalling the company's prospects

→ We now combine these two results to ensure that the dividend choice conveys information about the prospects of the company.
- We can now combine the condition that the company with good prospects chooses the high dividend and the company with bad prospects chooses the low dividend.
- This requires the differences in the dividends to be sufficiently large, but not to be too large.

⇒ [] By choosing the dividends appropriately, companies can signal through high dividends that they have good prospects.
→ Dividends can therefore be used by companies to signal their future prospects and investor would know their type by observing the dividend they announce.

Impact on company value

- Dividends can be used to signal the future prospects of companies
- High dividends reduce the future value as less can be invested and this is only sustainable for companies with high earnings
- The value of companies paying high dividends will increase as information on its prospects is revealed

Impact on company value

→ This information will affect the company value.

- Dividends are used as a signal to convey the prospects of the company and investors will take this information to determine the value of the company.
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  - They know that high dividends reduce future value as the investments need to be reduced,
  - they know that such high dividends are only beneficial to the manager if the company obtains high earnings to make substantial investments.
- This will increase the value of the company as investors know that the company has these good prospects and the reduced ability to invest after the high dividend payment has a smaller impact.

→ Hence, higher dividends increase the value of the company, but not because of the dividend itself, but because of the information such a high dividend conveys to investors about the prospects of the company.

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Andreas Krause
Department of Economics
University of Bath
Claverton Down
Bath BA2 7AY
United Kingdom

E-mail: mnsak@bath.ac.uk