High Dividends Make Perfect Sense

Aussie shareholders love their dividends. Probably too much so, which can be dangerous in today's low yield environment. Investors can often be lulled by high-yielding stocks with dividends that aren't sustainable or are subject to enormous business risk. It can be an unpleasant discovery that shares in real companies don't function at all like a cash deposit, and an extra 2% yield is small recompense if shares fall 30%.

Banks are a notorious example of businesses where investors tend to inappropriately fixate on dividend yield. They should be looking at the balance sheet, and thinking about business issues such as credit growth, bad debts and required capital ratios. They should also be thinking about disruptive threats to the traditional banking model.

So I had a quiet chuckle the other day when I read in the newspaper that ANZ was prepaying tax in order to maintain enough franking credits to fully frank its dividend (an allegation the company subsequently denied). It seemed a bit ridiculous, given the company has recently raised $3bn of new capital from shareholders in order to strengthen its capital base, that it was going to such extraordinary lengths to maintain a $5bn per year dividend. Why give with one hand and take with the other? Why not simply reduce the dividend to fund the extra capital?

Having spent a bit of time thinking, however, the joke is on me. What ANZ is doing makes perfect sense for shareholders.

ANZ could have funded the extra capital by cutting the dividend by around $1.04 per share. If they had done so, shareholders would have missed out on $0.44 of attached franking credits. The impact of this on shareholders depends on their marginal tax rate. To a shareholder that pays no income tax, $0.44 in value has been lost, assuming the franking credits aren't later distributed, because they would have been fully rebated the franking credits. To a 15% tax payer, $0.22 in value is destroyed. For a 30% tax payer, there is no difference. And a 45% tax payer will actually benefit from the reduced dividend by avoiding $0.22 per share in additional income tax.

But the franked dividend has implications beyond this year's income tax return. If ANZ cut the dividend by $1.04, every ANZ share effectively carries $1.04 in extra value through retained earnings. Each share has $1.04 more cash than if the dividend wasn't cut. That $1.04 is *eventually* going to be taxable as capital gains, depending on when each shareholder trades their shares. Compared with the result had the dividends been paid out, corporate shareholders would theoretically pay an additional $0.31 in capital gains tax.

Here's the benefit to various ANZ shareholders from *not* cutting the dividend by $1.04 (assuming 50% discount applicable to individual capital gains tax):

	Income tax benefit	Eventual capital gains benefit
0% tax individual	+ $0.44	-
15% tax superannuation	+ $0.22	+ $0.104
30% tax corporate	nil	+ $0.31

45% tax individual	- $0.22	+ $0.234

The exact value of the extra capital gains tax is debatable, because it depends on when the shares are eventually sold, and how the withheld cash is used in the meantime, but it's sure worth something. And with that factored in, across various shareholder tax scenarios, it overwhelmingly makes sense for Australian companies to distribute as much as possible in franked dividends. If a company needs funding to grow, shareholders are much better off funding it by issuing new shares, rather than retaining earnings within each share. The simple way of thinking about this is that franking credits associated with retained earnings are usually lost forever.

The value maximising strategy is to pay out 100% of earnings as fully franked dividends and issue new shares to fund a business's growth.

Of course, that doesn't mean that investors should be fooled by high dividends. A company that is paying dividends while raising capital is not as valuable as one that is paying the same dividend *without* needing to raise capital. The dividend is still a furphy, just a very tax effective one.