

Corporate Finance: Dividend Policy

Lancaster Colony, a diversified manufacturer and marketer, has increased its dividend payment to stockholders each year for the past 38 years. This impressive track record provides stockholders with a steady and predictable stream of income on which they can rely.

Since sales and earnings have reached new highs for 10 consecutive years, and because Lancaster sees several investment opportunities in their Specialty Foods division, they are considering cutting their dividend next year and using the funds to invest more heavily in the lucrative Specialty Foods Group. The Board of Directors feel the rate of return Lancaster could earn by investing the funds internally is greater than the rate of return their stockholders could get if they invested the dividend payments in an equally risky venture outside the firm.

To the Board, it seemed silly to pay out a dividend when they had a good use for the money internally. Still they recognized that cutting the dividend would stop their impressive 38 year streak and more importantly surprise investors in a negative way.

Table 1 shows the earnings per share (EPS), dividends per share (DPS), and corresponding dividend payout ratio for Lancaster over the past eight years.

Table 1

Year	DPS	EPS	Dividend Payout Ratio
1994	\$0.29	\$1.32	22.3%
1995	\$0.37	\$1.57	23.4%
1996	\$0.44	\$1.71	25.7%
1997	\$0.48	\$2.01	23.8%
1998	\$0.54	\$2.22	24.3%
1999	\$0.59	\$2.28	25.9%
2000	\$0.63	\$2.51	25.1%
2001	\$0.67	\$2.37	28.3%

Questions

1. Define the Residual Theory of Dividends. Does Lancaster appear to be employing this dividend policy alternative?

2. Define the Constant Payout Ratio policy. Does Lancaster appear to be employing this dividend policy alternative?
3. Define the Fixed-Dollar or "Regular" dividend policy. Does Lancaster appear to be employing this dividend policy alternative?
4. Define the Low-Regular-and-Extra Dividend policy. Does Lancaster appear to be employing this dividend policy alternative?
5. How would stockholders likely react if Lancaster decided to cut their dividend next year? (i.e. What would happen to the stock price and what would happen to investor composition?)
6. What could Lancaster's Board of Directors do to mitigate the reaction of its stockholders?