On 18 April 1995, ERA announced its intention to declare a fully franked special dividend of 62.5 cents a share to its A-class and B-class shareholders and the issue of bonus shares to its C-class shareholders. This was ERA's first dividend since November 1992, when the company announced a policy of directing available cash to the retirement of debt associated with the purchase of Jabiluka, rather than the payment of dividends.

The transaction also involved the implementation of a dividend reinvestment plan (DRP) and a bonus share plan (BSP) and, for regulatory reasons, a capital reduction and a 4-into-1 share consolidation, resulting in the special dividend equating to $2.50 a share. Of the total dividend, $206,870,625 (89.7%) was franked at a rate of 39% and $23,754,375 (10.3%) at a rate of 33%.

Before announcing the special dividend, ERA received an undertaking from major shareholders, including its 66.3% controlling shareholder, North Limited, that they would reinvest their share of the special dividend in ERA shares under the DRP. This reduced the maximum possible cash outflow resulting from the dividend to $35 million, thereby ensuring ERA retained a strong balance sheet after the distribution of the franking credits.

By observing the reaction of ERA's share price to the announcement of the special dividend and the share-price movement on the ex-dividend date, we draw some conclusions about the value realised for shareholders from the special dividend. We then consider the reasons for this value creation, including the identification of the price-setting investor and an investigation of that investor's taxation position. We also describe a structure which enables foreign investors, or investors not paying Australian corporate tax, to realise value from franking credits which they otherwise would forgo.

In the case of ERA, we conclude that about $35 million of value was created from the special dividend for holders of A-class shares. We believe there was the potential to create an additional $80 million of value for North's shareholders had North simultaneously distributed its share of the franking credits received from ERA to North shareholders.

**THE MARKET'S REACTION**

Figure 1 illustrates that over the day before the announcement and the day of the announcement of the special dividend, ERA's share price (A-class shares) jumped from $4.80 to $6.72, an increase of 40%. The chart also illustrates that the ERA share price fell by $3.94 over the two days after the shares began trading ex-dividend, well in excess of the $2.50 dividend paid.

Figure 2 shows ERA's share price movement, from April to July 1995, relative to movements in the All Mining index, the All-Ordinaries index and the share price of the Canadian uranium producer Cameco. Virtually all the share price volatility exhibited by ERA during
Figure 1: ERA's share price performance, April to July 1995

Figure 2: ERA's relative share price performance, April to July 1995

Legend:
- Cameco (rebased)
- All Ordinaries index (rebased)
- All Mining index (rebased)
- ERA (rebased)
DIVIDEND POLICY

Table 1: Net value of ERA's special dividend

<table>
<thead>
<tr>
<th></th>
<th>Individual shareholder with a marginal tax rate of:</th>
<th>Institutions*</th>
<th>Foreign Investorb</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>21.4%c</td>
<td>35.4%c</td>
<td>44.4%</td>
</tr>
<tr>
<td>Dividend</td>
<td>$2.50</td>
<td>$2.50</td>
<td>$2.50</td>
</tr>
<tr>
<td>Gross-upd b</td>
<td>1.56</td>
<td>1.56</td>
<td>1.56</td>
</tr>
<tr>
<td></td>
<td>$4.06</td>
<td>$4.06</td>
<td>$4.06</td>
</tr>
<tr>
<td>Tax</td>
<td>(0.87)</td>
<td>(1.44)</td>
<td>(1.80)</td>
</tr>
<tr>
<td>Imputation credit</td>
<td>1.56</td>
<td>1.56</td>
<td>1.56</td>
</tr>
<tr>
<td></td>
<td>0.69</td>
<td>0.12</td>
<td>(0.24)</td>
</tr>
<tr>
<td>Dividend</td>
<td>$2.50</td>
<td>$2.50</td>
<td>$2.50</td>
</tr>
<tr>
<td>Post-tax return</td>
<td>$3.19</td>
<td>$2.82</td>
<td>$2.26</td>
</tr>
</tbody>
</table>

NOTES
a Assumed to be an Australian superannuation fund with a marginal tax rate of 15% and excess tax payable against which the full imputation credit can be used.
b Resident in a country with which Australia has a tax treaty. Franked dividends are exempt from the 15% withholding tax.
c Assumed to have excess tax payable against which the full imputation credit can be used.
d 206,870,625 x 0.69 = 230,625,000 x $2.50 / 230,625,000 = 0.05

Table 2: Net return from short-term trading strategy

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price of 1 ERA share</td>
<td>(6.86)</td>
</tr>
<tr>
<td>Disposal proceeds from 1 ERA share</td>
<td>2.92</td>
</tr>
<tr>
<td>Brokerage and stamp duty*</td>
<td>(0.06)</td>
</tr>
<tr>
<td>Tax benefit of loss @ 15%</td>
<td>0.60</td>
</tr>
<tr>
<td>Value of fully franked dividend</td>
<td>3.45</td>
</tr>
<tr>
<td>Net return</td>
<td>0.05</td>
</tr>
</tbody>
</table>

* Brokerage at 0.5% and stamp duty at 0.15% is applied to both the buy and the sell transactions.

this period was specific to ERA and not related to the wider stockmarket, or to the mining or uranium sectors in particular.

How can we explain the sharp increase in ERA's share price on the announcement of the special dividend and the price drop-off on the ex-dividend date?

VALUE OF THE FRANKING CREDITS
Because of their different marginal tax rates and Australia's system of dividend imputation, the post-tax return from the $2.50 special dividend was not uniform for all ERA shareholders. Table 1 illustrates that the post-tax return is highest for those investors with the lowest marginal tax rate, provided those investors have other tax liabilities against which the franking credits attached to the special dividend can be utilised. Investors paying no tax, however, do not benefit from franking credits and have been ignored.

Table 1 shows that ERA's special dividend has the highest post-tax value ($3.45) for a domestic institution which can fully utilise the attached imputation credit. Foreign investors, on the other hand, do not benefit from franking credits. This contrasts with the situation for unfranked dividends, which are generally worth the same to both domestic and foreign investors.

The identification of the domestic institution as the shareholder which benefits most from a franked dividend, and which therefore, presumably, becomes the price-setting investor, is critical to understanding the market's reaction to unanticipated (or special) franked dividends.

For many Australian companies the price-setting investor is ordinarily an international financial institution which is a non-resident of Australia for tax purposes, and consequently does not benefit from franking credits. However, on the announcement of an unanticipated fully franked dividend, the price-setting investor switches from being a foreign institution to being a domestic institution and, other things being equal, the price of the stock is bid up to reflect the enhanced returns to the new price-setting investor.

Above, we calculated the value of ERA's $2.50 fully franked dividend to the price-setting investor to be $3.45. Why, then, did ERA's share price fall by $3.94 over the two days after the shares began trading ex-dividend? Would we not expect the price to fall by the reduction in value to the price-setting investor – that is, $3.45?

THE NEXT STEP – TAX LOSSES
A number of commentators have used share-price drop-off analysis to estimate the value attributed by the stockmarket to franking credits. This analysis, which has focused on ordinary dividends, has
consistently observed share-price drop-offs on the ex-dividend date less than that implied by the value of the franked dividend to the price-setting investor.

How do we reconcile this with the case of ERA’s special dividend, where the share-price drop-off of $3.94 exceeded the $3.45 value of the franked dividend to the price-setting investor (a domestic institution)? We believe the answer lies at least partly in the value of tax losses accruing to investors which buy the stock before the ex-dividend date and sell soon after.

Table 2 illustrates the returns that would have accrued to a domestic institutional investor from a short-term trading strategy of buying one ERA share for $6.86, and then selling that share after the ex-dividend date for $2.92.

The net return from this short-term trading strategy is approximately $0.05, equal to 0.7% on the initial outlay of $6.86. The low return is the result of price-setting arbitragers bidding up the cum-dividend share price in search of a short-term excess return. This analysis suggests that, in the case of ERA’s special dividend, the market fully values both the franking credits attached to the dividend and the tax losses accruing to the price-setting investor. This compares with the studies referred to earlier which have concluded that the market values franking credits at between 58% and 82% of their face value.

We believe these two conclusions are consistent since our analysis has focused on the value to a specific investor class (domestic institutions which, in ERA’s case, we argue were the price-setting investors) of franking credits attached to an unanticipated special dividend, whereas the previous research investigated the value of franking credits attached to ordinary dividends (which were anticipated by the market), where the price-setting investor could have been a foreign investor which did not benefit from the franking credits.
Further, we note that the proximity of ERA's ex-dividend date (29 June) to the end of the fiscal year enabled investors to quickly realise the benefits of the franking credits and any tax losses.

**THE IMPACT ON NORTH**

At the time of the announcement of ERA's special dividend, North owned about 67,974,000 ERA A-class shares. In normal circumstances we would expect the observed increase in the value of each ERA share of $1.92 at the time of the announcement of the special dividend to translate into an increase in the value of North's stake of $130 million, equivalent to $0.19 per North share, or 6% of the North share price on 17 April 1995 of $3.22. What is the observed effect on North's share price of ERA's special dividend?

Figure 3 shows the movement in North's share price relative to the All Mining index and the All-Ordinaries index from the day preceding ERA's announcement of a special dividend through to the end of July 1995.

No outperformance by North is evident around the time of ERA's special dividend announcement. However, over the longer period to the ex-dividend date, significant outperformance by North is apparent. In the period from 17 April to the ex-dividend date, North's share price increased by around 18%, compared with increases over the same period for the All-Mining index of around 7% and the All-Ordinaries index of around 5%.

We believe that some of North's outperformance over this period can be attributed to the benefits it received from ERA's special dividend. Other factors which may have contributed to North's outperformance include the successful joint bid with Rio Algom for International Musto Corporation, the half-owner of the Alumbrera copper and gold deposit in Argentina, and the granting of board approval for North's Lake Cowal project.

The evidence is therefore inconclusive as to the extent to which North benefited from ERA's special dividend. We believe the market did not fully value ERA's franking credits in the hands of North since the franking credits become valuable only when distributed to individual or institutional shareholders.

**HOW MUCH VALUE WAS CREATED?**

We have identified a share-price increase of $1.92 at the time of ERA's announcement of a special dividend. We believe that this additional value was, at the very least, available to all ERA's minority holders of A-class shares, implying that a minimum of $17 million of value was created.

The extent to which North benefited from the special dividend is unclear, although it is likely that the market did not fully value the franking credits in the hands of North. Also, given its position as controlling shareholder, and undertakings given to ERA not to reduce its shareholding, North was unable to benefit from tax losses in the same way as other investors. On balance, we believe the value created for North was of the order of $20 million.

We conclude that ERA's special dividend created approximately $17 million of value for minority shareholders and approximately $20 million for North, a total of $37 million, say $35 million. We note that had North fully distributed to its shareholders the ERA franking credits received, it may have created value for its shareholders of up to $100 million. In this case, the total value created would have been about $117 million, say $115 million.

**FOREIGN INVESTORS**

In the previous analysis we identified a tax-paying domestic institutional investor as the major beneficiary of franking credits. This is because franking credits have no value to foreign investors and none to investors which are not paying tax. In the case of a special dividend payout, an interesting arbitrage opportunity arises.

Australian institutions are likely to bid up the Australian company's share price in their quest to obtain franking credits. If true, foreign shareholders, who do not enjoy the benefits of franking credits, who sell to Australian institutions and then repurchase the stock once the franking credit account has been cleared can also benefit (albeit indirectly) from the franking credits.

There are, as well, formal structures which allow both foreign investors and non-taxpaying domestic investors to benefit from the franking credits attached to normal dividend payouts. One such structure was used in November 1993 by Capguard, a listed investment trust, to raise about $200 million against 57 million Coles Myer shares.

**DIVIDEND POLICY**

This note is titled "Unlocking value from franking credits". It is important to note that the locked-up value is a result of a sub-optimal dividend policy. If companies employed an efficient dividend policy - which we argue is to ensure the full payout of franking credits as they arise - there would be no accumulation of franking credits as occurred in ERA's case.

We are of course arguing for a 100% profit payout. Not only is this payout ratio unconventional, but it produces a variable dividend, linked to annual profits, which can fluctuate considerably in the resources industry. Since changes in dividend normally carry information about the company's future prospects, a communication issue arises, but one that is not insurmountable.

As a consequence of a 100% profit payout, retained earnings will cease to be a company's primary source of funding. We see a growing trend of additional
rights issues and dividend reinvestment plans.

We also note that, contrary to conventional finance theory (one of the Miller and Modigliani axioms), the advent of dividend imputation now means that dividend policy does matter in Australia.

The authors acknowledge the input of David Kingston, a director of Rothschild Australia Limited, to the analysis in this paper.

NOTES
1. ERA's A-class shares account for 75% of ERA's issued capital and are held by Australian resident investors. The B-class shares account for 15% of ERA's issued capital and are held by non-resident European power utilities and fuel companies. The C-class shares account for 10% of ERA's issued capital and are held by non-resident Japanese power utilities.

2. 62.5 cents multiplied by 4.
3. 76,875,000 A-class shares plus 15,375,000 B-class shares, multiplied by $2.50 each.
4. Share prices have been retrospectively adjusted to reflect the 4-into-1 share consolidation announced as part of the special dividend.
5. We have assumed that distributions from both the domestic Australian institution and the foreign investor to their respective beneficiaries are free from tax. Therefore the only relevant taxes for these investors are the 15% superannuation fund tax imposed on certain Australian institutional investors and the withholding tax of 15% applying to unfranked dividends paid to foreign investors. It is therefore consistent to compare the post-tax returns of these investor classes with the post-tax returns to Australian resident individual shareholders. Corporate shareholders gain no fiscal advantage from franking credits and have therefore not been considered in this analysis. Corporate shareholders do, however, benefit from franking credits to the extent that the credits enable them to pay franked dividends which in turn benefit their own shareholders. Accordingly, we later examine the impact of ERA's special dividend on its principal corporate shareholder, North.
6. We believe this conclusion is robust even in light of the lower cost of capital foreign investors enjoy (due to international portfolio diversification) relative to domestic investors. This is because the high dividend yield implied by ERA's special dividend results in additional tax benefits accruing to the domestic investor which would have been payable on unfranked dividends received.
7. Generally, because of international taxation treaties, any withholding tax which would have been payable on unfranked dividends received can be offset against the foreign investors' domestic tax liability.
8. Our conclusion that franked dividends benefit domestic investors without disadvantaging foreign investors suggests that a value-maximising policy is to fully distribute franking credits.
10. The price immediately before the ex-dividend date.
11. The closing price on 30 June 1995, the day after the ex-dividend date.
12. This assumes that the arbitrager's expectation of the ex-dividend price does not differ materially from the market's expectation, since on the ex-dividend date the arbitrager ceases to be the price-setting investor.
14. Adjusted to reflect 4-into-1 share consolidation announced as part of the special dividend.
15. We believe this was because of a lack of liquidity in ERA shares. For example, on the day of announcement of the ERA special dividend, approximately 120,000 ERA A-class shares were traded, representing 0.16% of ERA's A-class issued capital and 1.3% of ERA's free float.
16. 76,875,000 issued A-class shares less 67,974,000 A-class shares held by North, multiplied by $1.92.
17. We note that a value of $20 million implies the market valued the franking credits received by North at 20% of their face value (67,974,000 x $1.55 x 20% = $20 million).
18. Franking credits can be used only to offset current-year tax liabilities. If the recipient of a franking credit is not paying tax then no benefit from the franking credit is realised, and the franking credit is effectively lost since it cannot be carried forward.