Are scrip dividends, dividends?

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Abstract

Recently the Old Mutual plc announced it was prepared to 'pay' dividends in scrip not cash, the so-called scrip dividends. Old Mutual plc is now a UK based company trading on the London Stock Exchange (LSE) and is thus governed by rules of the LSE. It is thus not surprising to note that scrip dividends are well known in the UK. The issue of new scrip is usually associated with the raising of capital. The flow of cash with the issue of scrip is from shareholder to company. In the case of dividends the flow of cash is the other way round, from company to shareholder. This suggests that the nature of scrip dividends should be examined. This paper will analyse the general nature of dividends, the nature of scrip dividends and arrive at a conclusion answering the question, are scrip dividends in fact dividends?

JEL Classification: G32; G35

The recent announcement by the Old Mutual[3] of its Scrip Dividend Scheme giving shareholders the opportunity to receive new ordinary shares (scrip) instead of a cash dividend provides a convenient opportunity to discuss the nature of the so-called scrip dividends and in particular to answer the question; are scrip dividends, in fact dividends? The Old Mutual is registered in the UK and quoted on the LSE where scrip dividends are fairly common. Scrip dividends are not unknown on the JSE.

Dividends are amounts paid by companies to shareholders. Historically dividends constituted a cash flow from company to shareholder; a part return on their investment. The historical purpose of a company is known well enough. Individual with excess capital can invest that capital in profit making ventures. Should the venture be successful the persons receive an income, a return on their investment. There are several severe limitations facing individuals who partakes in a profit making venture, the most common is the limited amount of capital the individual has available to invest.

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[3] *Scrip Dividend Scheme* 24th August 2010.

This limits the range and scope of possible investments. A second limitation is the risk facing the individual. If something goes wrong with the business venture the individual could face ruin as his entire estate is exposed to claims arising from the failed venture. A third limitation is liquidity. The capital of individuals is tied-up in the venture making it difficult for individuals to access their capital. These limitations could be mitigated to an extent by two or more individuals joining in a partnership but his created a host of problems of its own, especially as the number of investors increased. So gradually the idea of a corporation, the corporate entity, evolved. This first appeared as the corporate form and then much later the idea of limited liability corporation appeared. The corporate entity also solved the liquidity problem. The shares held in the entity could be sold, traded to and with the third parties.

The corporate entity allowed a large number of individuals to invest via the entity in a venture with their risk being limited to their capital contribution. Right from the beginning this arrangement while solving one set of problems introduced others especially the agency problem. It could well be that individuals were being induced to invest in a corporation which turns out to be a fraud, or largely fraudulent with the promoters of the scheme being the main beneficiaries of the funds being invested. The purpose of the corporation is in this case not to make a profit for the benefit of shareholders but to deprive the shareholders of their capital. That this could happen and indeed happened became evident in 1720 with the Great South Sea Bubble fraud. No sooner was the corporate entity invented when it was used to defraud shareholders of their capital.

In the normal course of events, shareholders invest a sum of money C as capital which is placed at the disposal of the managers of the company to invest for a purpose defined by the memorandum and articles of association of the company. Assuming that N ordinary shares are issued then the initial contribution of each shareholder, representing shareholder value would be:

$$s_{bv} = \frac{C_0}{N_0}. \quad \text{........ (1)}$$

And the value of the shareholding of a shareholder who holds n shares would be:

$$S_{bv} = \frac{n}{N_0} \, . \; C_0 \quad \text{........ (2)}$$

The operations of the company are usually reported on a year to year basis and thus at the end of the year the annual income (I) is subtracted from the expenditure (E) to arrive at the annual profit before Tax (PbT), where income and expenditure items are those items which are consumed during the period, ie on the Trial Balance they have a zero balance at the end of the year.

Profit before Tax = Income – Expenditure …. (3)

Or

PbT = I – E … (4)

The Profit before Tax is usually split three ways, taxes, payment to shareholders and retained earnings or

PbT = Taxes (T) + Dividends (D) + Retained Earnings (ΔRE)

The Profit before Tax is split three ways, taxation (T), dividends (D) and the increase in the retained earnings (ΔRE). The increase in the retained earnings is added to the original capital and accumulated retained earnings to arrive at the Owners's Equity. The original capital, the retained earnings, invested in the company is translated in to assets and liabilities. This is reflected in the balance sheet, which are those items extracted from the Trial Balance which have a balance other than zero. This can be written as:

Owners' equity (OE) = (C_0+RE+ΔRE) = Assets (A) – Liabilities (L)[4] (5)

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[4] The first transaction that the company will record is to deposit the capital collected from shareholders into the company bank account in which event OE = C. At that stage there are no liabilities.

The Book Value of investment to shareholders for any year of investment is

$S_{bv} = \quad n/N .D + n/N (C_0 + RE +\Delta RE)\}$ ..... (6)

The market value to the shareholder is thus:

$S_{MV} = n/N D + n/N(C_0 + RE +\Delta RE)(1+\lambda)$ ……………………….. (7)

The expression $(C_0 + RE +\Delta RE)$ represents the book value of the shares. The benefit to the shareholder of owning shares is thus two fold – the receipt of dividends and the increase in the value of the shares.

Payment of dividends

Dividends thus as a general rule constitute a flow of cash to the shareholders derived from the operations of the company. The question is thus, is issuing scrip dividends the same as making the payment D.

Retained earnings

It could well be that the operations of the company are very successful and the rate of return on capital employed in the company, $(D+\Delta RE)/(C+RE)$, far exceeds the rate of return which the shareholder will receive by depositing the money in the bank. In this case shareholders may well be pleased not to receive a dividend at all but that all the earnings be retained. In this case what is D in the above equation becomes part of the retained earnings, or putting another way all earnings are retained. The Book value to the shareholder is thus:

$S_{bv} = \quad n/N . (C_0 + RE +\Delta RE+ D)\}$ ..... (8)

In comparing equations (6) and (8) it should be clear that no difference exists between the two situations. The book value of the share increases exactly in relation to the value of the dividends not paid out.

When it comes to considerations of market values a difference does appear.

S_{MV} = $n/N. (1+\lambda).(C_0 + RE + D + \Delta RE)$ ….. (9)

The difference between equations (6), the position when dividends are issued and (9) retained earnings is.

$= \lambda(C_0 + RE + \Delta RE + D)$

Seen from a market value the shareholder may be better off by the market premium of the share. Should the shareholder require cash

However in the case of retained earnings, without the issuing of shares, it is not argued that the company issued a dividend. Retained earnings are not dividends

Scrip dividends

Assume now that dividends are not paid but instead additional scrip is issued. The first consequence is that no cash flows from the company to the shareholders. In the face it no cash flowed from the company and it is tempting, for this reason, to say that scrip dividends are not dividends. On the other hand scrip passes from the company to the shareholder. The question is thus is this something, scrip dividend, the same as cash. For ease of analysis firstly assume that there is a hundred per cent take-up. N1 new shares are issued and these are distributed to each shareholder in proportion to their shareholding. Each share is valued at current market price and thus the value of the new shares equals exactly the value of the dividends.

If N_1 is the number of new shares then a shareholder with n shares will receive n/N . N_1 new shares

The book value of a shareholder's holding is after the issue of the new shares thus equal to:

$$S_{bv} = \frac{n + \frac{n}{N}.N_1}{N + N_1}.(C_0 + RE + \ \Delta RE + D)$$

$$S_{bv} = \frac{n}{N}.(C_0 + RE + \ \Delta RE + D)$$

Which is exactly the same as the value when shares are retained.

Conclusion

It would thus appear that scrip dividends are in fact not dividends.

Further research

Presumably the reason why scrip dividends are issued instead of being retained, which as seen produces the same result is to allow shareholder choice. The retention of dividends may not suit all shareholders. This raises a further question of whether scrip dividends with a partial take up is similar to rights issue where some of the existing shareholders take up the rights and others do not. Those who elect to take the scrip dividends can be equated to those who subscript to the rights issue and their retained dividends as the new capital while those who elect the dividends are similar to the existing shareholders who reject the dividends. A rights issue with a take up by some existing shareholders is not seen as the payment of dividends. If the analogy is correct then even with a partial take up scrip dividends will not constitute the distribution of dividends.