

# Basic Investment Course

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## Unit 2: Dividends



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## 2.1. Dividends

### 2.1.1. What are dividends?

We learnt previously that the reason it is important for you to learn about shares and investing is to ensure your financial future and security.

When you invest in shares you do so for several reasons as previously discussed, i.e. to achieve capital growth, regular income or both.

One way of obtaining an income from your share investment is by receiving a dividend.

Dividends are distributions of a companies' earnings to shareholders. Shares, unlike bonds, don't have a guaranteed interest return. The dividend earned on shares depends on the profits earned by the company. In any given year (or half-year), the directors may decide to increase or lower the dividend. They may even decide not to pay a dividend – but they had better have a very good excuse, otherwise the shares will be dumped. When a company is profitable it sometimes pays out a dividend to its shareholders.

Let's learn more about this.

### 2.1.2. Dividend policy of a company

When companies earn income they have a number of choices as to what to do with that income. There are a number of options namely:

- re-invest in operations
- buy back shares
- pay off debt
- distribute to shareholders

Let's look briefly at the policies that companies employ when distributing the income to shareholders.

There are a number of issues that need to be considered when a company distributes income in the form of dividends to shareholders. They are:

- How much to distribute i.e. what percentage of the income should be distributed?
- What form the payout should be – either cash or additional shares?
- Should the payout be the same from year to year or different each year depending on the income in that particular year?

All of the above mentioned issues form part of the dividend policy of a company. The dividend policy of a company is decided by management and can change from time to time.

### 2.1.3. Important dividend dates

There are three important dates relating to dividends:

- 1) **Date of declaration** – this is the date on which the dividend is declared by the company.
- 2) **Date of record** – Only shareholders registered on this date will receive the dividends. You may sell the shares after this date and still receive the dividends.
- 3) **Date of payment** – This is the date of payment of the dividend. Dividends are only paid to shareholders registered on the date of record.

## 2.2. What is a dividend yield?

The dividend yield is the percentage of net income to be paid out as cash dividends to shareholders. The company determines the dividend yield based upon its preferences, which are either to distribute income as cash dividends re-invest the income back into the company to generate further income.

As a shareholder who has purchased shares in a company, the dividend yield may be very important to you when considering purchasing a share. A high yield means you will receive a high income from the share.

A high dividend yield may not necessarily mean that your share value is maximised because companies that retain their earnings and pay low or no dividends may use those retained earnings to expand and build the company and thus grow your investment, which means you have a capital gain.

Obviously the ideal situation is to own a share that gives you both income and a good capital growth.

So, let us restate the important concept of a dividend yield. It is calculated by taking the amount of dividends paid per share over the course of a year and dividing by the share's price. Mature, well-established companies tend to have higher dividend yields, while young, growth-oriented companies tend to have lower ones, and most small growing companies don't have a dividend yield at all because they don't pay out dividends.

***Example***

Hypothetical Company A pays an annual dividend of R7 and trades at R910 per share; Company B pays an annual dividend of R2.72 and trades at R49.75 per share. By calculating the dividend yield, the investor can compare the amount he would earn in cash income annually from each security.

Company A dividend yield calculation:

$$\text{Dividend yield} = \frac{\text{Dividends paid}}{\text{Price}} = \frac{7}{910} = 0.0077 = 0.77\%$$

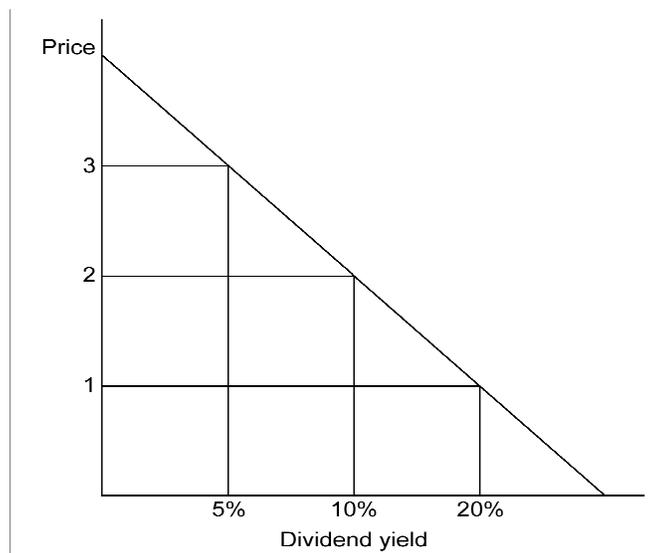
Company B dividend yield calculation:

$$\text{Dividend yield} = \frac{\text{Dividends paid}}{\text{Price}} = \frac{2.72}{49.75} = 0.055 = 5.5\%$$

In other words, despite the fact that Company A pays a higher per-share dividend, R100,000 invested in its common share would yield only R770 in annual income as opposed to the same amount invested in company B which would yield R5,500. An investor interested in dividend income and not capital gains should opt for the latter, all else being equal.

Because the share price is in the denominator, the dividend yield falls as the share price rises, assuming all things remain equal. The lower the dividend yield, the more expensive the share. An increasing yield may look attractive, but is a cause for concern because the share price is falling. When a company has a high yield, look at its dividend cover. If the dividend yield is unsustainable, the dividend cover will be low. If the yield is rising, investors have to ask why the price is falling. A rising dividend yield could mean the market's adjusting the share price down because it believes the company can't maintain its dividend.

The graph below illustrates the relationship between dividend yield and price.



Talking a certain kind of investor out of the conviction that a higher-yielding share should be bought is difficult. They don't realise that, in share investment, a falling dividend yield is a good thing because the price of the share is going up.

Note:

$$\text{Dividend cover} = \frac{\text{Earnings per share}}{\text{Dividend per share}}$$

The dividend cover tells management how many times bigger the earnings of the company are in comparison to the dividends paid per share. The bigger the number the better and the more healthy the company.

### 2.3. What is a dividend payout and a dividend payout ratio?

#### ***Dividend payout***

The dividend payout is the dividend that a company chooses to pay to its shareholders instead of retaining the profits in the company.

In the days of falling share prices, the board of directors will often begin to pay dividends to help stabilise the company's share. Many investors consider these dividends as a sign of safety and financial conservatism (which they are in many cases). Dividends in and of themselves, however, do not necessarily make the company a better investment.

Companies that earn high returns on equity, have little or no debt, and large room to expand in their current industry would best serve their shareholders by paying no dividends. Instead, they should opt to reinvest all of the company's available resources into growing the value of the underlying business. The shareholders will be rewarded through appreciation in the share price.

In other words, a company should only pay dividends if it is unable to reinvest its cash at a higher rate than the shareholders (owners) of the business would be able

to if the money was in their hands. For example, if company ABC is earning 25% on equity with no debt, management should retain all of the earnings because the average investor probably won't find another company or investment that is yielding that kind of return.

### ***Dividend payout ratio***

The dividend payout ratio is defined as the percentage of net income that is paid out in the form of dividends. This ratio is important in projecting the growth of a company because its inverse, the retention ratio (the amount not paid out to shareholders in the form of dividends), can help project a company's growth.

The dividend payout ratio is the dividends paid divided by company earnings over some period of time, expressed as a percentage.

$$\text{Dividend payout ratio} = \frac{\text{Dividends paid}}{\text{Net income}}$$

The payout ratio varies according to the stage of life of a company. When a company is young, earnings are retained and ploughed back into the business, so the payout ratio is small.

The payout ratio is the reciprocal of the dividend cover. A suitable payout ratio depends on a company's cash needs and investor expectations.

### ***Calculating the dividend payout ratio***

Company C's 2005 cash flow statement shows that the company paid R2.166 billion in dividends to shareholders. The income statement for the same year shows the business had reported a net income of R4.347 billion. To calculate the dividend payout ratio, the investor would do the following:

$$\text{Dividend payout ratio} = \frac{\text{Dividends paid}}{\text{Net income}} = \frac{2,166,000,000}{4,347,000,000} = 48.9\%$$

The answer, 48.9%, tells the investor that Company C paid out nearly fifty percent of its profit to shareholders over the course of the year. So, what this means is that approximately 50% of the company's earnings can be used to expand, maintain and grow the company. This can take the form of acquiring another business or simply upgrading computers.

## 2.4. Summary

In this unit we learnt about the basics of dividends. We learnt that one way of obtaining an income from your share investment is by receiving a dividend. We learnt that when companies earn income they can re-invest in operations, acquire securities, pay off debt or distribute it to shareholders as dividends.

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## Contact Details

Standard Bank Online Share Trading

4th Floor Entrance 1

3 Simmonds Street

Phone: 0860 121 161

Fax: 011 631 0649

Email: [securities@standardbank.co.za](mailto:securities@standardbank.co.za)

Web Address: [www.securities.co.za](http://www.securities.co.za) or via Bluematter