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DIVIDEND POLICY AND ITS INFLUENCE ON STOCK PRICE

In this article dividend policy and its influence on stock price in a foreign country are analyzed as well as issues of using them to develop the dividend policy of joint-stock companies in our country are researched.

Key words: dividend policy, stock, stock price, nominal price, cash flow, investment, investment projects

Mazkur ilmiy maqolada dividend siyosati va uning aksiyalar bahosiga ta’sirini bo’yicha xorijiy tajriba tahlil qilingan hamda mamlakatimizda aksiyanerlik jamiyatlari dividend siyosatini takomillashtirish uchun joriy etish masalalari tadqiq qilingan.

Kalit so’zlar: dividend siyosati, aksiya, aksiya bahosi, nominal baho, pul oqimi, investetsiya, investitsion loyihalar

В данной статье анализирован зарубежный опыт дивидендной политики и ее влияние на цену акции, а также исследованы вопросы внедрения развития дивидендной политики акционерных обществ в нашей стране.

Ключевые слова: дивидендная политика, акция, цена акций, номинальная цена, денежный поток, инвестиция, инвестиционные проекты

The impact of dividend policy decisions on firm’s stock price is an essential researched topic in the field of investment and finance. Nevertheless it is not clear if dividend policy impacts on the stock price or not. Some claim that dividend policy is not relevant to stock price. [1] Due to the fact, they argue an enterprise’s value ought to be determined by the basic earning power and business risk of the firm. There are several internal and external factors that influence stock prices. Before we start about the affects we should understand what the dividend policy is. Dividend policy is a main financial decision which includes the amount of payment to stockholders in return of the investment which they made. Once a company makes a profit, management must decide on what to do with those profits. They could continue to retain the profits within the company, or they could pay out the profits to the owners of the firm in the form of dividends. Once the company decides on whether to pay dividends they may establish a somewhat permanent dividend policy, which may in turn impact on investors and perceptions of the company in the financial markets. What they decide depends on the situation of the company now and in the future. It also depends on the preferences of investors and potential investors. Below some major approaches to dividends will be given: residual, stability or a hybrid of the two.

Residual Dividend Policy - Companies use this policy to use the internally generated own capital to finance any new projects. It means, dividends payments will be paid after project needed capital requirement are met.

Dividend Stability Policy -Fluctuations dividend policy established residual greatly contrasts with the certainty of stability policy dividends. Due to the stability of the policy, the quarterly dividend set at a fraction of annual income. This policy reduces uncertainty for investors and provides them with an income.

Hybrid dividend Policy-The final approach is a combination between residual and stable dividend policy. Using this approach, companies tend to consider the debt / equity capital in the long term, rather than short-term goal. In today's markets, this approach is commonly used by companies that pay dividends. Since these companies tend to experience fluctuations in the economic cycle, they tend to have one set of a dividend, which is set as a relatively small portion of the annual income and can be easily maintained.

Distributions paid to shareholders reduce stockholder's equity and its component, retained earnings. Distributions of cash, or cash dividends, are typically called "dividends." The way the company chooses between these alternatives are called its dividend policy. Figure 1 provides information about alternative uses of free cash flow.

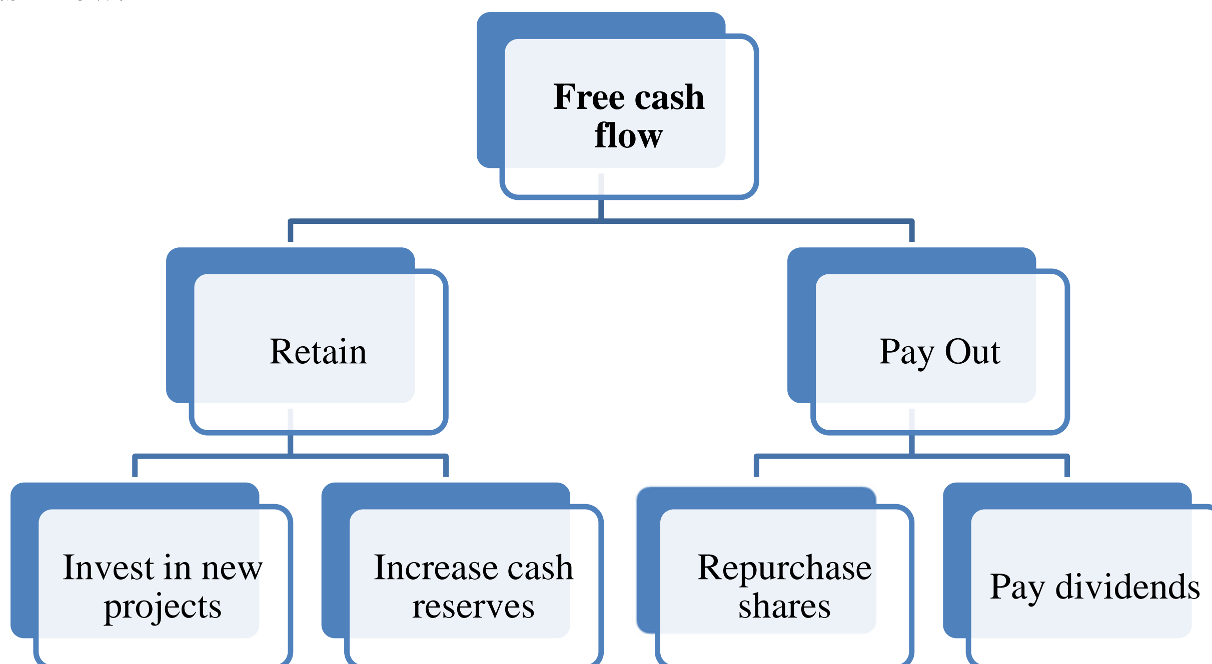

Figure 1. Uses of free cash flow [2]

A firm can retain its free cash flow, either investing or accumulating it, or pay out its free cash flow through a dividend or share repurchase. The choice between these options is determined by the firm’s payout policy.

Each firm has its own dividend policy and it is considered to be an important direction of financial policy of the firm. Therefore, to some extent, demand of the firm’s share depends on its dividend policy. Dividend policy is essential for investors, managers, lenders and for other stakeholders. Investors care about dividend policy because it is not just the source of making profit, as well as it is a means to assess the firms from investment point of view. It shows whether the company makes profit or not. Equation.1

$$Dividend\ yield = \frac{yearly\ dividend\ income}{current\ share\ price}$$

With the help of this equation we can find out the amount of received income in proportion to the share price. If enterprise’s dividend yield is lower than other enterprises’ dividend yield it may mean two things:

1. The price of a share is high, because the market thinks that the enterprise has high promising prospects, thus dividend payment is not a worrying question;

2. The company is in trouble and not able to pay the dividends out on time;

The most widely accepted objective of a firm is to maximize the value of the firm and to maximize shareholder wealth. In general, there are three types of financial decisions which might influence the value of a firm: investment decisions, financial decisions and dividend decisions. These three decisions are interdependent in a number of ways. The investments made by a firm determine the future earnings and future potential dividends; and dividend policy influences the amount of equity capital in a firm’s capital structure and further influences the cost of capital. In making these interrelated decisions, the goal is to maximize shareholder wealth. According to this, firms should pay attention to the amount of dividend, however, there are some factors which impact on the dividend policy of the firm

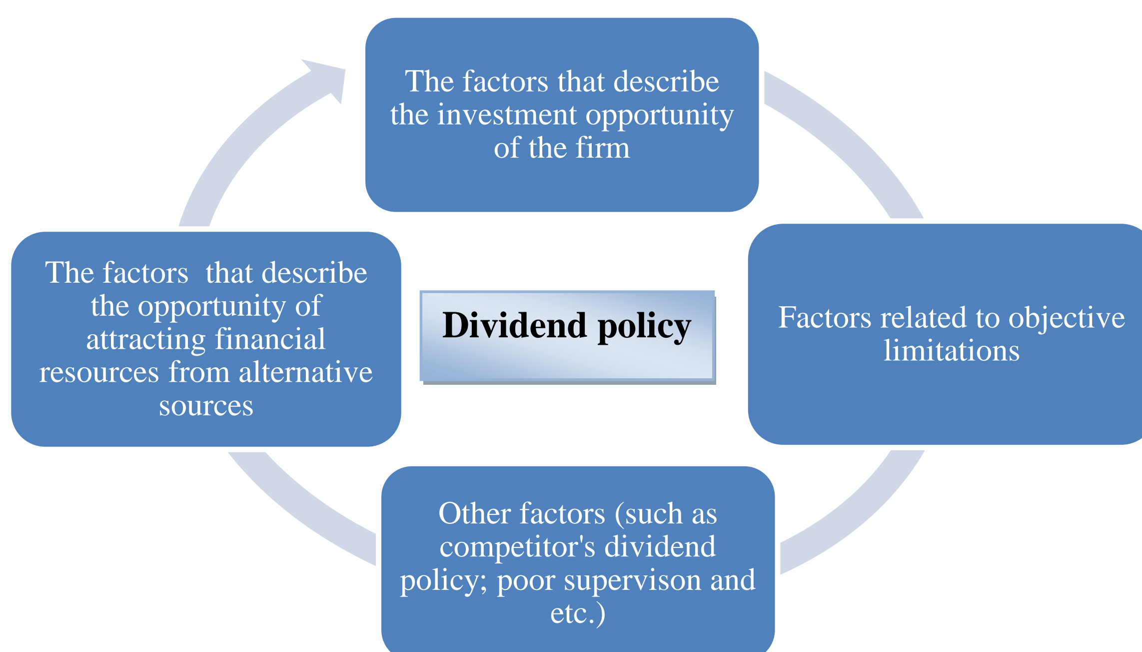

Figure 2. Factors that influence on dividend policy [3]

Each of the listed factors influence on the dividends policy, for example, a firm may have some investment opportunities that may bring more profit in the future, so to invest in those investment projects directly impact on the dividend policy, by far, this investment decision should be agreed at annual meeting shareholders. Opportunity of attracting financial resources from alternative sources may also impact on dividends policy of the firm. Some of objective limitations related to the taxes have influence on dividend policy.

According to the dividend policy, there are different forms of paying dividends out:

Cash dividends: dividends are paid out in cash;

Dividend reinvestment plans; investors are offered two options i.e. to get dividends in cash or to reinvest the dividend. As a result, a firm either issues additional stocks or buys its stocks from secondary market in needed quantity.

Stock dividends and Stock split; we will see below with examples what the stock dividend and stock split are.

As it is written above, each corporation sets the same goal: maximizing shareholder wealth. The goal is achieved in two ways, reinvesting cash in business and stimulating its growth and paying dividends to shareholders. The dividend can be given in the form of cash or stock. If it is given in a form of cash, a shareholder/stockholder gets cash based on the number of shares which they possess. Example: Let’s suppose a corporation proclaims a cash dividend of $0.30 per share, in case an investor has 10,000 shares, this investor will receive $ 3,000. From another side, this investor still has 10,000 shares, however the company proclaims a stock dividend of 0.3, it would mean for each share owned, 0.3 of a share is paid to the shareholder. It is called a fractional share. Therefore, that investor who has 10,000 shares, after the dividend was collected would have 13,000 shares (10,000x1.3). The impact of this type of dividend may not be as positive. Because stock dividend and stock split will increase the number of shares outstanding, and directly it will cause the stock price to fall. Thus, the price of stock would dilute from either a stock dividend or a stock split. The price of the stock is based on the value of the enterprise divided by the number of shares outstanding. On condition that the number of shares outstanding shares is increased, the stock price will go down. For instance, say there is a firm which has a market capital of $900 million, and there are 150 million shares outstanding at price of $6 ($900/150). If there is a stock dividend declared of 0.2, the number of shares outstanding will raise by 20% to 180 million. With this new number of shares outstanding, the company’s market capital stays unchanged; its share price will decline to $5($900/180). One positive characteristic of the stock dividend and stock split is that ownership is not further diluted. That is to say, all shareholders will own the same proportionate amount of the company after the dividend or split as they did before. Using stock split has some positive sides either, for instance, stock price will be lower and even small investors will buy the stocks. In case a firm decides to issue *stock split,* will stockholders pay taxes? If they will, what type of tax is it and how is it calculated? Stock splits generally aren’t taxable until the shares are sold. If one of the firms an investor owns shares in decides to issue a *stock split*, giving the investor additional stock for each share they own, they generally do not pay capital gains on the new shares. **It is when they sell those shares for more than their tax basis** that they will have to calculate capital gains on their taxes. To calculate these gains, they first need to figure out their *tax basis* in the old and new shares. After calculating their capital gains, they pay capital gain tax. Let’s take one practical example: Your tax basis, or overall cost, in the shares of stock you trade is generally equal to the market price you paid for them plus any commissions a broker charged to execute the trade. When you sell stocks, **your capital gain is the profit you earn on the trade**, calculated as the sales proceeds minus your tax basis. For example, suppose you first purchased 100 shares of Starbucks Corporation at $40, or $4,000 in total, and then an additional 50 shares at $44, or $2,200. In this scenario, your tax basis in the 150 shares is $6,200. Therefore, selling the stock for $8,000 would give you a capital gain of $1,800.

Furthermore, there are some problematic situations related to the dividend policy. Due to the fact that dividend policy is considered to be an essential part of financial management decisions of business. Dividend is that part of firm’s net

earning which is paid out to the shareholder. If dividends have an impact on the firm's value is the most controversial question in dividend policy. If dividends are not relevant, the firm should keep the earnings for investment opportunities. In case, there are not enough investment opportunities which provide expected return, the funds which are not used should be paid out as dividend. Dividends are considered to be the most attractive factor for stockholders. Therefore, high amount of dividends make the investors happy. However, on the other hand, payment of dividends decreases the internal financing required to invest in profitable opportunities. It will affect the firm's growth, which in turn affects the value of the stock either. It is obvious that investing in some golden i.e. profitable projects may bring more profit to the company in the future as well as it may raise Enterprise value.

There is another problematic situation related to the taxes. Taxes are an important market factor that impact on firm's decision on paying dividends or repurchasing shares. Admittedly, taxes are very essential in running business, investing money, buying and selling properties and etc. therefore entrepreneurs, investors and even individuals care about taxes before making financial decisions, before they make these types of decisions it is advisable to obverse and learn better the tax policy of the country in which they want to run a business. Thus in this field i.e. dividend policy, investors need to learn tax rates, because they directly influence on the amount of the dividend which they are willing to get from the corporation. Below, the following table illustrates information about long term capital and tax rates in the United States from 1971-2012.

Table 1

Long term capital gains versus dividend tax rates in the United States, 1971-till now [4]

Year	Capital gains	Dividends
1971-1978	35%	70%
1979-1981	28%	70%
1982-1986	20%	50%
1987	28%	39%
1988-1990	28%	28%
1991-1992	28%	31%
1993-1996	28%	40%
1997-200	20%	40%
2001-2002	20%	39%
2003-	15%	15%

According to the *Table 1* tax rate on dividends and capital gains tax have been decreased to 15 % since 1971. In Uzbekistan tax rate on dividends is 10 %. If the tax rate is lower, it also Shareholders must pay taxes on dividends and capital gains. They have to pay taxes on the dividends that they get as well as capital gain taxes when they sell their shares. Table 1 shows the rates on dividends and long-term capital gains for investors in the highest tax bracket. There is a controversial question. Which of them do investors prefer? When a firm gives dividend, investors are taxed

according to the dividend tax rate. If the firm repurchases shares instead of paying dividends, and investors sell their shares to make homemade profit, they have to pay capital gains tax rate. On condition that dividend tax rate is higher than capital gains tax rate, shareholders will prefer share repurchase to dividends. In this situation i.e. dividends are taxed at a higher tax rate, it will be undesirable for investors, because they will get less than their initial investment. When the tax rate on dividends exceeds the tax rate on capital gains, shareholders will pay lower taxes if a firm uses share repurchases for all payouts rather than dividends. This tax savings will increase the value of a firm that uses share repurchases rather than dividends. We can also express the tax savings in terms of a firm's equity cost of capital. Firms that use dividends will have to pay a higher pre-tax return to offer their investors the same after-tax return as firms that use share repurchases [4]. As a result, the optimal dividend policy when the dividend tax rate exceeds the capital gain tax rate is to *pay no dividends at all*.

To sum up, it is not always profitable and convenient way to pay the dividends out to investors. Admittedly, there is a high possibility of appearing some profitable investment projects as we mentioned above, company may lose these types of opportunities. From investor's point of view, tax policy i.e. tax rate on dividends and capital gains tax rate are important factor.

First of all, the tax rate on dividends is 10%, however, the tax rate for legal entities is 7.5%. The difference between these tax rates may influence on the decisions of local investors, therefore it would be useful to reduce the amount of dividend tax rate step by step. If we take example some developed countries dividend tax rate is much lower than the profit tax for legal entities. Certainly, in the beginning, dividend tax rate and tax on capital gains were pretty higher, but they have been decreased considerably so far. Due to the fact, investors care about taxes more than other factors.

Second of all, in order to attract foreign investments to our economy, the nominal price of stocks should be set legally, because if the stock price is lower, the amount of dividend will be lower, either. That is why trading stocks in foreign currencies may be a bit complicated and have some misunderstandings.

Third of all, as we have seen above in the example of the USA, they may give dividends or repurchase shares instead of giving dividends. From my point of view, repurchasing shares would be one of the key factors to improve secondary market in our country i.e. investors could buy and sell stocks easily; moreover, there would be one new type of tax, capital gains tax, either.

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