The Dividend – a Source for the Development of Companies or for the Growth of Market Value?

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Abstract. *Usually the dividend policy is seen as a way to approach the distribution of profit on the two classical directions. But the dividend policy influences the market value of a company, and if those who decide over this problem do not have an ethical behaviour, but pursue to distribute a great part of the profit as dividends under the form of free shares, contributes to the decrease in the current price of the company's shares. The conclusion drawn from the present study is that the market value of a company will grow only if the distributed dividend is situated on a continuous upward curve. This fact imposes to resort sometimes to accumulated dividends and other times to the reduction of the part from the profit meant for investments in order to complete the dividends so that they are greater than in the previous year.*

Key words: the dividend policy; the company's market value; the invested profit; the rate of dividend per share; the residual dividends; the accumulated dividends; the free shares; the company's market image; the subscription rights.

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The dividend policy of a company involves a sum of problems and interests that reveal, for example, the quality of the management. It also reveals the relationship between manager and administrators, how rational is the strategy of development of the company and the loyalty program for the employees. In the same time, it provides profound explanations of the evolution of the market value of shares and the company's public image. Therefore we believe that the development and implementation of a dividend policy appropriate to the characteristics of each company must be the main concern of management tasks and not the fulfillment by each employee of its work tasks, problem that can be left on the hands of a manager from inside. And a competent analysis and maybe an authorized public debate of the dividend policies of companies listed on the stock exchange is today the more necessary as they are expected to obtain in the same time, high economic performances and distribute constant high dividends. If these targets are not achieved concurrently, the company is sanctioned by a drop in the price of its shares on the exchange, through increased costs of alternative sources of financing, because some investors do not understand that businesses which, for example, waive for a few years to pay dividends or reduce their size – in order to survive through their own means – give proof of good sense and concern for the preservation of the capital invested by shareholders in the company.

It became common the recognition of the fact that, by increasing the proportion of profits distributed as a dividend, decreases the part of it accumulated in that year and that, together with it, there are reduced also the amounts available for investments. To not waive, for this reason, some profitable investment projects, the company will have to resort to a greater extent on external funds. When they reach appreciable dimensions and when they are associated with significant cash flows in the form of paid interests, the profits and the future possibilities to reward the shareholders will fall at least significantly. So the dividend policy, oriented to satisfy the shareholders' desire for gains – in the form of dividends – has a contradictory effect on their objectives in this plan, on short-term and long-term.

Firstly, this effect accentuates as the number of shares that exist at holders increases, because it is reduced the increase rate of the dividend per share. Secondly, as a market is more volatile, it also boosts the effect to which we refer, because in such circumstances it is given a greater value to a leu obtained from dividends than to the one resulted from capital gains (from price difference on the stock exchange), because of the differences in the risk levels of the two sources of financial advantages. The difference we talk about is favorable to the dividends.

The major objective pursued by the shareholders is increasing the market value of the company. It is obtained if the price of the shares in question increases on the market they are traded, or if the number of shares – issued by the company and held by the shareholders – increases to such an extent that they annihilate any further decreases in the price of those shares. But the market price of the shares is in a fragile balance with the dividend policy.

If the investors in a security estimate that the company that issued that security would ensure an increase of the dividend with a certain percentage, and it increased just as expected, the market price for the share does not change after the date of this announcement. In such cases, the dividend increase was anticipated by the market and it was included in the price before the confirmation of the anticipation's accuracy. Things happen in a diametrically opposed manner when the dividend achieves a lower growth than the estimated one. In such circumstances, the market price falls even if it has exceeded the planned profit, the respective difference does not cover the additional risk that threatens the obtainment of the anticipated dividend.

Finding the direct correlation, existent between the evolution of the dividend per share and its price, led some researchers to believe that it is determined by the investors' interest in dividends rather than in capital gains.

But two famous economists, M. Miller and F. Modigliani, support a different point of view, extremely useful to the decision makers, confirmed very frequently in practice. They start with the common asserting that the management of companies always expresses an appreciable dose of concern when they must reduce the level of dividends from one year to another and, therefore, increase the amount of dividends per share only when they are convinced that the profits that allow such a reward are stable, meaning they can be obtained also in the future. Miller and Modigliani expressed their belief that higher dividends than those estimated by investors represent a signal to them that the company is in extended favorable circumstances, while a reduction of dividends points to a forecast of lower earnings. Starting with this point of view, there is just a single step to the fact that the perception we mentioned influences the market price of the shares of that company in the logical direction of the meaning of the informational content of the deciphered sums.

The practice, inclusively in our country, confirmed what economic theory argued with logical arguments about the dividend policy. It is not so important the size of the distributed dividends or their proportion in the obtained profit, as the continuous upward trend of their size. In time, investors get to realize the relationship that exists between the profitability of an investment and the risk assumed by who invests, as well as the additional benefits brought by capital gains against those from dividends. Or vice versa. As a result, some will be attracted by the companies that distribute large dividends, others by those which allocate the profit giving priority to investments. There are shareholders who need current annual incomes, and they do not want to complicate themselves with obtaining them by selling their shares, even if their price has increased as a result of the capitalization of a large part of the profit. So a pertinent analysis of investors' preferences reveals that each company creates for itself, in time, a certain clientele, who prefers the features of the dividend policy practiced by the company.

Nevertheless, we draw attention on the effect of an unexpected change in this policy on the price of the company's shares. If the company retains and re-invests the obtained profit and does not pay the dividends expected even by the permanent shareholders, they will cover their needs of current income from loans or, more frequently, on account of capital gains by selling a part of the held shares. If the number of such operations is high, no other argument will stop the price from a vigorous correction.

The policy of residual dividends. The size of the dividends to be distributed to the shareholders can be specified only after the deduction from the net profit of the necessary fund for the investment budget. This kind of procedure is preferred by those shareholders which prefer that the company keeps and reinvests the profit rather that distributing it as dividends. Their choice is not necessarily determined by a reduced need for current incomes but by the conviction, fortified by the company's previous performances, that this way – by reinvesting the profit – they can obtain a profitableness rate greater than that offered by other investments with the same degree of risk. If the opportunity cost of the accumulated profit is given by the profitableness rate of the investments available for the shareholders, then the size of the owned capital and their knowledge in this area condition the acceptance degree of this variant of dividend policy. As a conclusion, the policy of residual dividends can be successfully applied by companies where the shares are concentrated in the hands of a few investors with great financial power and strong knowledge in the business domain.

After a company reached the optimum size and it keeps relatively easy the medium cost at a minimum level, it can afford to apply a policy of constant dividends. But remunerating the invested capital with set sums per share signifies a decreasing compensation when the inflation rate increases. This drawback, that can generate the desire to sell the respective shares, can be eliminated if the dividends are established to progressively increase with a rate equal at least with that of inflation. Because nowadays there are no more problems with des-inflation, it is recommendable that the companies never reduce the annual dividend per share. But anyone can realize that this becomes feasible on long-term just when (1) the profit increases with a rate identical with that of the dividends or (2) it is accepted to decrease the part of the profit meant for investments.

It is well known the anxiety reaction caused to the shareholders by fluctuating dividends, as well as the decreasing tendency of the market price of a company's shares, company that resorts to inconstant annual payments from profit. The big investors in shares listed on the sock exchange, the pension funds and the insurance companies avoid introducing in their portfolios securities with incomes from variable dividends. They appreciate the risk of investing in companies rather by the fluctuation in time of dividends than of profits, because it is taken into consideration the premise that the size of these can be influenced through appropriate accounting registrations.

The companies can avoid the problems associated with instable dividends through measures more or less accepted, like postponing to realize some foreseen investments, the reduction of profit distributed for accommodation, the issuing of new shares, the distribution of a sure dividend of reduced value to which there are made variable additions, named extra-dividend, depending on the size of the profit obtained in the previous year. Acting this way, the shareholders manage to know the minimum sum from dividends that they will certainly receive and on which they can count on. In the same time, they inform themselves indirectly about the company's performances situated above the planned ones. The drawback of this policy comes from a possibly regular payment of the extra-dividend. The cashing of this can become a usage so that its nonpayment at a certain moment generates similar effects with those created by the modification of the size of the regular dividend paid to the shareholders. But the relation of determination can be extended and, so, we identified a modality to annihilate this insufficiency: it is established as objective the dividend to distribute as average for a few years. Thus, the decrease of the size of the source from which the dividend payment for one year is realized can be supplemented by its increase in another year. In order to apply this variant of the dividend policy, the management of the company has to use important resources to inform the shareholders about its connotations, otherwise it cannot avoid the decrease of the market price for its own shares when the profit or the dividend decreases.

No repetitive issuing of new shares can be easily managed, even if the company uses this modality to finance its investment projects. When choosing the financing modality there have to be considered the issuing costs and the possibility to pay the dividends not only form the current profits, but also from those accumulated in the previous years; when the issuing costs of the new shares are reduced, it is recommended the variant of dividends representing a big part of the profit. If these costs are big, it is more economical the financing from profit than from the sums cashed through the selling of the new shares. By investing a big part of the profit, the value of the company increases, but it is possible that over the years – maybe even before the investment under implementation can reach its projected parameters – the profit and the dividends will not increase. And as between the size of the dividends and the market price of shares there is usually an undeniable and paradoxical relation, the shares' market price drops. This drop we did not manage to explain it in any other way than by the lack of economic knowledge of many investors. Another explanation, unconfirmed by practice, would be the appearance of some investment variants more advantageous or with more rapid profitableness, which determined the investors to reorient their investments towards other securities.

The securities generally tradable, but especially the stocks, have an interval of optimum price. When the price is in its interior, the value of the company is maximized. If the possibilities to reward the shareholders with dividends manage to become to big, in a year, probably because of obtaining an exceptional profit, the shares' price increases a lot, exiting the optimum interval. In these circumstances it is recommendable that a part of the profit to not be distributed as dividends, but to be accumulated in order to be paid in the following years. How many shareholders accept this solution? I think that many will adhere to this variant of the dividend policy, but just after they once endured the consequences of rejecting it.

The distribution of dividends as shares, named free shares, followed by the issuing of new ones, payable in cash, can lead to the alteration of the market's possibilities to self regulation, and as a consequence to the dramatic decrease of the shares' individual price. The investors, even the devoted ones, use – some until exhaustion – their available funds to buy the subscription rights. If then the market price of the shares drops, becoming attractive for buying operations, they cannot buy because they used their capital for underwriting. The decrease in the number of potential buyers through numerous issues with subscription rights advantageous for the shares reduces a lot the possibility of the price to stabilize itself through natural means of the market.

I think there can be accepted the thesis, which are real axioms, that through the increase of dividend it is transmitted an information referring to the future gains, and the decrease of the paid dividend represents a new information, sometimes unexpected, which contributes in a big way to the decrease of the shares' market price. The same happens when new shares are issued from dividends if this issue is not followed by the payment of some cash dividends with a greater value: the price of the share will drop, because the new information is not anything else than an anticipation of the future gains.

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