

9. DIVIDEND DECISIONS

ASSIGNMENT SOLUTIONS

MODEL 1: WALTER MODEL

PROBLEM NO. 1

Market Price (P) per share as per Walter's Model is:

$$P = \frac{D + \frac{r}{k_e}(E - D)}{k_e}$$

Where,

P = Price of Share

r = Return on investment or rate of earning

k_e = Rate of Capitalisation or Cost of Equity

Calculation of Market Price (P) under the following dividend payout ratio and earning rates:

	Rate of Earning (r)	(i)	(ii)	(iii)
		DP ratio 50%	DP ratio 75%	DP ratio 100%
(a)	15%	$5 + \frac{0.15}{0.10}(10 - 5)$ $\frac{12.5}{0.10}$	$7.5 + \frac{0.15}{0.10}(10 - 7.5)$ $\frac{11.25}{0.10}$	$10 + \frac{0.15}{0.10}(10 - 10)$ $\frac{10}{0.10}$
		$= \frac{12.5}{0.10} = 125$	$= \frac{11.25}{0.10} = 112.5$	$= \frac{10}{0.10} = 100$
(b)	10%	$5 + \frac{0.10}{0.10}(10 - 5)$ $\frac{10}{0.10}$	$7.5 + \frac{0.10}{0.10}(10 - 7.5)$ $\frac{10}{0.10}$	$10 + \frac{0.10}{0.10}(10 - 10)$ $\frac{10}{0.10}$
		$= \frac{10}{0.10} = 100$	$= \frac{10}{0.10} = 100$	$= \frac{10}{0.10} = 100$
(c)	5%	$5 + \frac{0.5}{0.10}(10 - 5)$ $\frac{7.5}{0.10}$	$7.5 + \frac{0.5}{0.10}(10 - 7.5)$ $\frac{8.75}{0.10}$	$10 + \frac{0.5}{0.10}(10 - 10)$ $\frac{10}{0.10}$
		$= \frac{7.5}{0.10} = 75$	$= \frac{8.75}{0.10} = 87.5$	$= \frac{10}{0.10} = 100$

PROBLEM NO. 2

- The EPS of the firm is Rs. 10 (i.e., Rs. 2,00,000/ 20,000).
- The P/E Ratio is given at 12.5 and the cost of capital, k_e , may be taken at the inverse of P/E ratio. Therefore, k_e is 8 (i.e., 1/12.5).
- The firm is distributing total dividends of Rs. 3, 20,000 among 40,000 shares, giving a dividend per share of Rs. 8.

(i) Value of the share as per Walter's model may be found as follows

$$P = \frac{D + \frac{r}{k_e}(E - D)}{k_e}$$

Where,

P = Price of Share

r = Return on investment or rate of earning

Ke = Rate of Capitalisation or Cost of Equity

$$P = \frac{8 + \frac{0.1}{0.08}(10 - 8)}{0.08} \quad P = 131.25$$

- (ii) The optimum payout ratio is Zero, since $r > k_e$

Therefore D/P ratio is not optimum

- (iii) The P/E ratio at which the dividend policy will have no effect on the value of the shares is such at which the k_e would be equal to the rate of return, r , of the firm. The k_e would be 10% at the P/E ratio of 10. Therefore, at the P/E ratio of 10% the dividend policy would have no effect on the value of the share.

PROBLEM NO 3:

- (i) Value of the share as per Walter's model may be found as follows

$$P = \frac{D + \frac{r}{k_e}(E - D)}{k_e}$$

Where,

P = Price of Share

r = Return on investment or rate of earning

Ke = Rate of Capitalisation or Cost of Equity

$$P = \frac{3 + \frac{0.15}{0.12}(5 - 3)}{0.12} = 45.83$$

- (ii) The optimum payout ratio is Zero, since $r > k_e$

Optimum Pay-out ratio

$$P = \frac{0 + \frac{0.15}{0.12}(5 - 0)}{0.12} = 52.08$$

- (iii) Payout ratio to keep Share price at Rs.50.

Let, the dividend pay-out ratio be X and so the share price will be:

$$50 = \frac{D + \frac{0.15}{0.12}(5 - D)}{0.12}$$

$$D = 1$$

Payout ratio = $1/5 = 20\%$

MODEL 2: GORDON'S MODEL

PROBLEM NO 4:

Price per share according to Gordon's Model is calculated as follows:

$$P = \frac{E_1(1 - b)}{K_e - br}$$

$$E = 10$$

$$K_e = 10\%$$

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	Pay-out ratio (30%)	Pay-out ratio (60%)	Pay-out ratio (80%)
If r = 15%	$= \frac{10(0.3)}{0.10 - (0.7)(0.15)}$ $= 60$	$= \frac{10(0.6)}{0.10 - (0.4)(0.15)}$ $= 150$	$= \frac{10(0.8)}{0.10 - (0.2)(0.15)}$ $= 114.29$
If r = 10%	$= \frac{10(0.3)}{0.10 - (0.7)(0.1)}$ $= 100$	$= \frac{10(0.6)}{0.10 - (0.4)(0.1)}$ $= 100$	$= \frac{10(0.8)}{0.10 - (0.2)(0.1)}$ $= 100$
If r = 12%	$= \frac{10(0.3)}{0.10 - (0.7)(0.12)}$ $= 187.5$	$= \frac{10(0.6)}{0.10 - (0.4)(0.12)}$ $= 115.38$	$= \frac{10(0.8)}{0.10 - (0.2)(0.12)}$ $= 105.26$

PROBLEM NO 5:

In this case the company has paid dividend of Rs. 10 per share during the last year. The growth rate (g) is 10%. Then, the current year dividend (D1) with the expected growth rate of 10% will be Rs. 11

$$\begin{aligned} \text{The share price is } = P_0 &= \frac{D_1}{k_e - g} \\ &= \frac{11}{0.2 - 0.1} = 110 \end{aligned}$$

(i) In case the growth rate rises to 12% then the dividend for the current year (D1) would be Rs. 11.2 and market price would be-

$$= \frac{11.2}{0.2 - 0.12} = 140$$

(ii) In case growth rate falls to 8% then the dividend for the current year (D1) would be Rs. 10.8 and market price would be-

$$= \frac{10.8}{0.2 - 0.08} = 90$$

PROBLEM NO 6:

(i) According to Dividend Discount Model approach the firm's expected or required return on equity is computed as follows:

$$\begin{aligned} &= \frac{D_1}{P_0} + g \\ &= \frac{50}{500} + 0.01 = 20\% \end{aligned}$$

(ii) With rate of return on retained earnings (r) 10% and retention ratio (b) 60%, new growth rate will be as follows:

$$g = br = 0.20 \times 0.30 = 0.06 = 6\%$$

Accordingly dividend will also get changed and to calculate this, first we shall calculate previous retention ratio (b1) and then EPS assuming that rate of return on retained earnings (r) is same. With previous Growth Rate of 10% and r = 20% the retention ratio comes out to be:

$$0.01 = b_1 \times 0.20$$

$$b_1 = 0.5 \text{ and payout ratio} = 0.5$$

With 0.5 payout ratio the EPS will be as follows:

$$\frac{50}{0.5} = 100$$

With new 0.70 (1 – 0.30) payout ratio the new dividend will be

$$D_1 = 100 \times 0.70 = 70$$

Accordingly new K_e will be

$$K_e = \frac{70}{500} + 6.0\% = 20\%$$

MODEL 5: MODIGLIANI AND MILLER MODEL

PROBLEM NO 7:

Given,

Cost of Equity (K_e)	9.6%
Number of shares in the beginning (n)	8,00,000
Current Market Price (P_0)	Rs.120
Net Profit (E)	Rs.1,60,00,000
Expected Dividend	Rs.6.4 per share
Investment (I)	Rs.3,20,00,000

$$(i) \quad P_0 = \frac{P_1 + D_1}{1 + K_e}$$

$$120 = \frac{P_1 + 6.4}{1 + 0.096}$$

$$P_1 = 131.52 - 6.4 = 125.12$$

$$(ii) \quad P_0 = \frac{P_1 + D_1}{1 + K_e}$$

$$120 = \frac{P_1 + 0}{1 + 0.096}$$

$$P_1 = 131.52 - 0 = 131.52$$

(iii) Calculation of funds required for investment

Earning	1,60,00,000
Dividend distributed	51,20,000
Fund available for investment	1,08,80,000
Total Investment	3,20,00,000
Balance Funds required	3,20,00,000 – 1,08,80,000 = Rs.2,11,20,000

$$\text{No of shares} = \frac{\text{funds required}}{\text{price at the end}(P_1)}$$

$$\Delta n = 2,11,20,000 / 125.12 = 1,68,797.95 \text{ or } 1,68,798 \text{ share}$$

$$(iv) 1,60,00,000 / 131.52 = 1,21,655 \text{ Shares}$$

PROBLEM NO 8

Given,

Cost of Equity (K_e)	10%
Number of shares in the beginning (n)	10,000
Current Market Price (P_0)	Rs.100
Net Profit (E)	Rs.1,00,000
Expected Dividend	Rs.5 per share
Investment (I)	Rs.2,00,000

Case 1 - When dividends are paid

Step 1

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

Case 2 – When dividends are not paid

Step 1

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

$100 = \frac{P_1 + 5}{1 + 0.10}$ $P_1 = 110 - 5 = 105$ Step 2 Calculation of funds required for investment: <table border="1"> <tr><td>Earnings</td><td>1,00,000</td></tr> <tr><td>Dividend Distributed</td><td>50,000</td></tr> <tr><td>Retained Earnings</td><td>50,000</td></tr> <tr><td>Total Amount require for Investment</td><td>2,00,000</td></tr> <tr><td>Retained Earnings</td><td>50,000</td></tr> <tr><td>Balance funds required through fresh issue</td><td>1,50,000</td></tr> </table>	Earnings	1,00,000	Dividend Distributed	50,000	Retained Earnings	50,000	Total Amount require for Investment	2,00,000	Retained Earnings	50,000	Balance funds required through fresh issue	1,50,000	$100 = \frac{P_1 + 0}{1 + 0.10}$ $P_1 = 110 - 0 = 110$ Step 2 Calculation of funds required for investment: <table border="1"> <tr><td>Earnings</td><td>1,00,000</td></tr> <tr><td>Dividend Distributed</td><td>NIL</td></tr> <tr><td>Retained Earnings</td><td>1,00,000</td></tr> <tr><td>Total Amount required for Investment</td><td>2,00,000</td></tr> <tr><td>Retained Earnings</td><td>1,00,000</td></tr> <tr><td>Balance funds required through fresh issue</td><td>1,00,000</td></tr> </table>	Earnings	1,00,000	Dividend Distributed	NIL	Retained Earnings	1,00,000	Total Amount required for Investment	2,00,000	Retained Earnings	1,00,000	Balance funds required through fresh issue	1,00,000
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Step 3 No. of shares required to be issued for balance fund $\text{No of shares} = \frac{\text{fundsrequired}}{\text{price at the end}(P_1)}$ $\Delta n = \frac{1,50,000}{105} = 1,428.57$	Step 3 No. of shares required to be issued for balance fund $\text{No of shares} = \frac{\text{fundsrequired}}{\text{price at the end}(P_1)}$ $\Delta n = \frac{1,00,000}{110} = 909.09$																								
Step 4 Calculation of value of firm $V_f = \frac{(n + \Delta n)P - I + E}{1 + K_e}$ $V_f = \frac{\left(10,000 + \frac{1,50,000}{105}\right)105 - 200,000 + 1,00,000}{(1 + 0.10)}$ $= \text{Rs. } 10,00,000$	Step 4 Calculation of value of firm $V_f = \frac{(n + \Delta n)P - I + E}{1 + K_e}$ $V_f = \frac{\left(10,000 + \frac{1,00,000}{110}\right)110 - 200,000 + 1,00,000}{(1 + 0.10)}$ $= \text{Rs. } 10,00,000$																								

MODEL 6: BUY BACK OR STOCK REPURCHASE**PROBLEM NO 9**

i) Let be the buyback price decided by Rahul Ltd.

Market capitalization after buyback

1P (original shares – shares bought back)

$$= 1.1P \text{ (5lakhs- 27% of 50 lakhs/P)}$$

$$= 5.5\text{lakhs} \times P - 13.5 \text{ lakhs} \times 1.1 = 5.5 \text{ lakhs } P - 14.85 \text{ lakhs}$$

$$\text{Again, } 5.5 \text{ lakhs } P - 105 \text{ lakhs} + 14.85 \text{ lakhs}$$

$$\text{Or } P = 119.85/5.5 = \text{Rs } 21.79 \text{ per share}$$

ii) Number of shares to be bought back:

$$\text{Rs } 13.5 \text{ lakhs} / \text{Rs } 21.79 = 61,952.02 \text{ (approx.) or } 61,952 \text{ share}$$

iii) New equity shares:

$$5,00,000 - 61,952 = 4,38,048$$

$$\text{Therefore, EPS} = 1.5 \times 5\text{lakhs} / 4,38,048 = \text{Rs } 1.712$$

$$\text{Thus, EPS of Rahul Ltd., increases to Rs } 1.712$$

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THE END