THE READER

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COVER STORY

INTRODUCTION TO DIVIDENDS

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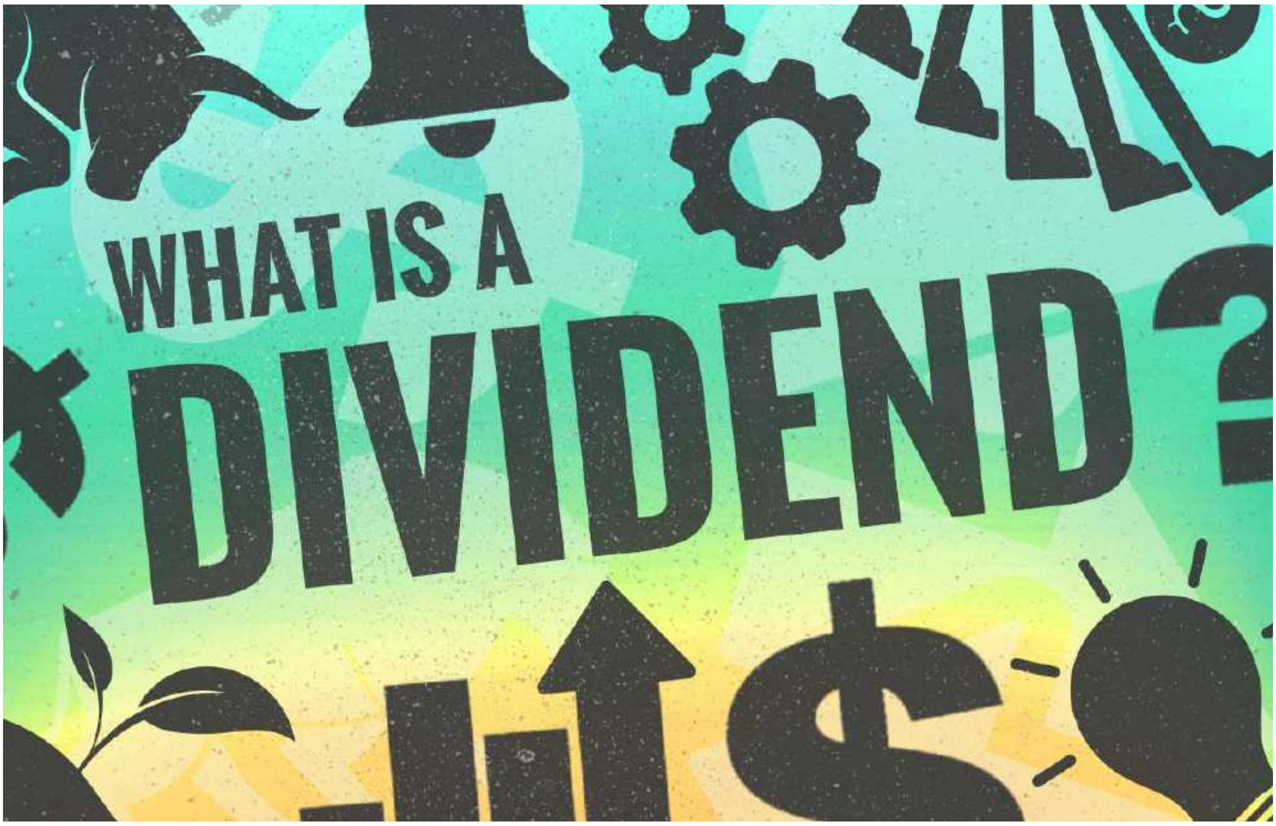
INTRODUCTION TO DIVIDENDS



What is dividend?

Lets begin with the myth that few people have. Dividend is often misunderstood as the so called “return” earned on investment in shares of any public company which is plain stupid. Here is why, Let's say you own a stock trading at around 1200 and after a year company makes good profit and now its traded at 1500 per share thereby giving you returns of Rs. 300 per share in a year irrespective of what dividend company is paying out. Now what if company had declared and paid a dividend of Rs. 100 per share, would that make your return 400? That is 300 plus 100?

Answer will be a resounding NO. Tell your greedy mind to calm down. The moment when the dividend of Rs. 100 will be paid out share price will drop down to Rs. 1400 as Rs. 100 has already been paid out to you.

Let us compare the same logic with a small self owned firm. I have a capital of Rs. 2,00,000 in the beginning and made a profit of Rs. 50000 during the year, so that will naturally increase my capital to Rs. 250000. Now dividend is similar to drawings which u take away out of profits instead of reinvesting the same money into the business. What if I withdrew Rs. 10000 out of profits for personal use, will that drawings be considered as your earnings from the business for that year? --- No, profits earned will be Rs. 50000 irrespective of whether you withdraw or do not withdraw. My returns from the business is Rs. 50000 and not Rs. 10000 which I took home and spent on my leisure. So dividend is withdrawing some part of your earned profit to spend/invest elsewhere.

IDEAL DIVIDEND PAY OUT RATIO (how much to re-invest and how to distribute to shareholders)

Let’s say there is a highly sophisticated company with very qualified and reputed managers and investors who earns huge profits every year and is growing like anything. They have earned profits of Rs. 10 crore in this given year. What should they do? Re-invest or give it away to shareholders who can spend that money on holidays or fixed deposit bearing a meagre 7% interest or some highly depreciable assets like cars or other luxury goods. The answer is simple, they shouldn’t give a dime to their shareholders because of two reasons, first being that if they distribute it as dividend, they will have to again borrow from other lenders such as banks or debentures to meet additional fund requirements for expansion and growth of the business and second being 90% of the shareholders dont know how to spend/invest that money so as to increase their wealth in future.

So for any growing company who is going to out-score average rate of return of the market should always give 0% dividend to the shareholders and re-invest all the money into the business as that is the best possible rate of return they could possibly get. But on the other hand if the company is not growing and does have a lot of surplus cash which cant be invested in profitable ventures due to lack of opportunities or recession in economy or lack of managerial or geographical efficiency, then the company should pay out 100% dividend and let the investors decide where to invest their money.

What does "the goliath of stock market" Warren Buffet thinks?

Warren Buffett thinks that a company can do four things in this specific order with their profits:

1. Re-invest in the company which he says is pure organic growth
2. Acquire shares of different companies
3. Re-purchase of shares
4. Pay out dividends

"The company has paid only one dividend, in 1967, and Buffett later joked that he must have been in the bathroom when the decision was made." Warren Buffett likes to receive dividends, infacts he loves those companies that promises regular growth based dividend like coca cola in which he is a long time investor and other companies like apple inc. he says its better to get regular cash flows with which company can use that money to invest in other brighter prospects and earn more money. But when it comes to paying dividend he has 0% pay out strategy. He says " we don't pay dividends because we think we can turn every dollar we retain into more than a dollar at market value, the only reason to keep your money is if it becomes worth more by us keeping it than it would be worth if we gave it to you and if we can create more than a dollar at our market value for every dollar we keep, you are better off whether you want to take that dollar out by selling a little piece of your stock or whether you continue to leave it in. Thats the test if we come to the conclusion that **we can't do that** and we could come to the conclusion sometime then we should distribute it to you."

Simple answer : money can be better spent in other ways.

IF NO DIVIDEND, WHAT ELSE?
(Other arrangements to give cash to shareholders)

As we all know that dividend is taxed by dividend distribution tax which makes cascading effect of tax as dividend is given out of profits which is after deducting the taxes. So in order to avoid this tax, companies go for buy back of shares or commonly referred as repurchase of shares. This way, shareholders get some cashflows to work with if they were in dire need of it and DDT can be avoided. How does this work? Lets take another example: you have 100 shares of some company traded at 30 per share making your wealth at Rs. 3000. Imagine company has surplus cash and wants to distribute it among shareholders, they have two further options:

1. To give dividend of Rs. 6 per share. This way your wealth is still Rs. 3000 [Rs. 600 cash (100 shares * Rs. 6 dividend per share) received and 100 shares now at new price of Rs. 24 making it worth Rs. 2400]. In this assumption, the amount actually received would be less then Rs. 600 as DDT would have been charged.

2. To buy back 20 shares from the market. This way again your wealth is Rs. 3000. [Rs. 600 cash (20 shares * Rs. 30 per share) and remaining 80 shares still trading at Rs. 30 per share making it worth Rs. 2400.]

As you can compare from the two options that there is actually a way to give cash to your shareholders [only happens when there is no intelligent investing or expansion options with the company] without going for the dividend option. Another advantage of buying back the shares instead of declaring dividend is that as mentioned by warren buffet, shares can be bought back when in market value (i.e. current price due to day to day demand and supply of shares) of shares is less than the intrinsic value (i.e. the actual/real/book value of the share at which share should have been traded at). In simple terms, market will give you the opportunity buy Rs. 100 at Rs. 90 some days, you just have to keep looking.

So what happens in real life?

A simple question, to a small scale businessmen, whether to draw money from profit or to reinvest. Because both has their own needs and values? Common sense says it should be wherever you can earn more. But in real life, for a company it depends upon the discretion of the owner and liquidity (cash reserves) in the company whether or not to re-invest or distribute.

Major universities and financial institutions incline on declaring dividends and so do companies like Apple, Coca Cola, Bank of America, Wells Fargo even though they have tons of other opportunities to re-invest or to acquire some other business by the surplus cash rather decide to give dividends to appease investors who are expecting dividends and wants that flow of income on yearly basis. Eventually what makes investors happy, even though short term, is what is generally decided by the boards but there are few investors like Warren Buffet who can & does convince their shareholder and board to not declare dividend.

Authored by:
Aakash Shah
Accounting & Statistics
Faculty at SGT

BLOOD DONATION DRIVE

Giving blood is a simple thing to do, but it can make a big difference in the lives of others. At SGT, we try our best to do whatever we can to make this difference in the society & motivate the people in joining our drive for blood donation.