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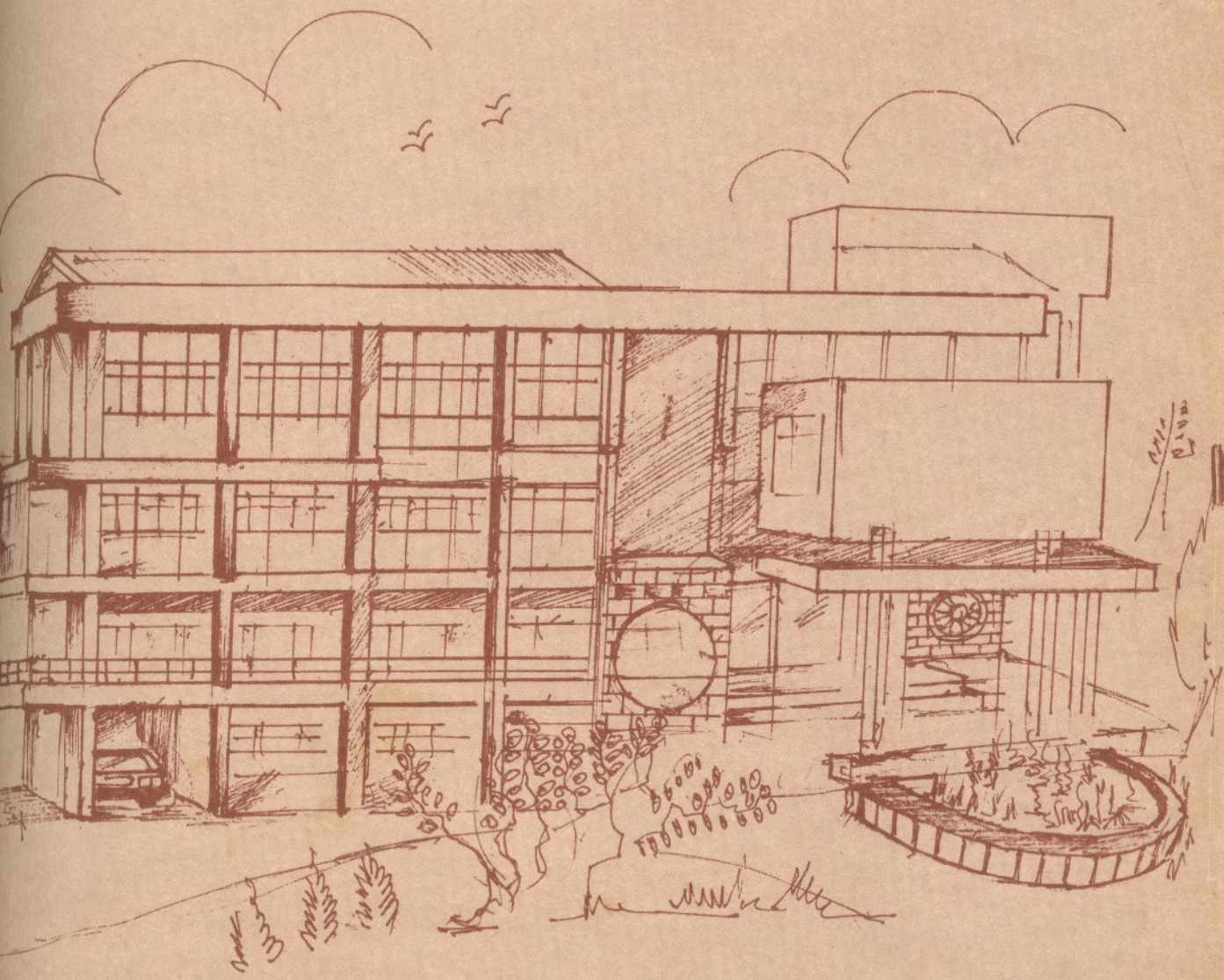

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On the Dividend and Bonus policies of the Indian companies.

Abstract

The Indian shareholders consider bonus issue as a gift from the management though the theory of finance discounts bonus issue of shares (or stock dividends as known abroad) as an accounting gimmick without having any impact on the value of the company. This phenomenon is something new to India and it happens here mainly because of two reasons. First, the shareholders expect that after the bonus issue, the dividend rate (defined as the ratio of equity-dividend per share and the face value of the share) will not go down and therefore the total cash inflow through dividends increases (because the same dividend per share is expected to be paid on the new shares issued). The second reason is that the liquidity of the stock increases after the bonus issue. The stock prices also fall thus making it more affordable to the shareholders.

This paper attempts to see the dividend paying behavior of around 200 to 250 (it varies across years) companies for a period of 15 years to see whether the above-mentioned expectation of the shareholders is valid, i.e., whether it is supported by empirical data.

It was found that most of the companies either maintained the dividend rate after the bonus issue at the pre-bonus level or have decreased it (but not proportionately).

A well performing company can either make a bonus issue and maintain a more-or-less constant dividend rate or it can increase the dividend rate without giving any bonus shares. Therefore this paper also attempts to see whether the companies making bonus issue have been able to generate more returns to their shareholders compared to companies that have not made any bonus issue but have maintained a steadily increasing dividend rate. It has been found that in the 1982-91 period the bonus issuing companies have been able to generate more returns to their shareholders than the companies that have not made any bonus issue in the said period but have maintained a steadily increasing dividend rate.

However, this phenomenon was reversed in the second period of the study namely, 1992-96.

The declining tendency of the MNCs to issue bonus shares was found to be one of the reasons of such return behavior.

Introduction

Bonus issue or stock-dividend as perceived in the theory of finance. Modern theory of Finance believes that a firm's making a bonus issue (or for that matter stock split) does not add value to the company. This is because bonus issue is just an accounting adjustment (without at all affecting the value of a company). The accountant just makes a book entry by debiting some free reserves account and crediting the share capital account. It does not require any cash inflow or outflow and therefore it is supposed that it does not add value to the company.

In India, however, shareholders look at the bonus issue as a gift from the management. There are many reasons for this. When there is a bonus issue, the ex-bonus price is usually higher than what the theoretical price should be. This is because the dividend rate (defined as a percentage of the face value) usually does not change after the bonus issue. When the company makes a bonus issue, the shareholders perceive that the management is confident of the future. (In the sense that the management can maintain the existing level of dividend).

Most companies also think that the Indian shareholders expect the dividend rate to remain constant even after a bonus issue. This is the explanation that the CEO of an Indian company gave when he was asked why his company does not give any bonus to its shareholders. In fact this company gave a bonus to its shareholders after a gap of 14 years in 1997.

One has to know how the Indian companies give dividends in India to understand this phenomenon.

Difference in India because of the way companies give dividends. In India companies declare the dividend as a percentage of the face value. Thus, when a company with a face value of Rs. 10 gives a 30% dividend, then each shareholder gets Rs. 3 as the dividend per share. This practice, however, is completely different from the practices followed abroad where a company pays a dividend as a percentage of the profit after tax (PAT). Thus a typical US company

will have a more-or-less constant payout ratio (defined as the ratio of total equity-dividends proposed to be paid divided by the PAT) if it has got any clear-cut dividend policy. Thus for a well performing company in the US, as the PAT (or the net income) increases the dividend will automatically increase. In India, however, the payout ratio keeps on fluctuating because the parameters of the dividend policy in India are different. This is evident from the following.

A quick survey of the payout ratio of the 6297 companies (from Prowess database) shows that most of the companies do not maintain a constant payout ratio. The companies prefer to maintain a more-or-less constant dividend rate and therefore the dividend payment remains constant year after year. Thus when the PAT changes the payout ratio also changes. The findings have been briefly summarized here.

Since it is not practical to maintain an exact payout ratio every year, even if a company wants to (because the companies will usually round off the rupee dividend to the nearest five paise) it was decided to see how many companies maintain a payout ratio that varies by a maximum of 5% points from the previous year. The latest five years' data were taken from the database. For the sake of analysis, it was also decided to see how many companies maintain a payout ratio that fluctuates in a range of 1% over the previous year. Thus, for example, if the payout ratio of a company in 1993 was 20%, then it was included in the sample only if its payout ratio was between 19% and 21% in 1994.

Out of 6297 companies, only 274 (4%) have maintained a payout ratio within a range of 5% in three out of the last five years.

Eighty-six companies (a little more than 1%) have maintained a payout ratio in a range of 1% in three of the last five years.

It is in this context that the bonus issue by a company becomes important. The cash flow to the shareholder is expected to increase after the bonus issue since the dividend rate does not fall and the number of shares increases. The ex-bonus stock price is therefore less than the theoretical ex-bonus price. Therefore the

bonus paying companies are expected to generate more returns to the shareholders than the non-bonus-paying company.

However, it may be perfectly possible to think of a situation where the company is not able to maintain the dividend rate because of some cash flow problem. Here the expectations of the shareholders get belied and therefore the share prices fall. It would therefore, be interesting to see whether the shareholders' expectation is valid, that is, whether the actual dividend rate movement is consistent with the shareholders' expectations.

This paper attempts to study the dividend and bonus policy of Indian companies, and tries to see how much return such companies have been able to generate for its shareholders. Nowhere any attempt is made to attribute the excess return generated (by the bonus paying companies) to the bonus issue, per se. Usually, only the healthy companies issue bonus shares. The Companies Act says that only free reserves can be capitalized. Therefore, to be able to give any bonus share a company must have sufficient free reserves with it. And that is possible only if the company has made enough profit in the last few years. Thus when one observes high returns generated by the bonus paying companies a large part of this return can be explained by the profitable nature of the business.

This paper does not attempt to do any event studies either (to see how the stock prices behave on the bonus announcement day) because many literatures (See for example, Ramachandran(1988) and Obaidullah(1992)) are available that have found that the stock prices react positively to the bonus announcement made by a company.

Sample

It was decided to study the bonus and dividend policy of the companies from the period 1982 to 1996. Data for the 1992-91 period were obtained from the stock market year book (SMYB) published by Quantum Financial Services Private Limited. Data for the 1992-96 period were obtained from the CMIE database Prowess. There are 250 companies in all about whom information are available in

the SMYB. Though it is desirable to maintain the same sample in both the sub-periods, it could not be done for two reasons.

1. Some companies have already been merged with one another and therefore the sample size gets reduced.

2. Secondly, some companies no longer exist or have been referred to the BIFR. Information about certain companies are also not available in the CMIE database. Therefore, in the second sub-period, the sample size was reduced to 201.

First Sub-period:

Out of the 250 companies only 160 made bonus issue during the 1982-91 period. The total number of bonus issues made was 236.

The distribution of bonus is given in the following table.

Group Name	Bonus size	no of ~~companies~~ bonus
A	More than 1:1	2
B	1:1	90
C	Between 1:1 and 2:1	99
D	less than 2:1	45
Total		236

The dividend rate of the companies was studied in the year following the bonus issue. The following table summarizes the findings. As can be seen in 52% of the cases the dividend rate either increased or remained constant. In another 41% of the cases though the dividend rate declined the decline was not proportionate and therefore the cash inflow of the shareholders increased.

Overall Statistics

	A	B	C	D	TOTAL
inc in div	0	15	27	12	54
same div rate	1	25	24	18	68
decline but not proportionately	1	44	39	14	98
prop decline	0	6	0	1	7
negative	0	0	9	0	9
total	2	90	99	45	236

Second sub-period:

Out of the 201 companies only 91 made bonus issues. The total number of bonus issues made was 134. The distribution of the bonus issue is given in the following table.

Group Name	Bonus size	no of ~~companies~~ Bonus
A	More than 1:1	4
B	1:1	52
C	Between 1:1 and 1:2	62
D	less than 1:2	16
Total		134

Similarly, the dividend rate of the companies was observed in the year following the bonus issue. The following table summarizes the findings.

	A	B	C	D	TOTAL
Inc in div	0	11	12	6	29
same rate	1	12	11	5	29
decline but not proportionately	3	26	27	3	59
prop decline	0	2	0	0	2
negative	0	1	12	2	15
total	4	52	62	16	134

Thus we saw that after a bonus issue is made, usually a company maintains the dividend rate or reduces it less than proportionately.

Though the shareholders expect the dividend rate to remain constant, it may so happen that the dividend actually declines after a year or two of the bonus issue (though it increases in the first year). The shareholders do not always lose if the dividend rate declines. Only if the rate declines more than proportionately, do they stand to lose. So it was decided to see how the rupee dividends (adjusted for the bonus issue) of the companies are varying over the next three years.

The findings have been summarized in the following table. Here increase3 means the rupee dividend has increased in all the subsequent three years. Increase2 means the rupee dividend payments have increased in the two years ***immediately*** following the dividend rate. Increase1 has got a similar meaning. Here, it is important to understand that whenever the rupee dividend payments have decreased in the year immediately following the bonus issue, it has been clubbed in the decline category irrespective of whether the dividend rate has increased in the subsequent years or not. Since the rupee dividend has increased

in all the cases where the bonus rate is greater than 1:1, it has not been reported here.

Distribution of dividends in the three years after the bonus issue.

For the period 1982-91

	less than 1:2	1:2 and 1:1	1:1	Total
increase3	38	88	74	200
increase2	5	3	9	17
increase1	1	2	5	8
decrease	1	6	2	9
total	45	99	90	234

For the period 1992-96.

	less than 1:2	1:2 and 1:1	1:1	Total
increase3	11	53	45	109
increase2	0	2	2	4
increase1	0	0	2	2
decrease	5	7	3	15
total	16	62	52	130

As is obvious from the above table, the cash flow to the shareholders have in fact increased in most of the cases after the bonus issue.

A well performing company can decide to increase its dividend rate or prefer to give a bonus without increasing the dividend rate. There are certain reasons to

believe that bonus issuing companies will give higher returns than the non-bonus issuing (but maintaining a steady increase in the dividend) companies.

a. Market expectations of an increase in cash flow to the investors because of an increase in dividend rate. The market becomes more confident of the cash flow for a company that gives bonus issue compared to another company that does not give any such bonus.

b. Price goes down though not proportionately and therefore, liquidity increases. Those who were not able to buy it before will buy now. The number of shares will also increase and that increases the floating stock of the company.

Therefore it was decided to see the returns that the dividend paying companies have been able to generate vis-a-vis the companies that have rewarded their shareholders via an increase in dividend rate year after year in the same period. Data about stock prices were obtained from ICFAI data base, economic times, and CMIE Database.

There were some companies that had a stock split in the sample period of study (but which did not have any bonus issue). Such companies were not included in the sample because here one of the objectives of the study was to see the liquidity effect of the bonus issue. The liquidity increases any way when there is a 10:1 split, for example.

In the 1982-91 period, there were altogether 23 companies that had a steadily increasing dividend rate (with stagnant dividend rate in one or two years) that did not give any bonus in the 9-year period.

These 23 companies on an average generated an annual return of 23.18% in the period. The returns varied from a high of 49.4464% to a low of 2.41%.

In the same period, there were 160 companies that made a bonus issue. The average returns they were able to generate was 29.34% per annum. The returns varied from a high of 69.065% to a low of -6.45%. It is interesting to note that none of the companies that did not give any bonus (but maintained a steady dividend rate) yielded a negative return. Of course there were only two companies in the list of bonus paying companies that gave a negative return.

This difference in return is statistically significant at the 1% level of significance.

Explanations of the excess return in the first sub-period.

Companies Act in India says that only free reserves can be capitalized. These free reserves are created out of the profits created by the company. And since profitable companies do experience higher stock returns, it is obvious that companies that give bonus to their shareholders will yield higher returns.

For 1991-96 period.

The returns were -8.4% for the companies that gave no bonus issue but had an otherwise steady dividend growth rate. This return was -12.11% for the bonus paying companies. There were only 11 companies that yielded positive returns among those that gave bonus.

This statistically significant return differences persisted even after deleting the extreme observations.

	1982-91	1992-96
non bonus but increasing in dividend	23.18%	-8.4%
bonus	29.34%	-12.11%
no bonus after dropping the extremes	22.88%	-8.22%
bonus after dropping the extremes	29.32%	-12.41%

Explanation of bad performance of the bonus paying companies in the second period:

The following are the possible reasons why the returns in the second period were less for the bonus paying companies.

Earlier there was a restriction on the MNCs repatriating profits to their parent company. Therefore, they were rewarding their parent companies by issuing

bonus shares. But after the recent liberalization process has started, the MNCs have started giving more dividends. The number of bonus issues made by MNCs has also declined. This is evident from the fact that in the first sub-period, out of 57 MNCs, only 16 did not have any bonus issue in the 10-year period. In the second period, however, out of 42 MNCs as many as 22 did not have any bonus issue.

It was argued initially that the liquidity of the stock increases after the bonus issue and therefore they probably could generate higher returns for their shareholders. The probable reason this has not happened in the second sub-period is that since the share prices are falling any way, it is probably not as much relevant now as it was before 1991.

Limitations of the study:

This paper does not attempts to see the returns corresponding to the different bonus ratios. This was not done here because this paper was more concerned with the long term returns the bonus paying companies are able to generate for their shareholders. Since most companies issue bonus shares in different proportions at different times, such an analysis was not perceived to be desirable.

Conclusions:

A study of the dividend and bonus policies of Indian companies revealed that most of the companies do not maintain a constant payout ratio. Rather, they maintain a constant dividend rate and this rate does not change after a bonus issue (or at least does not decline proportionately). Most of the companies reward their shareholders by making a bonus issue and maintaining the dividend rate. It was observed that most of the companies have been successful in maintaining the dividend rates after the bonus issue. It was also observed in the 1982-91 sub-period that the returns that the bonus issuing companies have been able to generate is higher that the reruns generated by companies that do not issue bonus shares but prefer to increase the dividend rate over time.

However, in the 1992-96 sub-period the bonus issuing companies have been found to under-perform companies that have increased the dividend rate but have not issued any bonus shares. Two plausible explanations have also been offered for this phenomenon.

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