DIVIDENDS, SHARES AND ALTERNATIVES TO SUSPENSION OF DRPs

The disadvantages of dividend reinvestment plans have caused some companies to suspend the plans. JONATHAN FARRER (above) and TONY CUSACK point out that alternatives exist which may eliminate negative aspects of DRPs and introduce new benefits for both companies and shareholders.

While companies have cited sound reasons for suspending their dividend reinvestment plans (DRPs), managers may sometimes have acted without considering alternatives. Other options may include reducing the discount rate offered under the plan or limiting the extent of participation.

This article considers the pros and cons of three scenarios:
- suspension of the DRP;
- reducing or eliminating the DRP discount rate; and
- placing a limit on the number of shares that any single shareholder can be entitled to under a particular DRP allotment.

DRPs allow shareholders to elect to receive all or part of their dividends in the form of additional shares in the company rather than in cash. Shares distributed under a DRP are usually issued at a discount of between 5 per cent and 10 per cent to the weighted average ex-dividend market price, with brokerage and stamp duty costs being met by the company, not the shareholder.

Participation in the plan is entirely at the discretion of the shareholder, who may elect to reinvest all, a portion or none of the dividend entitlement. Shareholders may change their participation status in the plan at any time.

ADVANTAGES OF DRPs FOR SHAREHOLDERS

The discount to the market price and an absence of transaction costs make DRPs an inexpensive and convenient way for shareholders to systematically increase their equity investment in the company. Unlike rights issues, DRPs require no physical outflow of cash; the investor merely forgoes dividend payments. DRPs smooth the average purchase price of the stock and allow shareholders to receive the benefits of dollar-cost averaging, which is particularly attractive for small, less sophisticated investors.

It has been argued that DRPs should appeal to all of the company’s shareholders, irrespective of whether they participate in the plan. This is because a DRP enables the company to have a relatively low “cash” payout ratio, thus allowing larger dividend payments to all shareholders. Higher dividend payouts should benefit shareholders regardless of their personal preferences with respect to reinvestment.

For example, higher dividend payments reduce agency costs arising from the manager-shareholder conflict. If shareholders are not participating because they lack liquidity, then a DRP will increase their liquidity by way of higher cash dividend payments. If this increase in liquidity is too great, then they can reinvest any “excess” liquidity through partial DRP participation.

For Australian companies with the ability to pay franked dividends, an increased payout ratio means all shareholders receive more imputation credits. This high payout policy allows many shareholders to be taxed effectively only once, at the personal marginal rate, while retention of profits can lead to double taxation. A DRP gives both participant and non-participant shareholders the ability to receive more dividends, and hence more imputation credits. Thus, having a DRP arguably puts all shareholders in a better after-tax position and

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at the very least makes no shareholder worse off.

The discount feature of DRPs can give institutional investors the opportunity to make arbitrage profits. Institutions will receive the benefit of the discount and no transaction costs are payable on the buying side. By immediately selling their DRP entitlement at the full market price, institutions can make essentially risk-free arbitrage profits.

DISADVANTAGES OF DRPS FOR SHAREHOLDERS

Small shareholders and the company itself are made worse off by these arbitrage schemes because they drive down the value of the company’s shares, which is obviously to the detriment of shareholders. The strategy cannot be implemented by small shareholders because of the high costs they would incur on the selling side.

Participation in a DRP reduces a shareholder’s liquidity because dividends that would otherwise be received are forgone. This problem can be mitigated by selling the shares, but transaction costs would be incurred on the sale.

Shareholders who do not participate effectively subsidise any benefits received under the plan because it is the whole firm – participants and non-participants – which ultimately bears the costs of a DRP. These costs include the discount given, the transaction costs paid for and the associated administrative costs. Investors who need the liquidity that dividends provide, or foreign investors who may be excluded from the plans, are not likely to be amenable to supporting a plan which actually dilutes their interest.

DRPs often create odd lots or non-marketable parcels, which increases brokerage fees when the shares are sold. Share top-up plans can negate this problem, although they require additional cash contributions, which are a further drain on shareholder liquidity.

Most shareholders have no control over the issue price of DRP shares, and are therefore unable to time their run into the market so that shares can be purchased cheaply. This problem will be of less concern to small investors, who are less likely to be well informed about the state of the market than large institutions. Shareholders may in fact value the smoothing effect that DRPs have on their the average purchase price.

ADVANTAGES OF DRPS FOR COMPANIES

A DRP strengthens the company’s equity base, allowing it to accept new positive NPV opportunities without incurring further debt. Consequently, there is improvement in the company’s balance sheet, its gearing ratio and its credit rating, which in turn lowers the cost of debt and reduces agency costs. Greater equity capital also allows a company wishing to increase its borrowing to do so in absolute terms while keeping its gearing ratio constant.

DRPs also provide companies with a relatively stable, assured and continuous flow of new equity capital regardless of market conditions. The company’s risk with respect to variations in the cost of capital caused by market fluctuations will consequently be reduced. This may be valued by companies which require regular injections of new equity capital to facilitate growth, such as banks. The market can better digest a smaller, steady stream of equity under a DRP than a large sum raised at a one-off public offering. Capital raised under a DRP can also be incorporated into internal capital budgeting procedures.

Consistent with Myers’ Pecking Order Theory, DRPs allow the firm to avoid a negative market response to either raising funds externally or using internal funds supported by way of a dividend cut. Managers are usually reluctant to cut the dividend rate per share, so with new shares being issued under a DRP total dividends paid will increase, which the market may view positively.

It is often claimed that DRPs improve shareholder relations, and this, combined with the fact that DRPs give participants a greater share of the company, means that the plans help to provide resistance to a hostile takeover. This contention lacks empirical backing; indeed, if DRPs allow a company to build up too much financial slack this could in fact attract predators. Nevertheless, augmenting resistance to takeovers is still seen by some as an advantage of having a DRP.

Additionally, having a plan may attract new shareholders who favour companies with a DRP. In turn, the increased demand for the company’s shares should boost its share price.

DRPs appear to be an attractive alternative relative to other methods of equity raising. Rights issues are usually underwritten and involve high administrative costs, and a substantial discount from the market price is usually offered. Another advantage of DRPs over rights issues is that the latter require investors to raise large sums of cash in a relatively short time, which small investors in particular may be unable to do. Of course, if the rights issue is renounceable then the rights can be sold, but this results in the investor’s stake in the company being diluted.

DRPs are also more economical than private placements, which usually offer shares at a discount of 10 per cent, slightly higher than most DRP discounts.
Further, heavy agency costs are associated with private placements because wealth is taken away from existing shareholders and their control is diluted.

DISADVANTAGES OF DRPS FOR COMPANIES
A major concern with DRPs is whether the firm will be able to effectively utilise all the capital generated, so the company should generally be able to predict several years of consistent growth and expansion before implementing a DRP.

A company may be hesitant to introduce a DRP because of the resultant dilution of EPS. A DRP will increase the number of shares on issue, so unless there is a corresponding increase in total earnings, earnings on a per share basis will be lower as a result of the DRP. By increasing the free cashflow available to management, DRPs may also raise the level of agency costs arising from the shareholder-manager conflict.

As has already been noted, a discount is offered under a DRP there will be arbitrage opportunities for institutional investors, which has detrimental consequences for the firm as a whole. The selling pressure created by arbitragers may depress the price of the firms shares in the five-day period used to determine the “market price” for the DRP allotment. This results in the company selling shares at a lower price under the DRP than it otherwise would have, thereby raising the cost of the issue. This arbitrage practice has prompted several companies, including Foster’s Brewing, to suspend their DRPs. As well as driving down the value of the company’s shares, the arbitrage strategy makes the firm’s ownership structure more diffuse because the shares are not being kept by existing shareholders.

In some circumstances debt may be preferred to the equity that would be raised under a DRP, particularly where the company would be able to utilise further interest tax shields.

In the case of small companies, they often cannot justify the costs of setting up a DRP, which include legal, administrative and printing expenses.

SUSPEND THE PLAN?
Several companies, including Amcor, Boral and Foster’s, have recently suspended their DRPs. The common factor in these suspensions was the belief that raising equity capital, particularly at a high discount rate to the market price, could not be justified in the prevailing economic conditions. Firms were finding it difficult to maintain EPS even without a DRP exacerbating the situation. Foster’s stated publicly that it had abandoned its DRP because of institutional arbitragers taking advantage of the discount feature of their plan.

As the tables show, suspending a DRP will eliminate any net advantage of the plan. Firms that suspend their DRPs must therefore believe that the plans are a net disadvantage to the company and its shareholders.

This paper outlines two strategies that in many cases may be better alternatives than suspension:
- eliminating or reducing the discount rate under the plan; and
- limiting the extent to which any single shareholder may participate in the plan.

Although some firms have adopted these options, the large number of suspensions suggests that some firms have not fully considered all options available to them.

ELIMINATING OR REDUCING THE DISCOUNT RATE
The discount rate set will determine the extent to which the various advantages and disadvantages of a DRP are in fact realised. Research has shown that the discount rate offered is a major determinant of the level of participation in a DRP. In turn, the participation rate will help determine the effective payout ratio, and the extent of EPS dilution and institutional arbitrage will depend largely on the discount level offered.

Altering the discount rate can affect the relative advantages and disadvantages of having a plan, and the change may have a larger incremental impact on either the advantage side or disadvantage side, so that there may be either a net gain or a net loss from a change in discount rates. For example, the discount offered is a part of the cost of the issue to the company. If the discount rate was changed from 5 per cent to 10 per cent, the negative consequences of the increase, particularly the higher cost to the company of the issue, may outweigh the benefits received from the change in discount rate, such as giving the company a greater ability to distribute franking credits.

On the other hand, the benefits resulting from a reduction in the discount rate may be such that a plan previously perceived by the company as having a net disadvantage may become advantageous. Anecdotal evidence suggests that some firms which have suspended their DRPs have ignored this and gone directly from a high-discount-rate plan to no plan at all. A lowering of the discount rate may have enabled the plan to start bringing net benefits to the firm and shareholders.

Several major companies, including Goodman Fielder, National Australia Bank, the Commonwealth Bank and TNT, appear to have chosen this alternative course of action and have dropped their discount rate to 2.5 per cent.

Consider the case of removing the discount rate component of the plan altogether, so that shares are issued at the market price. The following arguments also apply, to a lesser extent, where a small discount is offered. Several disadvantages commonly attributed to DRPs would be eliminated and there would be less backlash from non-participants.
because their "subsidies" have been reduced (see Table 1).

Related to this is the fact that the company's cost of capital, which depends on both the administrative issue costs and the discount rate, is significantly reduced. In fact, without the discount rate, capital raising under a DRP will be cheaper than almost any other method of raising equity funds. This may benefit all shareholders: the only direct costs incurred are issue and transaction costs, which could constitute 1-2 per cent of the total capital raised.

Table 2 shows that some of the most commonly cited reasons given by companies to justify the suspension of their DRP, including a dilution of EPS, will be either partially or fully eliminated if the discount feature of the plan is removed. This is a similar result to suspending a DRP, which eliminates all disadvantages and advantages. Under suspension, the only disadvantage that remains is the odd lots that have already been created. This can be overcome by introducing a one-off share top-up plan immediately before the DRP suspension, as companies such as Boral and Westpac have done.

However, Table 2 demonstrates that under the zero-discount plan several advantages are preserved. Under a zero-discount plan the company will receive a smaller and more cost-effective injection of equity funds than under a plan with a positive discount rate.

The DRP is still an effective way to systematically participate in the equity market, with the benefit of smoothing in the absence of transaction costs remaining. While some shareholders will undoubtedly drop out of the plan, all shareholders can still decide whether to participate or not. If the DRP is suspended, all shareholders must effectively drop out, including those small investors who would have participated even without the discount rate carrot.

LIMITING THE EXTENT OF REINVESTMENT

An alternative to either suspension or changing the discount rate is to place a limit on the amount that each shareholder can reinvest. For example, Coles Myer has placed a maximum participation of $1,500 per dividend for each shareholder. When Pioneer International mooted a similar change the company found that the level of participation of about 90 per cent of participants would not be affected because their dividend payment fell below the reinvestment limit. However, this figure would differ between companies and it seems likely that in some cases more than half of a company's issued shares (as opposed to shareholders) may be ineligible to participate in the DRP if a reinvestment limit is imposed.

Several issues should be carefully considered before deciding to limit the level of reinvestment.

In most cases, such a changes to the rules of the DRP would require shareholder approval at the annual general meeting. Not only is the wait for approval inconvenient for management, but approval is not guaranteed. To avoid this problem later, companies that are considering imposing a limit on DRP reinvestment in the future could seek approval from shareholders at their next general meeting to amend the company's constitution and allow the directors to place a limit on dividend reinvestment in the future. Most companies have already done this in relation to suspending the plan and changing the discount rate.

Voting control is a controversial issue under this alternative. Large shareholders who are using the DRP as a means of increasing control are unlikely to be happy with a limit. Their percentage of voting power may be diluted even if they choose to participate in the DRP to the maximum possible extent.

Contrast this with the alternative of removing the discount rate altogether, which will induce other shareholders to drop out of the plan. This would allow a major shareholder who continues to participate to increase their percentage voting power even more than under a DRP with a positive discount rate, because if others drop out they will be receiving a greater percentage of DRP shares being allotted than before, even though they would have received more shares in total under a plan with a positive discount rate.

A reinvestment limit would be effective in preventing institutional arbitrage at the expense of other shareholders, which has in the past led to disharmony among major shareholders in large corporations. For example, when Foster's suspended its plan, it was largely because of pressure from BHP, which was not itself participating in the DRP. BHP was unhappy that another major shareholder of Foster's was adopting the arbitrage strategy outlined earlier and devaluing Foster's share price. BHP may have been satisfied if Foster's had placed a limit on reinvestment for each shareholder, which would have prevented arbitrage profit-making by other institutions while allowing the majority of shareholders to continue to receive benefits under the existing DRP.

Large shareholders, whose level of participation would be restricted by a reinvestment limit, may feel that it is unfair to make them effectively subsidise the discount and administrative costs of small shareholders. Limiting reinvestment is effectively like suspending the DRP for large shareholders but allowing small shareholders to continue to participate. Major shareholders, particularly those that themselves participate, are unlikely to be pleased with this and will pressure companies not to introduce such proposals.

Loopholes are likely to enable investors to get around the limits, at least to some extent. For example, the limits could be effectively raised by holding shares in
<table>
<thead>
<tr>
<th><strong>DRP Advantage</strong></th>
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<th><strong>Extent mitigated by zero discount rate</strong></th>
<th><strong>Extent mitigated by limit on participation</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares &quot;cheap&quot; due to discount</td>
<td>Eliminated</td>
<td>Eliminated</td>
<td>Maintained, but less so than previously for large shareholders</td>
</tr>
<tr>
<td>Systematic participation in equity market with smoothing</td>
<td>Eliminated</td>
<td>Preserved</td>
<td>Preserved for small shareholders. Largely eliminated for substantial shareholders</td>
</tr>
<tr>
<td>No transaction costs</td>
<td>Eliminated</td>
<td>Preserved</td>
<td>Preserved</td>
</tr>
<tr>
<td>Larger dividend payments for all shareholders including more imputation credits</td>
<td>Eliminated</td>
<td>Preserved, although reduced to some extent as participation in the DRP is likely to decline</td>
<td>Preserved, but to a lesser extent as large shareholders will receive mainly cash, meaning less will be reinvested</td>
</tr>
<tr>
<td>Arbitrage profits for corporate shareholders</td>
<td>Eliminated: no shares received</td>
<td>Eliminated: no discount to market price on DRP shares, but selling side transaction costs</td>
<td>Eliminated: not enough shares are issued to any individual investor to make the practice cost-effective</td>
</tr>
<tr>
<td>Participation status needs may be varied at any time to suit personal needs</td>
<td>Eliminated</td>
<td>Preserved</td>
<td>Preserved for small shareholders, but substantial shareholders now have limited participation options</td>
</tr>
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<td><strong>DRP Disadvantage</strong></td>
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<td>Arbitrage profits drive down share price</td>
<td>Eliminated: companies do not receive shares</td>
<td>Eliminated: institutions will not engage in arbitrage transactions as there is no longer an advantage for them</td>
<td>Eliminated, as arbitrage no longer a cost-effective strategy</td>
</tr>
<tr>
<td>Non-participants subsidise the DRP</td>
<td>Eliminated. Not a disadvantage for participants</td>
<td>Subsidy reduced to transaction and administrative costs. Not a disadvantage for participants</td>
<td>Remains, and accentuated as large shareholders are forced to subsidise small shareholders. Not a disadvantage for full participants</td>
</tr>
<tr>
<td>Shareholder liquidity reduced</td>
<td>Eliminated. Not a problem for non-participants</td>
<td>This problem remains, but can be eliminated by the individual shareholder choosing not to participate: yet a choice still remains. Not a problem for non-participants</td>
<td>Remains for small shareholders, but not a problem for large shareholders or non-participants</td>
</tr>
<tr>
<td>Odd lots created by DRP</td>
<td>Not eliminated, as former DRP participants still have odd lots (although companies may well have a one-off top-up plan at the time of the suspension). This is not a problem for those who never participated</td>
<td>Not eliminated. This is not a problem for those who never participated</td>
<td>Still a problem for participants, and unless a top-up scheme exists the problem remains for those who drop out. Not a problem for those who never participated</td>
</tr>
<tr>
<td>Most shareholders have no control over issue price or timing of the issue</td>
<td>Eliminated, but was never a problem for non-participants</td>
<td>Still a disadvantage for participants but was never a problem for non-participants. This is really only an issue for large investors</td>
<td>Still a disadvantage for participants but was never a problem for non-participants. Large Investors not likely to care as their participation is now much smaller than before</td>
</tr>
</tbody>
</table>
Table 2: Advantages and Disadvantages for Companies

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Strengthens company's equity base, leading to several advantages including lowering the cost of debt and reducing agency costs</td>
<td>Eliminated</td>
<td>Preserved, although reduced to some extent as participation in the DRP is likely to decline</td>
<td>Preserved but to a lesser extent</td>
</tr>
<tr>
<td>Small, stable and cost-effective injection of new equity capital</td>
<td>Eliminated, though many companies argue they have not wanted any new capital</td>
<td>Preserved, though there is a smaller injection (which may be advantageous in some circumstances)</td>
<td>Preserved, though there is a smaller injection (which may be advantageous in some circumstances)</td>
</tr>
<tr>
<td>Signalling consequences: Myers' Pecking Order Theory</td>
<td>Eliminated</td>
<td>Preserved but to a lesser extent</td>
<td>Preserved, but to a lesser extent</td>
</tr>
<tr>
<td>Shareholder loyalty and resistance to a hostile takeover</td>
<td>Eliminated, and the suspension may lower shareholder loyalty</td>
<td>Preserved, although less than under a high discount rate</td>
<td>May maintain loyalty among small shareholders</td>
</tr>
<tr>
<td>Attracts shareholders who like DRPs</td>
<td>Eliminated</td>
<td>Preserved, although investors may prefer companies offering high discount rates</td>
<td>Preserved for small investors only</td>
</tr>
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<tbody>
<tr>
<td>Company must absorb transaction and administrative costs</td>
<td>Eliminated</td>
<td>Not eliminated, but reduced because there will be fewer participants</td>
<td>Not eliminated but reduced</td>
</tr>
<tr>
<td>Company not able to utilise cash raised</td>
<td>Eliminated</td>
<td>Eliminated to some extent because a smaller amount of cash will be raised, but could still be a problem for some companies</td>
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</tr>
<tr>
<td>Agency costs associated with free cashflow</td>
<td>Eliminated</td>
<td>Reduced</td>
<td>Reduced</td>
</tr>
<tr>
<td>EPS dilution</td>
<td>Eliminated</td>
<td>Eliminated to some extent because fewer new shares will be issued. If the funds are used effectively (which is likely, given that only a small amount is being raised), EPS may increase in the long term</td>
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</tr>
<tr>
<td>Arbitrage strategies drive share price down</td>
<td>Eliminated: companies do not receive shares</td>
<td>Eliminated: companies will not engage in arbitrage transactions as there is no longer an advantage for them to do so</td>
<td>Eliminated: arbitrage schemes are no longer cost-effective</td>
</tr>
<tr>
<td>Debt may be preferred over equity, particularly where interest tax shields can be utilised</td>
<td>Eliminated</td>
<td>Reduced: less equity will be generated, so more debt can be used</td>
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Note:
The extent that advantages/disadvantages for the zero discount rate alternative are retained or eliminated will largely depend upon the level of the drop in the participation rate.
The extent that advantages/disadvantages for the limit on reinvestment alternative are retained or eliminated will largely depend upon how diffuse the shareholder base is. For example, if there are mainly small shareholders then most advantages and disadvantages will remain, but where there are several large shareholders and few small shareholders the effective result will be similar to that for suspension.

different names, including the names of wholly owned subsidiaries or trusts. If this practice became common, the scheme could lead to a more dispersed shareholder base, which may not be in the company's best interests.

CONCLUSION
The tables contains a summary of the main arguments outlined in this paper. Before suspending their company's plan, managers should carefully weigh up whether it would be better to reduce or eliminate the discount rate offered under their DRP, or whether a limit should be placed on shareholder participation in the plan. The option eventually chosen will, to a large extent, be a value judgment dependent on company-specific circumstances.

The company's shareholder base and the views of major shareholders will be critical to the decision, particularly if the reinvestment limit option is chosen, as this favours small shareholders at the expense of large shareholders. It is also worth considering that reducing or eliminating the discount rate is the only alternative which gives all shareholders a complete and unfettered choice as to their participation status.

While suspension may in some circumstances be the best option, directors should justify this choice to shareholders and state why it is preferred over the alternatives.