



# SICASA E - NEWS LETTER



Tuticorin Branch of Southern India Regional Council of The Institute of Chartered Accountants of India  
(Set up by an Act of Parliament)

*December 2010*

## SICASA Chairman's Writes:



Dear Friends,

Greetings!

Exam spree has finally been settled after a long duration. Students, how so ever the preparation is, have settled down from the examination mood. Hope everything will go good. It has been said by our elders that our duty stops with the moment we made fullest preparation and presentation and rest rests with the almighty. So lets all hand over everything to Him. It has been observed amongst students that they have a tendency to keep themselves away from books after exams. I, as a SICASA Chairman of the Branch and more above as a well-wisher of students, personally want every student to keep reading and learning something on a regular basis since our syllabus alone is not the whole we want to learn. Outside it, there are plenty to be known. Hence keep learning some thing useful and let it be not only those relating to our field but in general too. Because we, as dignity professionals, must have our mind and views wide, open. Knowledge grows geometrically when we keep learning. Our Branch doors are always open for the students to keep them imparting with all knowledge within our capability. Library is the best place to confine one to grow in knowledge. I expect more students to keep flowing into Tuticorin Branch library so that we get more opportunities to enlarge the scope of books and resources available in the library. Students may also try out for some other courses like that of some computer aiding courses or even other professional courses. All these add value to our profession. To conclude I'm quoting this "Idle man's brain is the devil's workshop"

Vande Mataram!

With warm regards,

**CA.G.Manoj Rodrigo**  
**SICASA Chairman**

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## How Dividend Drives Market Price?

The value of any asset is the present value of the cash flows associated with the asset discounted for the time value of money. The future cash flows associated with equity are dividend and sale value. Since market price is itself based on an estimate of future dividends one can argue that the value of a share is only the present value of future dividends.

### Consider the following logic:

An investor with a one – year time horizon buys a share today ( $P_0$ ) in anticipation of dividend in the first year ( $D_1$ ) and a sale price at the first year ( $P_1$ ). The investor who buys at  $P_1$  buys in anticipation in the second year ( $D_2$ ) and a sale price at the end of the second year ( $P_2$ ).

If the two investors were to be considered as a team, then the purchase made in  $P_0$  is in anticipation of dividends in the first two year ( $D_1$  and  $D_2$ ) and market price at the end of the second year ( $P_2$ ). It has been replaced by  $D_2$  and  $P_2$ .

Thus each investor who buys from the previous investor buys in anticipation of both dividend and capital appreciation in the next year. Consequently each year's price is replaced by the next year's dividend and the next year's market price. If we consider all the successive investors as a group of investors and if we assume that the life of the company is very large (say 100 years) the market price today become a function of the dividends of each of the next 100 years and the market price of the 100th years.

Since the present value of the 100th year's market price will be negligible (PV of years at say 12% is 0.00000!) we can logically conclude that the market price of a share is the present value of future dividends!

## The payout conundrum

Would the fact that the market price of a share is the present value of future dividends mean that we must distribute all our earnings as dividends? Surprisingly, the answer is "Not necessarily so." Here's why.

The investor's return consists of two components, dividends and capital gains. Dividend policy affects both these components. An early lower dividend can actually translate into a higher later dividend since the retained earnings too earn returns leading to a growth in earnings. The story of ABC and XYZ tell you how.

Years	ABC growth =17.5%				XYZ growth =7.5%			
	Net Worth	Earnings	Dividend (30%)	RE (70%)	Net Worth	Earnings	Dividend (70%)	RE (30%)
1 <sup>st</sup> year	1000	250	75	175	1000	250	175	75
2 <sup>nd</sup> year	1175	294	88	206	1075	269	188	81
3 <sup>rd</sup> year	1381	345	104	241	1156	289	202	87
4 <sup>th</sup> year	1622	406	122	284	1243	311	218	93
5 <sup>th</sup> year	1906	477	143	334	1336	334	234	100
6 <sup>th</sup> year	2240	560	168	392	1436	359	251	108
7 <sup>th</sup> year	2632	658	197	461	1544	386	270	116

8 <sup>th</sup> year	3093	773	232	541	1660	415	291	124
9 <sup>th</sup> year	3634	909	273	636	1784	446	312	134
10 <sup>th</sup> year	4270	1068	320	748	1918	480	336	144
11 <sup>th</sup> year	5018	1255	377*	878	2062	516	361*	155

\* Dividend of ABC overtakes XYZ in the 11<sup>th</sup> year.

As the above table shows, XYZ pays out more dividends initially, but some time in the 11<sup>th</sup> year ABC's dividend payment outstrips that of XYZ's. This happens because ABC retain more than XYZ and consequently the growth in its earnings, dividends and networth is faster than that of XYZ. The growth rate as we know is given by the formula  $g = b \times r$ . The rate for the first company is  $0.70 \times 0.25$  viz 17.5% and that for the second company is  $0.30 \times 0.25$  ie 7.5%.

By

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**CA Final Student**

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**If God answers your prayers, he's increasing your faith.  
If he delays he's increasing your prayer. If he doesn't answer  
he knows you can handle it perfectly.**