

Dividends Part Deux!

“Do you know the only thing that gives me pleasure? It's to see my dividends coming in.”
John D. Rockefeller

Indeed, many of us can relate to the above quote. In fact, in the last article I wrote I spoke about the recent interest in dividends in the present bear market conditions. I also wrote about the basic fundamentals involved in paying dividends and the process involved from the date of declaration to the payment date. While my article was very simple and straightforward, I was pleasantly surprised to see how many people responded and were interested to learn more or in some cases used the information to determine when was the best time to sell or purchase stocks. So, as promised and with pleasure I would like to go a little deeper in this article and explain some of the common terms you would come across which relate to dividends, in addition to the implications surrounding dividend payments.

Firstly, I would like to explain the concept of *Dividend Policy*- this is when a company establishes that it would pay dividends by using some sort of guided principle. For instance, **National Enterprises Limited (NEL)** which is listed on our local exchange has a dividend policy which states that *“dividends are forecasted at 90 per cent of dividends received less administrative expenses.”* This is because NEL is an investment holding company and as such it does not produce any earnings, thus the subsidiary companies would pay a dividend to NEL and then this is passed on to the shareholders of NEL through its dividend policy. This example may not be a common way for a company to payout dividends, but nonetheless it is a dividend policy set by the company. A more common policy would be to have a constant dollar amount or a fixed dividend payout ratio. A fixed *Dividend Payout Ratio* means that the company determines a fixed percentage of dividends that will be paid out of the company's earnings or net income. It is calculated by dividing the yearly dividend payment by the earnings per share; or total dividends paid divided by net income. More mature companies will tend to have a higher payout ratio as there is less need to re-invest capital. While some companies may have some general idea as to what they would like to payout in dividends, this may not always be realized due to various reasons, such as: poor performance, new strategic direction, outstanding debt obligations and so on. On the other hand a company may also be in a position to payout higher than expected dividends due to an outstanding performance or a one time financial windfall.

The inverse of the Dividend Payout Ratio is known as the *Dividend Coverage Ratio*, which is, earnings per share divided by dividend per share. Basically, this ratio is used to determine whether earnings are enough to cover dividend payments. Coverage of about 2 or 3 is considered safe, however if a company's coverage slips below 1, it means that the company is using its retained earnings from the previous year(s) to pay this year's dividend. Additionally, if the coverage ratio is becoming too high, for example 5, this could mean that the management of the company is withholding excess earnings from shareholders. While this may be for a valid reason such as re-investment for expansion, investors should still be wary of a coverage ratio that is too high.

The *Dividend Yield* is another term that we often come across when investing. This is a ratio that is used to measure the amount of income that is received in proportion to the share price. Thus it is the annual dividend income per share divided by the current share

price. When a company has a low dividend yield in comparison to other companies in the same sector, it can mean one of three things:

- 1) The share price is significantly higher because the market considers the company to have fundamental value and therefore low dividend payments are not as important to the investor;
- 2) The company is a growth company and therefore retained earnings are re-invested into the company to take advantage of opportunities that it believes would be more beneficial to the shareholders in the long run. That is, the management of the company believes the return or capital gains that shareholders will receive from reinvestment is greater than current income in the form of a dividend or;
- 3) The company is not performing well and therefore cannot afford to payout dividends that are comparable to its counterparts in the industry.

While a high dividend yield is favorable, investors should also be cautious since this could mean that the company is not performing well and this is reflected in a low share price. In the long run a prudent investor would not invest in such companies.

So, now that we have an idea of the above terms I would like to enlighten you on some of the implications of a dividend payment. In the first instance, when a company pays a dividend it affects their retained earnings account. This occurs for both cash and stock dividends. As mentioned in my last article, the total amount of the cash dividend declared is transferred from retained earnings to an account called dividends payable. The liability is removed when the payment is actually made. If a stock dividend is paid however, the amount transferred from retained earnings goes to the share capital account and new shares are issued to existing shareholders. Thus, while retained earnings are reduced, the share capital account is increased by the same amount. As such, there is a cancellation effect and total shareholder's equity will remain unchanged. Nevertheless, the number of shares outstanding increases and this has the implication of diluting earnings per share, which is not generally looked upon favourably.

With respect to investors, Trinidad and Tobago citizens investing in Trinidad and Tobago Registered Companies listed on the Trinidad and Tobago Stock Exchange (TTSE) are not subject to taxes on dividends received. However, a Trinidadian citizen investing overseas may be subject to a withholding tax on cash dividends. In the case of corporations whose core business is in trading and investing, the dividends received are taxed at the corporation tax rate or 25 per cent.

Finally, I would like to close by talking about the effects of dividends on the stock price. Essentially, there are no significant effects, the only small exception being on the day that the stock goes ex-div (the ex-dividend date). On the day a share goes ex-dividend the price of that share may fall by roughly the same amount as the dividend. This is because the stock market adjusts the price to reflect the fact that a buyer is no longer entitled to the dividend. However, other market factors may push the price lower than the amount of the dividend or, alternatively, drive the share price up to such an extent that the fall caused by going ex-dividend is reduced or eliminated. Consequently, in most cases the price adjustment for the dividend is not even noticed by the average investor.