Newsletter

Knowledge is power

With investing, knowledge is power. When a listed company has something to say, you should listen - this means keeping up with company announcements and making sure you understand what your options are.

Announcements are posted on ASX as soon as they are released – see company announcements.

There is a wide variety of announcements and in this newsletter we will just take a look at a few of them.

Prior to an announcement being made, a company may go into a trading halt. This will happen if the announcement contains market sensitive information that may affect the price of a security. A company can also request a trading halt, this can last up to 2 trading days. If the company requires more time, the stock is then put into suspension, until the company is ready to report to the market.

If you would like to have more insight into what companies are required to do when it comes to announcements, watch the following video: Continuous disclosure: what do listed companies have to tell the market and when?

Corporate actions are a feature of company announcements. A corporate action is an event initiated by a listed company that will affect trading in the stock Understanding corporate actions can give you a clearer picture of what is happening with a company financially and it may help you with your buy, sell or hold decisions. Below we will cover just a few corporate actions that you may have already come across in the Game.

A takeover can affect the value of your shares whether it is the company making the takeover offer (known as the bidder) or it is the target.

A takeover is when the bidder puts forward a proposal to acquire all the shares in another company. A takeover offer would be expected to immediately put upward pressure on the share price of the target. This is because the offer price will include a takeover premium, in order to encourage shareholders of the target company to accept the offer. The bidder is prepared to pay a higher price (the premium) in order to get total control of a company. A good example of this in the Game is PRG – Programmed Maintenance Services – where Peresol Holdings is wanting to acquire 100% of PRG. You will notice that the price of PRG shares have jumped to the premium price that Peresol is willing to pay.

In the case of the company making the takeover offer, if it is listed, the share price may go down or up depending on whether the market thinks the purchase will be of overall benefit and whether the price they are going to pay is good value.

A rights issue / capital raising offer is when a company offers eligible shareholders the chance (or the rights) to buy additional shares at a discounted price for a specified period of time. Companies do this for purposes including, to pay down debt, provide working capital or to apply to a new project or acquisition.

In this Game, a company that has had a capital raising offer is SYR - Syrah Resources, they did this in order to be able to fund some of the projects they have in progress. In the Game, you cannot participate in a rights issue, however the question that needs to be asked is: should you take up a rights issue if you are given this option when investing in the real market?

There are 3 things you can do:

- take part in the rights issue
- do nothing
- or in some cases (if the rights are transferrable) you can sell the rights.

Your first reaction might be just to do nothing because you don't really understand the process; however, you need be aware that the value of your shareholding may be diluted due to the extra shares issued. It is also wise to look at the company's reason for wanting to raise additional finance.

For more see: Understanding Rights Issues by Ben McClure

A delisting is when a company is removed from the ASX as a listed company and its shares are no longer traded. So what happens if you hold shares in a company that is delisted? It really depends on why the company is delisting as to what happens with the shares.

If a company is being delisted because it has done poorly and is going out of business you would expect the shares to be trading at close to zero before delisting, in this case it may not be possible to sell the shares as it might be difficult to find someone prepared to buy them.

Other companies might be delisted because the owners (either new or existing) no longer want the company to be listed on the Exchange. There are a number of reasons why this decision might be made. If a company is being delisted and you own shares, it would be wise to investigate why this is happening and decide if you wish to keep holding them or not.

This is another reason why it is important to keep up to date with company announcements.

Dividends - Companies use the money they make as profits to pay dividends as a way to reward shareholders. By paying dividends the company makes itself more attractive to investors. If you feel you still don't understand how dividends work, you can learn more here.

To be entitled to a dividend a shareholder must have purchased the shares before the ex-dividend date. In the real world a dividend will be paid into a shareholder's nominated bank account on the payment date, sometime after the ex-date. In the Game, a dividend gets paid on the ex-date into your Game account as cash.

Something to be aware of, is a lot of shares fall in price by the dividend amount the day they go ex-dividend. Sometimes companies don't fall in price after they go "ex" and this is referred to as "holding their dividend". It is a good outcome for you if you own the shares, you get the dividend and the shares don't drop by the dividend amount. For more on dividends, see the Simply Wall St article below.

We have only touched briefly on the subject of corporate actions and if you are looking to invest in the live market, we encourage you to do more learning on this subject.

Additional Reading

- Share course number 7 - Record keeping
- Read what are corporate actions - Investopedia
- What are corporate actions - Commsec

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A deep-dive into dividends

Now that you have an overview of corporate actions, let's take a further look into dividends.

When it comes to investing, your return from a stock can either come from capital gains or dividends. Capital gains are a result of changes in the share price while dividends are distributed to shareholders by a firm's management (generally twice a year).

Given the uncertainty around a stock's share price, some of you might think that it would be a prudent investment strategy to simply invest in stocks that pay out a large dividend regularly and call it a day; however, before you proceed – there are a few things you should probably understand.

In this article, we'll explain where dividends come from and why companies pay out dividends at all.

<u>Where do dividends come from?</u>

In very simply terms, when businesses conduct business, they make a profit and in rarer cases a loss. As a shareholder and part-owner of the business, you are entitled to the after-tax profit that the business has generated but ultimately, the firm's management get to decide if (1) they retain the profits within the business to invest in new projects or (2) they return those profits to investors in the form of cash as a **dividend**.

The proportion that companies pay out in dividends is known as the dividend payout ratio and is calculated using the formula below.

Payout ratio = Dividend per share / Earnings per share

<u>Why do companies pay out a dividend?</u>

At this stage, you may be asking yourself, why don't all companies just keep all their profits, reinvest it in new projects and in turn grow the company even more? Good question! Let me try and explain how companies make this crucial decision in simple terms.

First, we need to understand why people invest at all. When a company raises money by raising equity from shareholders, shareholders naturally and logically expect a healthy return on their money. Why else would we invest? The rate of return that investors demand is called the **cost of equity**. Generally speaking, the riskier a company is, the higher the return investors will demand. The way we calculate the cost of equity to shareholders is through a Nobel prize-winning model called the CAPM, which follows the aforementioned logic.

After raising all that equity capital from investors, companies in turn invest that money in their businesses to hopefully generate a positive return. This is referred to as their return on equity. Ultimately, management's aim is to maximise shareholder value by ensuring the company's **return on equity** always exceeds shareholders' cost of equity.

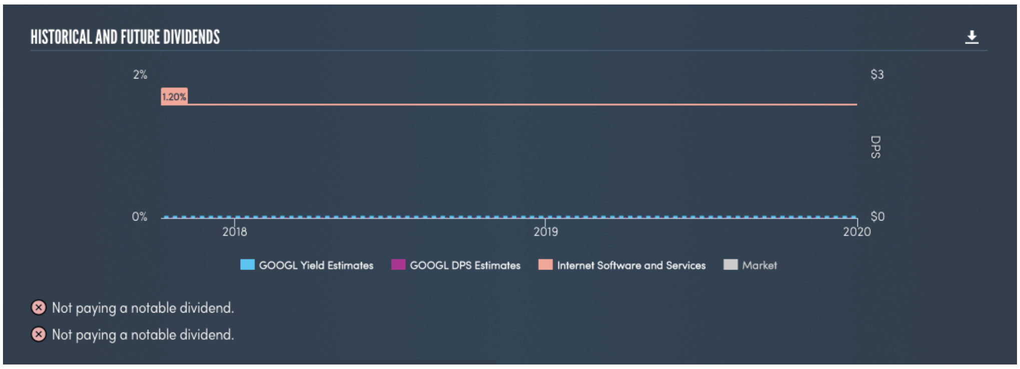
So how does this relate to dividends? As we explained earlier, managers have to make a decision to either keep profits for further investment or pay profits out to investors in the form of dividends. If management believe that there is a fantastic project that will generate a return on equity far greater than the shareholders' cost of equity, they will generally choose to retain those profits to generate a return on equity far greater than the shareholders' cost of equity, they will generally choose to retain those profits to invest. Alternatively, if there are no projects that management believe they can invest in that will generate a return on equity greater than shareholders' cost of equity, then it would make no sense to retain those profits. In that case, investors would expect the firm to have the profits released to them in the form of dividends.

<u>But wait, there's more…</u>

Based off our simplistic explanation, one could almost imply that high dividend paying companies are almost admitting to shareholders that they no longer have any projects to invest in that will generate an acceptable return for shareholders. Additionally, it should probably make sense to you if I told you that most fast-growing young companies tend not to pay out a dividend since they have plenty of growth opportunities to invest in.

Before you assume that this is the hard and fast rule to determining if a company has future growth potential or not, you must realise that managers are fully aware of this dynamic and therefore may shape their dividend policy to fit their company's narrative, which is bad for investors.

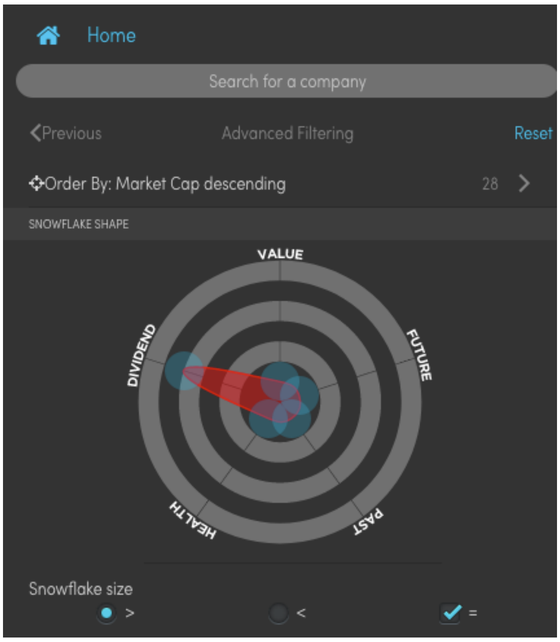
For example, Alphabet, the parent company to Google, has never issued a dividend and does not intend to in the near future. While many investors would accept that Alphabet continues to innovate in various exciting fields, other more cynical investors might accuse Alphabet of retaining profits to maintain a fast-growing image to markets even though their projects are not as fantastic as they appear to be.



It is also important to note that in practice, firms may decide to retain or pay out profits for reasons outside of those that we have discussed. One example is banks. Since banks have very complicated and opaque balance sheets that are often difficult to value and analyse, many investors and stakeholders have historically relied on the frequency and amount of dividend payments as a proxy for financial strength. As such, banks that pay and increase their dividends year on year are perceived as highly solvent and robust.

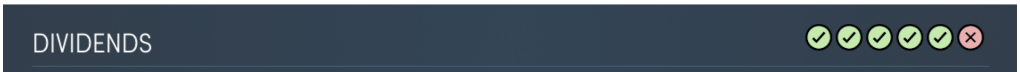
<u>An example</u>

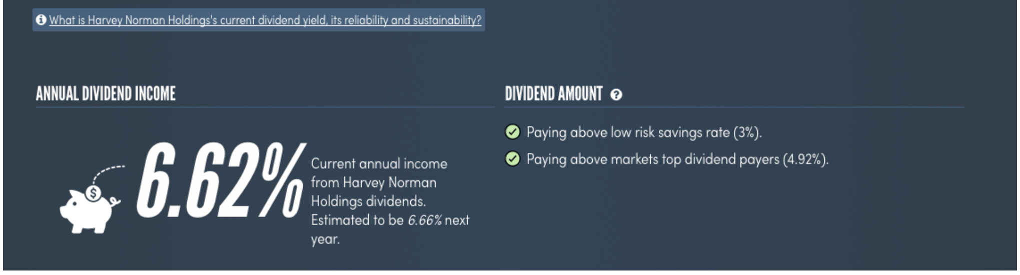
With this in mind, let's take a look at a stock to see all this theory in action. If we open our Simply Wall St account up, and click "New Filtered View" on the panel on the left-hand side, we can subsequently filter for stocks that are paying out large dividends. To do this, drag the dividend part of the snowflake to the position shown below.



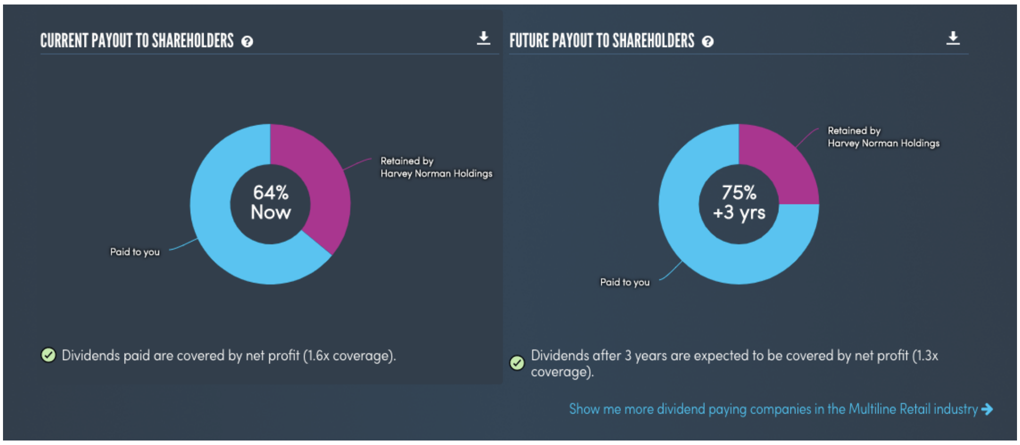
By scrolling through, we can see that Harvey Norman is one of many stocks that are paying out a significant dividend to shareholders; however, before we jump to any conclusions about the stock, let's take a closer look.

We can see that Harvey Norman's dividend yield is 6.62%, which is significantly above the low risk savings rate of 3%.

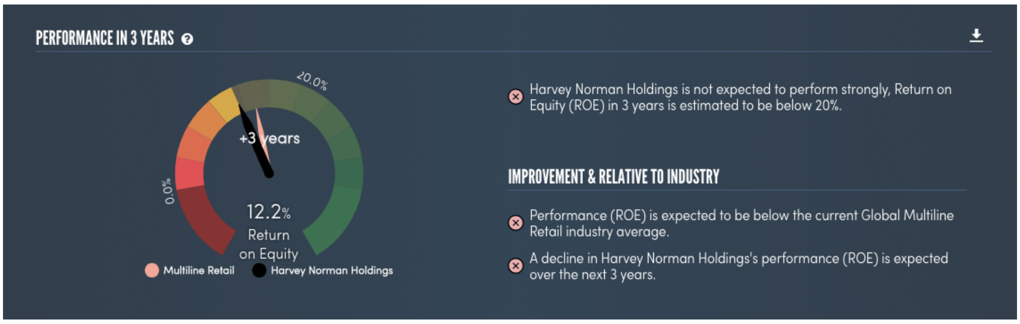




Additionally, we can also see the reason it has such a high dividend yield is because it is currently paying out 64% of all profits to investors in dividends. This number is expected to increase to 75% in the future.



So is management doing the right thing by giving over 60% of profits back to investors? Should they instead reinvest these profits internally to fund growth projects? We can see that the market expects Harvey Norman to generate a return on equity of 12.2% in three years, which is below the average for Multiline Retail peers. As such, on a superficial level, it makes some sense that profits should be returned to investors in the form of a dividend.



Ultimately, management are doing shareholders a service by returning profits to them since shareholders can take that money and invest it in other higher returning assets. Harvey Norman's dividend policy; however, does shed some light on the firm's maturity and slowing growth profile. Nonetheless, this does not make Harvey Norman a bad investment given its 6.62% dividend yield is significantly higher than any bank savings rate you will find in Australia. Just don't expect the share price to move like an upstart tech stock unless you have a unique investment thesis and catalyst that markets are unaware of.

<u>Final words</u>

Now that you are more aware of what dividends are and how firms decide on paying out a dividend, hopefully you can make more informed investing decisions. While dividends are an important consideration, remember that they are not the only factor you should be thinking about.

If you want to read more about Harvey Norman, check out the company here.

Game update