# Setting the Dividend

*by Sophia*

WHAT'S COVERED

In this lesson, you will learn about the residual dividend model. Specifically, this lesson will cover:

## 1. Target Payout Ratio

The **target payout ratio**, or dividend payout ratio, is the fraction of net income a firm pays to its stockholders in dividends. It is calculated by dividing the dividends distributed by the net income for the same period. The part of the earnings not paid to investors in the form of a dividend is left for investment to provide for future earnings growth. Investors seeking high current income and limited capital growth prefer companies with high dividend payout ratios.

However, investors seeking capital growth may prefer lower payout ratios. This is appealing to some investors because a lower dividend implies that more earnings are being reinvested in the company, which should cause the stock price to rise. Some investors, such as young people saving for retirement, may prefer higher returns later than smaller cash distributions now.

The target payout ratio depends on what investors the management of a company are trying to attract, and what current investors' expectations are. It also depends on the growth goals of the company. If a company is trying to grow very fast, it may prefer to reinvest its income in expanding operations.

An established firm with a secure market likely does not need to grow its operations and would opt to direct its earnings to compensation for its investors. High-growth firms, in their infancy, typically have low or zero payout ratios. As they develop, they are apt to give back more of the earnings to investors.

DID YOU KNOW

Since the 1940s, the payout rate has slowly declined from 90% of operating earnings to approximately 30% currently. The average payout rate for smaller growth companies can be as low as 10%.

TERM TO KNOW

**Target Payout Ratio**
The fraction of net income a firm pays to its stockholders in dividends.

---

## 2. Residual Dividend Model

 

The **Residual Dividend Model** is a method a company uses to determine the dividend it will pay to its shareholders. Companies that use retained earnings to finance new projects use this method. The company first determines which new projects it wants to finance, dedicates funds to those projects, and then distributes any leftover profits to its shareholders as dividends.

This model can lead to unpredictable and inconsistent dividend returns for the investor. However, the company's goal is to generate further profits from the projects it funds, which benefits the shareholders overall.

The Residual Dividend Model is an outgrowth of the Modigliani and Miller theory that posits that dividends are irrelevant to investors. Advocates of this model are of the opinion that investors do not adhere to any predilection for current dividends versus capital gains. It goes on to say that dividend policy does not determine the market value of a stock. Accordingly, the shareholders are indifferent to the two ways by which their investment grows:

- Receiving a dividend
- Share price increasing due to retained earnings

However, investors do seek high returns - whether expressed as dividends or reinvestment of retained earnings by the company.
The Residual Dividend Model policy is a passive one and, in theory, does not influence market price because the same wealth is created for the investor regardless of the dividend. The firm paying out dividends is obviously generating income for an investor; however, even if the firm diverts some earnings for investment opportunities, the income of the investors will rise later, assuming that those investments are profitable. The dividend, therefore, fluctuates every year because of different investment opportunities and earning levels.

TERM TO KNOW

**Residual Dividend Model**
A method a company uses to determine the dividend it will pay to its shareholders.

---

# 3. Methods of Paying Dividends

A dividend is allocated as a fixed amount per share. Therefore, a shareholder receives a dividend in proportion to their shareholding. The following methods can be used to pay dividends:

| Methods | Description |
|---|---|
| Cash | Cash dividends are those disbursed in currency, typically through an electronic funds transfer or a physical paper check. This is the most common way that companies share their profits with their shareholders. For each share owned by a shareholder, an established amount of money is distributed. |
| Stock | Stock and scrip dividends are dividends disbursed as additional stock shares of the issuing company or one of its subsidiaries. Typically, they are issued proportionate to the amount of shares owned. If new shares are issued as payment, the process works like a stock split; it increases the overall number of shares while decreasing the price of each share without altering the market capitalization, or total value, of owned shares. |
| | Also known as dividends in specie (Latin for “in kind”), property dividends are disbursed in the |

 

| | |
|---|---|
| Property | form of assets from the distributing corporation or one of its subsidiary corporations. This type of dividend is somewhat rare and is usually expressed as securities of other companies owned by the distributor, though they can take the form of products and services. |
| Interim | Interim dividends refer to dividend payments paid out prior to a company's annual general meeting and release of final financial statements. In most cases, this announced dividend occurs in tandem with the company's interim financial statements. |
| Other | In structured finance, there are other dividends that can be utilized. Companies can distribute financial assets with a determined market value as dividends; warrants are often distributed in this manner. Large companies with subsidiaries can disburse dividends in the form of shares. Lastly, a common method used to "spin off" a company from its parent is to allocate shares in the new company to the shareholders of the parent company, shares that can be traded independently henceforth. |

## SUMMARY

In this lesson, you learned about two methods that companies use to set dividends. Companies can set a **target payout ratio** based on their capital needs and their beliefs about their investors' expectations. Other companies use the **residual dividend model** to set dividends, which involves putting aside earnings to finance new projects and distributing the remaining profits. There are several **methods of paying dividends**, including cash dividends, stock dividends, property dividends, and interim dividends, among others.

Best of luck in your learning!



## TERMS TO KNOW

**Residual Dividend Model**
A method a company uses to determine the dividend it will pay to its shareholders.

**Target Payout Ratio**
The fraction of net income a firm pays to its stockholders in dividend.