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ABSTRACT

It has generally been noticed that the declaration of dividends or an increase in the dividend results in an upsurge in the price of a stock, while a dividend cut leads to a drop in the stock prices as well as the market reputation. Similarly, a high or low debt-equity ratio may have its own implications on the value of the firm. Changes in dividends and capital structure policies transmit information to the stock market about the future performance of the firm. A combination of debt and dividend payments provides greater information concerning the firm's future cash flows. Present article attempts to explain the impact of these two important financial variables viz. dividends and debt on the market value of equity of companies.

Keywords: Dividends, Debt, Debt-Equity Ratio, Capital Structure Policies, Market Value.

INTRODUCTION

Business firms are the organizations involving the collective efforts of a large number of people and possessing the ability to produce large quantities of goods and services. These organizations require various dynamic resources to generate and distribute goods and services. Production and distribution of goods and services involves financial resources as well as human resources. Financial resources imply the provision of money as and when required. A firm must have enough funds to execute its plans and support the operations. Financial manager plays a dynamic role in a modern company's development. Most companies need finances to purchase land, buildings, equipment and materials. The financial manager causes to create wealth of the firm by efficiently acquiring, financing and managing assets and contributes to the growth of the economy.

Funds can be raised either externally by selling stock or by borrowing in the financial markets; or by reinvesting a portion of the earnings. In other words, a business firm can be viewed as a pool of funds supplied by a variety of sources like investors in the company stock, creditors who lend their money and past earnings retained in the business. As payment of a specific amount of interest to the creditors is a legal commitment on the part of the firm, equity holders also invest their funds in expectation of returns in the form of dividends and capital gains.

The extent to which the market price fairly reflects true value is a complex and difficult issue. In the short run, stock market prices are influenced by many factors beyond the control of management, such as general economic conditions, government actions and the emotions of investors. Over the long run, market prices are a function of fundamental economic variables i.e. earning power and cash flows which can be controlled by the management. Even though external factors may cause short run fluctuations; in the long run, wise managerial decisions are recognized and reflected in the market prices of the shares of a firm. Successful management decisions lead to higher stock prices in the market and, hence, market values become important to financial decision making. If the finance manager wishes to enhance the market value of the firm, he must enhance the market value of both equity and debt. It is also essential to understand how the financial markets value the firm's equity and debt. There is a need to identify various factors influencing the value of the firm.

BASIC CONCEPT

In company form of business, the wealth created is reflected in the market value of its shares. The market price of a firm's stock represents the focal judgement

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of all market participants as to the value of a particular firm. It takes into account present and expected future earnings per share; the timing, duration, and the risk of these earnings; the dividend policy of the firm; and the other factors that bear on the market price of the stock. The market price serves as an indicator of performance of companies. The creation of wealth, in the form of enhanced market value of equity shares, is a result of financial decision making. Financial decision making involves three major decision areas i.e. investment decision, financing decision and dividend policy decision. Therefore, financial decisions will cause to create wealth and it is indicated or reflected in market price of company's shares.

Dividend policy decision is one of the major decision areas in financial decision making. Theoretically speaking, the present market value of a share is a function of the returns expected by the shareholders and the risk associated with the share. This is based on the premise that market price of a share is equal to the present value of all expected future receipts (taking the form of dividend payment) and the sale proceeds realized when the share is sold (taking the form of capital gains).Both future dividend payments and capital gains are dependent on the expected future earnings of the concern. The discount rate used to calculate present value is a result of both the prevailing general market rate of interest and risk (both business and financial) attached to the share. The appropriation of earnings between dividends and retention affects both the expected future earnings of the concern and the discount rate to be applied and, hence, the present value of the share. That is why investors give different weights to earnings that are distributed in the form of dividends and to earnings that are retained for re-investment. The final decision will depend upon the preference of the shareholders and investment opportunities available within the firm.

Another important decision area of a company involves the formulation of its appropriate capital structure. A capital structure with a reasonable proportion of equity and debt is called an optimum capital structure. The best design or the structure of the capital helps the management to achieve its ultimate objectives of minimizing the overall cost of capital, maximizing profitability as well as earnings per share and also enhancing the value of the firm. Capital structure decisions assume vital significance in corporate financial management due to their influence both on return and risk of shareholders. It is well recognized that there is a close relationship between the judicious use of debt and the market value of the firm. Excessive use of debt may endanger the survival of a corporate firm whereas a conservative policy may deny the benefits of leverage to the equity shareholders.

LITERATURE ASPECT

Dividends and Value

Financial literature has provided various theories concerning the relationship between dividends and value of the firm. There are divergent views on the critical aspect as to whether dividends are relevant for the valuation of the firm. According to one school of thought, dividends are irrelevant [(Modigiliani-Miller Hypothesis (1961)] so that the amount of dividends paid has no effect on the valuation of the firm. On the other hand, certain other theorists [Walter (1963), Gordon (1962)] consider the dividend decision as relevant to the value of the firm measured in terms of market price of the shares. They contend that an increased amount of retained earnings has much less weight in the valuation of shares than the dividends paid today. The effect of retained earnings on share prices is a result of the corporate investment opportunities. If the rate of return on new investments is more than the minimum rate required by the shareholders, it certainly has the positive effect on the price of the shares of the company. The division of residual income between dividends and retained earnings is a major financial decision. Studies have been conducted to find out whether accounting earnings are empirically associated to the changes in the stock prices. It has been explored that if earnings announcements have an informational content, then they should affect stock prices and hence the returns realized by the investors. The tests have revealed that the larger the increase in the annual earnings, the greater will be the associated stock price increase. It has been observed that an increase in the dividend is often accompanied by a rise in the stock price, while a dividend cut generally leads to decline in the price.

Debt and Value

The basic objective of financial management is to maximize the wealth of the shareholders. Usually, the firm raises funds in the form of equity and debt. The

cost of equity and the cost of debt are the consideration required to be offered to the providers of equity and debt funds. The cost of equity is normally higher than the cost of debt whereas the debt funds carry the financial risk. While it is true that financing mix cannot affect the total operating earnings of a firm as they are determined by the investment decision, it can affect the share of earnings belonging to ordinary shareholders. Leverage can influence the value of the firm through the cost of capital.

There is a viewpoint that strongly supports the close relationship between leverage and value of the firm [Net Income (NI) Approach by Durand(1959)]. There is an equally strong body of opinion which propounds that the combination of debt and equity has no impact on the shareholders' wealth and the capital structure decision is irrelevant [Net Operating Income (NOI) Approach by Durand (1959) & Modigiliani-Miller Hypothesis (1958)]. The traditional approach, also known as intermediate approach propounded by Ezra Soloman (1963), is a compromise between NI and NOI Approaches. The Traditional view says that through judicious use of debt and equity, a firm can increase its total value and reduce its overall cost of capital. The justification behind this view is that debt is a relatively cheaper source of funds compared to ordinary shares. With a change in the leverage i.e. using more debt in place of equity, a relatively cheaper source of funds replaces another source which involves a relatively higher cost. This causes a decline in the overall cost of capital.

FACTORS INFLUENCING DIVIDEND POLICY DECISION

Dividend policy determines the division of earnings between payments to shareholders and reinvestment in the firm. Retained earnings are one of the most significant sources of funds for financing corporate growth whereas dividends constitute the cash flows that accrue to the shareholders. Companies generally specify dividends in terms of a dividend rate. They also tend to increase dividend rate if their profits increase. There are so many considerations relating to the dividend policy of a firm. The factors which generally influence the dividend policy of the firm are as follows:

1. **Dividend Payout (D/P) Ratio** - D/P ratio is the percentage share of net earnings distributed to the shareholders as dividend. A high payout ratio means a liberal distribution policy but this reduces the cash resources of the company. A low payout ratio indicates conservative distribution policy which enables the firm to accumulate internal resources for further expansion programmes.

2. **Stability of Dividends** - Stability or regularity of dividends is considered a desirable policy by the management as well as shareholders of most companies. The stability of dividends may take any of the three forms: Constant dividend per share, Constant D/P ratio and Constant dividend per share plus extra dividend. There are several reasons why investors would prefer a stable dividend policy and pay a higher price for the shares of a firm like resolving of investors' uncertainty, their desire for current income etc. In India, various financial institutions generally invest in the shares of those companies which have a record of paying regular dividends. Apart from theoretical reasons for the desirability of stable dividends, there are many empirical studies which support the viewpoint of stability in the payment of dividends. According to John Lintner's study (1962), dividends are 'sticky' in the sense that they are slow to change and trail behind shifts in earnings by one or more periods. Lintner concludes that dividends represent the primary active decision variable in most situations. Savings or retained earnings in a given period generally are largely a by-product of dividends actions, taken in terms of well-established practices and policies.

3. **Legal Provisions** – Generally countries do not allow firms to pay dividends that would harm the initial capital contribution to the firm. According to the provisions, a company can declare dividends only after transferring a certain percentage of profits of current year to reserves. The Company must earn distributable profits from which the actual payment of dividends is made. A company may declare dividend out of reserves if currents profits are not adequate, subject to legal provisions.

4. **Contractual Constraints** - When the company obtains external capital by borrowings, the terms

of the contract of loan may contain restrictions on dividends payments. These restrictions are imposed in order to ensure that the firm will have enough funds to meet its obligations to the loan providers. The payment of cash dividend in violation of a restriction would amount to default, therefore, the financial manager must always ensure that the payment of dividend is within the covenants.

5. **Internal Constraints -** Certain factors which are unique to a firm include the following:

   (a) **Liquidity:** Dividends are paid in cash. Although a firm may have adequate profits to declare dividends, it may not have enough cash to pay dividends. Thus, the availability of cash with the firm is an important consideration in paying dividends.

   (b) **Investment Opportunities:** A dividend policy is greatly influenced by the financial needs of the company. A growing firm gives priority to the retention of earnings over the payment of dividends in order to finance its expanding activities.

   (c) **Access to Capital Market:** Easy accessibility to the capital markets provides flexibility to the management in paying dividends as well as meeting the corporate obligations. The greater the ability of the firm to raise funds in the capital markets, the greater will be its ability to pay dividends.

   (d) **Stability of Earnings:** Earnings stability also affects the decision. A stable firm is more likely to pay a higher percentage of its earnings as dividends than a firm with fluctuating earnings.

   (e) **Degree of Control:** The firm will not rely on the external sources of finance if the management desires to have a close control over the firm. It will prefer a low dividend payout policy and instead use retained earnings to finance the requirements of the company.

6. **Owners' Considerations -** The dividend policy is also affected by the owners' considerations. If the rate of return earned by the firm is less than the rate which could have been earned by the investors themselves from external investments of funds, the firm should not retain. Such a policy would be detrimental to the interests of shareholders. Also, by retaining a high percentage of its earnings, the firm can minimize the possibility of dilution of ownership.

7. **State of the Economy -** Finally, the prevailing state of the economy is also an important factor influencing the dividend policy decision. In an uncertain economic environment, both political and economic, the firms tend to maintain a low dividend payout policy, to survive in the risky situations. The capital market conditions, rate of inflation and government policies also influence the dividend policy.

To sum up, it can be concluded that a company should seek a stable dividend policy and try to avoid occasional reduction of dividends. Investors favorably react to the price of shares of such companies and there is a price enhancing effect of such a policy as it resolves the uncertainty regarding the anticipated stream of dividends. Above all, it poses the image of a stable operating environment. An increase in the dividend communicates about the wellness and prosperity of the firm.

FACTORS INFLUENCING FINANCING DECISION

Theoretically, the financial manager should plan an optimum capital structure for the firm. An optimum capital structure is obtained when market value per share is the maximum and the overall cost of capital is the minimum. In operational terms, every firm should try to design such a capital structure. Generally, following factors should be taken into consideration whenever a capital structure or financing decision is to be taken:

1. **Leverage (EBIT-EPS Analysis) -** As the primary objective of financial management is the maximization of market value of the firm, the EBIT-EPS analysis is the important tool in designing a firm's capital structure. Because of its effects on EPS, financial leverage is one of the important considerations in planning the capital structure of a company. Companies with high level of EBIT can make profitable use of high degree of leverage to increase the return on equity shares.

2. **Cost of Capital** - The finance manager must evaluate the alternative sources of finance and their costs. A firm should possess the earning power to generate revenues to meet its cost of capital and finance its future growth. Generally, debt is the cheapest source of funds because interest is a tax deductible expense. There should be a judicious use of different sources so that the overall cost of capital is the minimum.

3. **Cash Flow Ability of the Company** - A firm is conservatively financed if it is able to service its fixed charges under adverse situations. One important ratio which should be examined at the time of planning the capital structure is the ratio of net cash flows to fixed charges (debt-servicing ratio). It indicates the number of times the fixed financial obligations are covered by the net cash inflows generated by the company. The greater the coverage, the greater the amount of debt a company can use.

4. **Control** - In designing the capital structure, sometimes the existing management is governed by its desire to continue control over the company. Generally, the holders of debt do not have voting rights. Therefore, it is suggested that a company should use debt to avoid loss of control. However, the use of large amounts of debt puts a lot of restrictions on the company.

5. **Flexibility** - Flexibility means the firm's ability to change or adapt its capital structure according to the needs of the changing conditions. Company should be able to raise funds without undue delay or cost, whenever needed to finance the profitable investment opportunity.

6. **Size of the Company** - The size of a company influences the availability of funds from different sources. A small company finds great difficulty in raising long-term loans. If it is able to obtain some long term loan, it will be available at higher rate of interest and inconvenient terms. A large company has relative flexibility in designing its capital structure.

7. **Marketability and Timing** - Marketability means the readiness of investors to purchase a security in a given period of time. Marketability does not affect the capital structure but it is an important consideration to decide about the appropriate timing of security issues. The capital markets are changing continuously. At one time, the market favors debenture issues and at another time, it may readily accept common shares. Due to changing market sentiments, the company has to decide whether to raise funds with an equity issue or debt issue. The alternative methods of financing should, therefore, be evaluated in the light of general market conditions and the internal conditions of the company.

8. **Floatation Costs** - Floatation costs may also influence the designing of the capital structure of a company. Floatation costs are incurred when the funds are externally raised. Usually, the cost of floating a debt is less than the cost of floating an equity issue. This may encourage the company to use debt rather than issuing common shares. If the owners' capital is increased by retaining the earnings, no floatation costs are incurred.

9. **Risk** - A firm with more business risk favors to have low levels of debt because earnings are highly unstable. A firm with low level of business risk can have higher debt as it does not fear the risk of changes in expected earnings.

10. **Tax Considerations** - Income Tax Act does not allow the dividends payable to be deducted from taxable income whereas interest paid on debt is a tax deductible expense. In order to reduce the cost of capital component, the tax savings on interest charges present an attractive option. Earnings available to the equity shareholders can be increased by increasing the debt component in the capital structure.

To sum up, the factors mentioned in the above discussion on capital structure decision do not lead to any precise conclusion. The determination of most desirable debt-equity ratio is affected by various considerations, which have to be taken care of by the management.

SUGGESTIONS AND RECOMMENDATIONS

It should be noticed that the information contained in the published accounting statements is value relevant. The listed companies can use dividend policy to signal the information indirectly to the investors which is not contained in accounting documents. However, this cannot act as a substitute to the accounting statements. Investors must look at the consistency of dividends before anything else. A regular income and downside protection is something growth investors will get if they invest in high dividend yield stocks. Reading fine prints of the company's dividend policy is advisable. The companies should take vigilant decisions while deciding about the capital structure of the firm as it may have an impact on the market value of its shares. The investors should be advised to give a careful attention to the accounting information for the listed companies with special reference to their dividend policy and capital structure decisions.

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