

## CHAPTER NO. 8 : DIVIDEND POLICY

### Points to be discussed

- Introduction
- Forms of Dividends
- Types of Dividend policies
- Theories of Dividend
  - Walter's Model
  - Gordon's Model
  - Modigliani Miller Model

→ Introduction

Dividends = Returns to shareholders for providing capital

↑ Dividends → ↓ Retained Earnings

↓ Dividends → ↑ Retained Earnings

} Inverse Relationship

→ Forms of Dividend

Cash  
Dividends

Stock  
Dividends

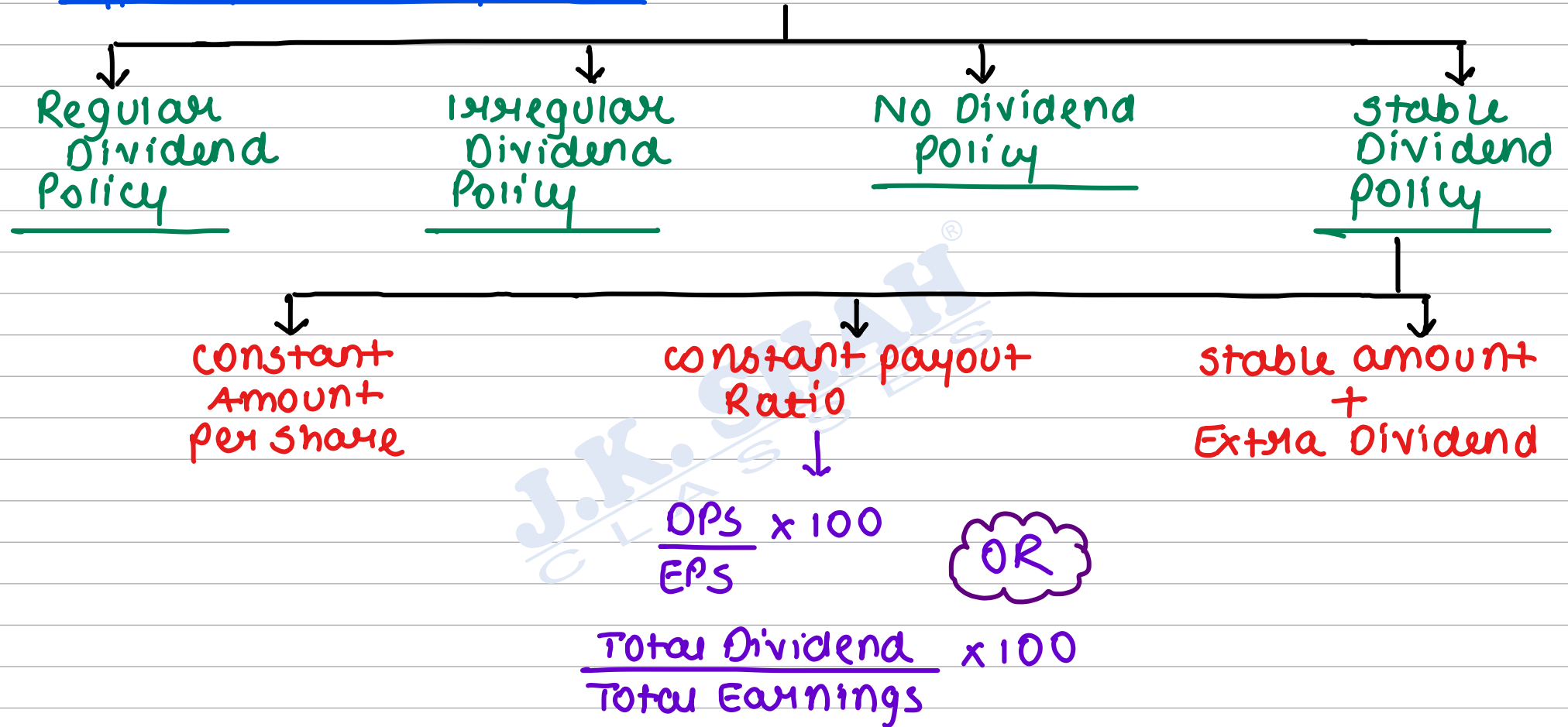
Bond  
Dividends

Property  
Dividends

Not allowed in  
INDIA

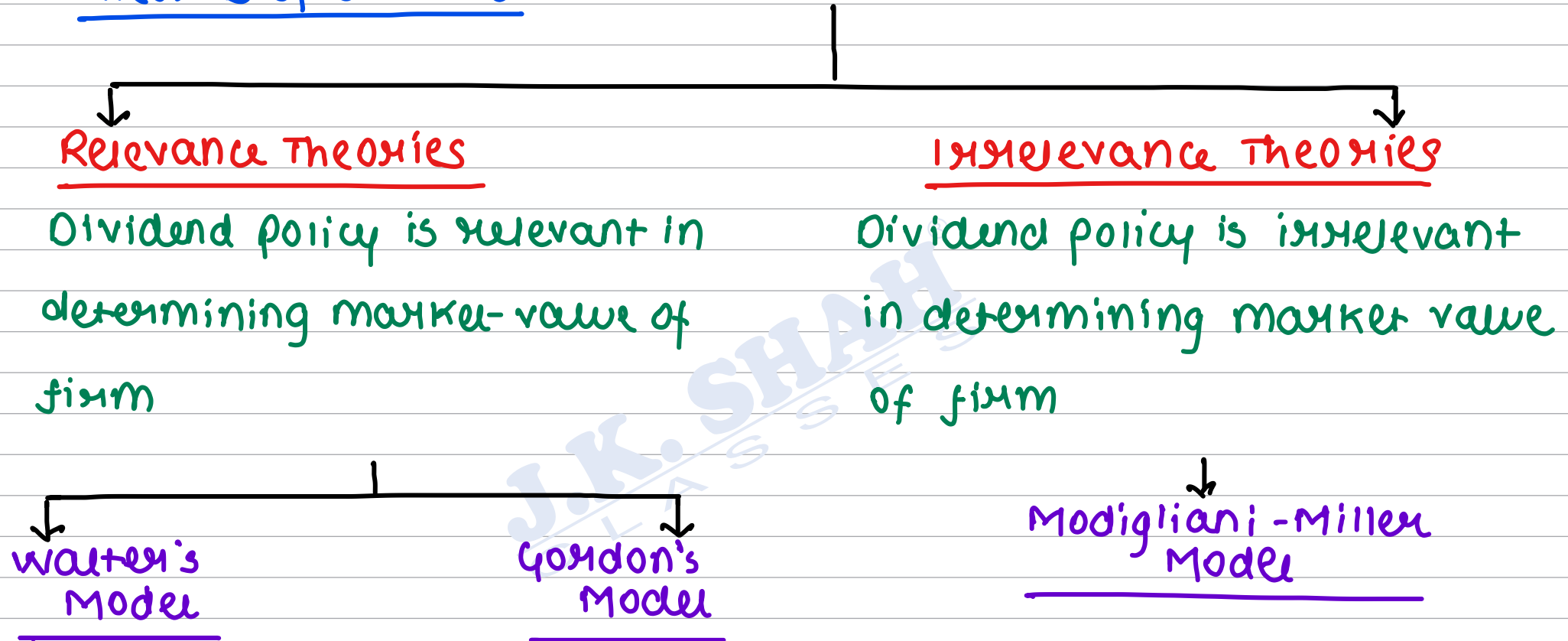


→ Types of Dividend policies



1 - D/P Ratio = Retention Ratio

→ Theories of Dividend



Optimum Dividend payout Ratio is the one at which Market value of the firm is maximum.

## 1. Walter's Model

Dividend policy of a firm is relevant in determining market value of firm.

Formula: 
$$P_0 = \frac{D + \frac{r}{K_e}(E - D)}{K_e}$$
 where

$P_0$  = current market price

$D$  = Dividend per share

$E$  = Earnings per share

$r$  = Rate of Return of the company

$K_e$  = Cost of Equity capital / Equity  
capitalisation Rate

As per Walter, if —

$r > k_e \rightarrow$  optimum D/P Ratio : 0%

$r < k_e \rightarrow$  optimum D/P Ratio : 100%

$r = k_e \rightarrow$  optimum D/P Ratio : Any ratio

## 2. Gordon's Approach

Also called as Dividend Growth Model / Dividend capitalisation Model.

Introduced the concept of  $g$  growth where  $g$  growth is the product of the retention ratio and the firm's rate of return.

Formula :  $P_0 = \frac{E(1-b)}{K_e - g}$  OR  $P_0 = \frac{D}{K_e - g}$  Where

$P_0$  = Current market price

$E$  = Earnings per share

$b$  = Retention Ratio

$K_e$  = cost of Equity capital

$g$  = Growth Rate

= Retention Ratio  $\times$  Rate of Return

=  $b \times r$

$(1 - b)$  = Dividend payout Ratio

As per Gordon, if

$r > K_e \rightarrow$  optimum D/P Ratio : 0%

$r < K_e \rightarrow$  optimum D/P Ratio : 100%

$r = K_e \rightarrow$  optimum D/P Ratio : Any ratio

### 3. Modigliani Miller Model

According to MM, Market value of a firm is a result of the earning power of Assets and not the bifurcation of earnings into dividends and retained earnings.

Hence, dividend distribution does not have any impact on the market value of the firm.



Formula : 
$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$
 where

$P_0$  = current market price

$P_1$  = market price at the end of Year 1

$D_1$  = Dividends at the end of Year 1

$K_e$  = cost of Equity capital / Equity  
capitalisation rate

Steps to solve full question

1. calculation of  $P_1$
2. calculation of NEW no. of Equity shares to be issued
3. calculation of Market value of Firm.

