BLOG

Family Business Director

Corporate Finance & Planning Insights for Multi-Generational Family Businesses

Five Things to Keep in Mind When Evaluating the Dividend Policy of Your Family Business

Dividend Misunderstandings?

June 29, 2020 **Dividend Policy**

In a recent *Wall Street Journal* article, Professor Alex Edmans of the London Business School offers an impassioned plea for public companies to stop prioritizing dividend payments. In “Why Many People Misunderstand Dividends, and the Damage This Does,” Dr. Edmans contends that investor aversion to dividend cuts causes public companies to make irrational investment and expense management decisions. Furthermore, Dr. Edmans postulates that over-reliance on dividends encourages an unhealthy degree of investor passivity.

> Is dropping the regular dividend a viable option for closely held family businesses?

Rather than paying a stout, maintain-at-all-costs regular dividend, the author suggests that companies rely on share buybacks and non-recurring “special” dividends to provide returns to shareholders. Perhaps this is the proper prescription for public companies – after all, shareholders can readily “replace” the lost dividend income by simply selling a portion of their holdings. Doing so is really no different than receiving a dividend, which reduces the value of the shares owned. But is dropping the regular dividend a viable option for closely held family businesses?

Unlike public company investors, family shareholders do not have access to ready liquidity for their shares. This can have profound implications for dividend policy. Family shareholders cannot easily create their own “synthetic” dividend by simply selling a portion of their holdings. Opportunities to sell shares in the family business may come only sporadically and may be on disadvantageous terms. For example, family shareholder liquidity programs – when they exist – often allow for transactions just once per year, have hard caps on the total repurchase budget, may occur at a discounted price, or may provide consideration in the form of a multi-year note. In short, despite being an important part of the shareholder engagement toolbox, family shareholder liquidity programs are no substitute for the freely traded shares of a public company.

Five Things to Keep in Mind

So how should family businesses think about dividend policy? Here's a non-exhaustive list of five things to keep in mind while evaluating your family business's dividend policy.

1. Dividends Are Not a Substitute for Freely Traded Shares, But They Do Help

A predictable dividend stream does not provide the near-instantaneous liquidity that public shareholders enjoy, but it does provide access to liquidity over time. Since family shareholders cannot easily sell small portions of their holdings to fund major life purchases, they instead rely on dividend income to supplement other sources of cash flow as personal needs arise.

2. Dividends Help Reduce the Risk Faced by Family Shareholders

A long-time client of ours endured a significant business crisis several years ago. In order to survive, the company had to raise capital from outside investors, which diluted the ownership position of the family. In short, the wealth of the family – as represented by the value of the family business – fell materially. However, prior to the crisis, the family business had a long history of paying regular and substantial dividends to shareholders, which provided many of them the opportunity to diversify their overall personal balance sheets. As a result, the sharp drop in the value of the family business's shares, while certainly unpleasant, was not as devastating as it would have been in the absence of the outside wealth accumulation permitted by the prior dividend payments.

3. Dividends Provide a Signal Regarding the Health of the Business That All Shareholders Can Understand

Positive shareholder engagement is critical to the sustainability of any family business. We are firm believers in the benefits of clearly **communicating financial results to family shareholders**. Yet, the surest way to communicate with shareholders is through the dividend. Financial reports and management letters may or may not get read, but dividend checks always get cashed.

A regular dividend that fluctuates in response to the performance of the business may be the most effective communication tool available.

Public companies allocate about twice as much to share buybacks as dividend payments each year. They do so, in part, to uncouple the dividend from the inevitable year-to-year fluctuations in business performance; during boom years they simply repurchase more shares, and during lean years, they cut the repurchase budget.

For many family businesses, share redemptions cannot provide a comparable release valve on shareholder distributions. As a result, family business directors should consider "training" their shareholders to anticipate year-to-year fluctuations in dividend payments that track the underlying health of the family business.

4. Dividends Can Help Managers Be More Selective in Making Capital Investments

The natural tendency of corporate managers toward "kingdom building" is well-documented. We suspect that family business managers are not immune to this urge. Forcing corporate investments to compete with dividend payments for scarce capital can be a very helpful antidote to the tendency of corporate managers to over-invest. In fact, **some researchers have concluded** that the investment discipline associated with paying dividends actually contributes to better returns on capital and higher earnings growth.

5. Dividends Help Bring the Trade-Off Between Future Growth and Current Income Out Into the Open

When asked if they want to maximize cash flow for current shareholders or growth for future generations, many shareholders respond with an emphatic "Both!" But in the economic world that we live in, that's not really a feasible posture.

Dividends are the most tangible manifestation of **what the family business really means to the family**. Identifying and – if needed – adapting the meaning the family business to the family is one of the most important tasks for senior leaders of the family.

Conclusion

Professor Edmans makes some provocative suggestions in his *Wall Street Journal* article. While they may have some merit for public companies (which were, in all fairness, the professor's intended audience), his suggestions do not translate well to most family businesses.

Give one of our family business professionals a call to discuss the challenges you face in setting a dividend policy for your family business.

AUTHOR

Travis W. Harms, CFA, CPA/ABV

Senior Vice President

(901) 322-9760

Email **View Bio**