Management Development Institute

Adequacy of Dividend Policy

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It is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation.

The case/background note/article was compiled from published sources.

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Abstract
This case discusses the significance of an adequate dividend policy by Strong Motors Company and its impact on the market performance for shareholders' wealth maximization. It further explores the importance of bonus issue and buyback as methods of rewarding the shareholders and their effect on stock price of the company. This will help to find out the pattern of growth for shareholders' interest.

Keywords: dividend policy, shareholders, market performance, bonus issue, buyback

The CMD of Strong Motors Company was under constant pressure from all the corners to fix the issue of falling market price. The company had paid dividend after a gap of five years and that was not enough to keep shareholders happy and that got reflected in the market performance. The shareholders were demanding liberal dividends and incentives. The immediate challenge for the CMD was to adopt an adequate and suitable dividend policy for shareholders' satisfaction; else it might be too late.

STRONG MOTORS COMPANY

Strong Motors Company was established in 1994 as a private limited company in Mumbai, India. In 1997, they went public and became a publicly held company. It was now one of the leading global automotive players. In the last ten yeas, they had invested more than US$ 1 billion to expand their manufacturing facilities and dealership footprint to meet rapidly rising demand in growing auto market.

Strong Company now operated a modern, integrated manufacturing facility at Hyderabad, which produced its award-winning range of products in passenger segment. The company had positioned itself as a name to reckon with small cars and fuel efficient engines for both domestic and international market.

THE AUTOMOTIVE INDUSTRY

The automotive industry was getting global, with interlinked, specialized clusters. Global integration had advanced the entire value chain, from the design stage to the delivery, with firms leveraging engineering effort across products sold in multiple end markets. Lead firms were demanding their largest suppliers to have a global presence and system design capabilities.

The impact of the global financial crisis of 2008-09 on the automotive industry had been more severe than for any other industry except housing and finance, which prompted large-scale government intervention around the world. "The value chains led by the American Big 3 automakers were in particularly bad shape, with declining market share, global overcapacity, and rampant supplier bankruptcy. For companies already on life-support, the freezing of credit markets meant cancelled orders, unpaid supplier invoices, and "temporarily" shuttered plants. Huge debt loads, high fixed-capital costs, high labor costs, and immense pension and health care commitments to retirees added to the immediacy of the damage. Second, the high cost and growing longevity of motor vehicles prompted buyers to postpone purchases that they might otherwise have made. Vehicle sales plunged, and as a result, beginning in the fall of 2008, the industry fell into the most severe crisis experienced since the Great Depression.[1]"

The structure of the global auto industry post-crisis was still taking shape, as many firms yet had liquidity problems, and was on the verge of completing their complete their restructurings. "The industry's growth in the developing world was limited to a specific subset of countries. The market size dictated the potential for the industry's growth. Furthermore, the ascendance of Chinese companies and India's Tata into the top 20 could have far-reaching effects on the global automotive market.[2]"

COMPANY'S RECOVERY & DIVIDEND POLICY

Strong Co. was one of the most consistent dividend paying companies in the past of the profits until they stopped paying dividends in 2008 on account of global turmoil, which affected the company as well. After a gap of five years, they restarted paying dividends in 2014. They were aware that 'cash was the lifeblood of every business and efficient cash management was inevitable in a business unit.' This was all the more relevant in Strong Company which had seen a long phase of continuous losses. At this stage, they could not afford liberal cash outflows. They needed optimum cash reserves for a series of business processes from acquisition of raw materials and final delivery of goods and /or services. Thy had to make sure the efficient rotation of money in the various levels of operating cycles without creating adverse situations of cash surplus or deficit.

Their restructuring plan, made public in 2009, was known as 'The Road Now.' The company was attempting to cut its fixed capital costs while maintaining a special focus on cars in the country and globally. The idea was that over time, it would make more of its product line profitable instead of relying on a few products to make profits. Making good profits across the product line requires that the company reduced the costs of development and production, while introducing new products that could connect with consumers. The plan got revised in 2009 as "The Road Now" included resizing the company to match current market realities, dropping most of the unprofitable and inefficient models, consolidating production lines & shutting down three vehicle assembly plants &two parts factories.

Finally, the results started showing and the company returned to profitability in 2013-14. Therefore, they started paying dividends in 2014 with a payout of 20 percent (see Exhibit I).

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[1] http://feb.kuleuven.be/public/N07057/CV/vbs10WBbook.pdf,p. 213accessed on October 27, 2014.

[2] http://feb.kuleuven.be/public/N07057/CV/vbs10WBbook.pdf,p. 218accessed on October 27, 2014.

SHAREHOLDERS' DEMAND

Shareholders' were concerned about their well-being. The value delivered to shareholders was based on the management's ability to grow earnings, dividends and share price. In other words, shareholder value was the sum of all strategic decisions that affected the firm's ability to efficiently increase the amount of free cash flow over time.

Therefore, they had been pushing Strong Co. to return cash to investors in the form of an extra dividend or a stock buyback for a while now, especially after the leading financial institution in India sold the last of its stake in the company in February, 2014. Weak industry demand had driven the company to seek bankruptcy protection in 2009 and it was bailed out by this financial institution with cash infusion of INR 5 million.

The company said it would seek to save INR 2 million to pay off a note held by A&B Bank. Therefore, they could not afford to pay higher than the present payout. But, the Board was thinking on other forms of dividend (bonus) for stopping the shareholders' unrest.

DIVIDEND TREND OF INDIAN AUTO INDUSTRY

The entire auto industry in India showed inconsistency in the dividend payout policy. The dividend payout was dependent more on the financial situation of the company and its short-term sustainability issues. Besides Strong Co., there were players in the industry who would pay the dividend on the common stock in almost six years. This could be seen as marking another step in the global automaker's recovery since 2008.

The No. 1 Indian automaker, which last paid a dividend in June 2008 before it moved to save money during the recession, said it would pay shareholders a dividend of 20 percent. In 2008, its annual dividend was 17 percent. Every company was playing it safe.

FUTURE ORIENTATION

The company was hopeful that if they went conservatively on dividend payment, they would go from strength to strength and they would be able to offer a stable and liberal dividend payout and better performance to shareholders in future. They knew that shareholders favoured cash dividends, but they also liked to have growth in EPS that resulted from ploughing earning back into the business. The Board was also thinking on other forms of dividend (bonus, buyback, etc.) for stopping the shareholders' unrest.

Exhibit I

Dividend Payment of Strong Motors Co. (207-08 to-2013-14)

	2007-08	2008-09	2009-10	2011-12	2012-13	2013-14
PAT (Rs. in mn.)	(4,500)	(3,800)	(2,450)	(1,500)	(200)	2,800
EPS (Rs. per share)	-	-	-	-	-	1.50
DPS (Rs. per share)	-	-	-	-	-	0.30

Source: Annual Reports of Strong Co.

Exhibit II

Excerpts from the Balance Sheet of Strong Motors Company as at March 31, 2014

(In Rs. million)

Liabilities	Amount	Assets	Amount
Share capital (10 million shares of Rs. 10 each)	100	Fixed assets	250
Reserves	200	Current assets	100
Net worth	300		
Current liabilities	50		
	350		**350**