MODULE TITLE: Corporate Finance

PROGRAMME: MBA for executives

MODULE PERIOD:

SUBMISSION METHOD/MODE:
Online via turnitin,

ASSESSMENT TYPE: Typed written assignment

Executive Summary

This report analyzes the dividend payment policy of Telecity Group in comparison to its competitors. The four main theories of dividend payment had been analyzed in detail with giving reference to the empirical studies and support. The Telecity Group is listed in the London Stock Exchange and the main competitors are listed in the NASDAQ. Payment of dividends could be seen relevant or irrelevant. But the shareholders prefer dividends and companies seek to invest the earnings for future growth. Hence there is a contradiction and companies need to balance the interests of both parties. And also a greater concern has to be there because dividends are a source of information about the company to the existing and potential investors. Hence the choice of the dividend policy would be decisive of the shareholder value that could be created.

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Part 1 (a) - The activities of the company and its position in the industry

Introduction

Telecity Communications is a company that is listed in the telecommunications sector of the London Stock Exchange with recording a market capitalization of 2.2 billion as at October 2015. The company was inaugurated in 1998 and it is currently headquartered in London, United Kingdom. The company is into the operating of data centers that offer inter location services and other associated services for countries in the Euro area such as France, Germany, Italy, Bulgaria and non-Euro countries such as United Kingdom. Mainly the company provides hosting facilities and service infrastructure for business information systems, companies that provide cloud computing service, Designing IT infrastructure, providing consultation, network services both internal and external etc. Further the company has excelled in the intrusion detection systems and managing firewalls. The provision of data backup and recovery, maintenance of databases are special services performed by Telicity Communications services. (Telecity Group, 2015)

The business model has been very unique and value adding because of the resulting high quality of the service based on high standards and informational infrastructure. The systems and services are designed in a very user friendly manner and the customers are supplemented with locating their IT infrastructure in resilient conditions which is facilitated with data centers of Telecity Communications PLC. (Telecity Group, 2015) The data centers facilitate direct connections to a wide range of local and international network providers and internet exchanges. Since these are located in central locations in main cities, the communications are carried out with constant integration and an integrated fashion.

The currently progressing mergers and acquisitions in the data center service providers have created opportunities as well as threats to Telecity Communications. For example, the acquisition of the main data center of Bulgaria by 3DC has provided a high quality strategic position in Balkans. This has created Bulgaria to be a site with data traffic that is rapidly developing.

Performance of the company

The unified business model of Telecity Group has reported high profits sector wise and its major business is in London, UK. The company was able to reach many customers after the inauguration of the Joule House in Manchester and the expansion capacity at Power gate and Harbor Exchange in London during 2012. Therefore the sales income also began to show improved positive trends. According to Eric Hageman the Chief Financial Officer, the Telecity Group has reported a very valuable set of indicators for capital investment efficiency and returns. Not only within UK, had the company's performance been fascinating. It is holding strong positions in places such as Frankfurt, Milan, Istanbul, Amsterdam etc.

Future growth Telecity Group had been underpinned by the customer demand as well as good corporate leadership. The increasing Earnings per Share has been an indicator of this fact.
The challenging market conditions in Frankfurt had been occurred as a result of the increase in the electricity prices and thereby had an impact on the customer demand and short term churn rate. This had been overcome by the strong market opportunities and company's performance in the Paris market. (Telecity Group, 2015)

When considering the expansion projects, the group has established new positions in markets such as Sofi, Warsaw, and Istanbul. Telecity Group became shortlisted in the ICAEW Sustainable Business Award at the National Business
Awards 2014 in recognition of the Group's organization-wide energy efficiency strategy. The award had been offered for organizations that follow sustainability business practices and has structured them into their governance structure. Further, the award is offered for the gains obtained through high financial performance, competitive ability, staff involvement, future growth prospects etc. (Telecity Group, 2015)

Competitive position

The competitors of Telecity Communications are the Demandware Commerce and Interxion which are also into the same business such as providing cloud computing networks, information infrastructure and maintaining data centers. Telicity Group holds a competitive position with considering the market capitalization of 2.2 billion and Demandware having 2.0 billion and Interxion having 1.9 billion.
The total assets of Interxion had been 1,173.1 Euros and that of Demandware had been 345.2 US Dollars with compared to 934.7 GBP in Telecity. Therefore based on the total asset base, the highest position is held by the Telecity and thus the market share measured by total assets is higher for Telecity. (Telecity Group, 2015)

Demandware and InterXion had been identified as the main competitors of Telecity Group who are in the same sector.

Demandware Commerce provides on demand IT solutions to its customers where its business is carried out digitally over the internet with using a standard web browser. The Demandware Commerce Cloud provides the consumers with customized experiences that focus on the information collected from many digital sources. The Demandware Commerce cloud is the foundation of the company's business solutions and integrates with customers. The intelligence centers are where the company's predictive capabilities are included and focus on online and offline customers and product data to customize products, services, marketing activities etc. By the end of 2014, the number of revenue generating sites on its platform was 1143.

Interxion is the other competitive partner of Telecity which has approximately 1500 customers connected via 39 data centers. The company was incorporated in 1998 according to Netherland law.

The Telecity Company has experiences a contraction in the bottom line to 59.7 million GBP over the year 2014 despite the revenue increase in the same year. The major reason could have been the rise in the selling, general and administration expenses increase by 11%. Demandware has experienced an increase in the losses to 27.1 million USD over 2014 although its revenues grew by 106.6 million USD. On the other hand, the revenues of InterXion Holdings has increased from €340.6M Euros. And also the costs on seling, general and administrative costs had been slightly reduced to 36.14% of sales. (Telecity Group, 2015)

Telecity Company's management has decided to go for a leveraged situation that is according to the industry standards. Although the liquid assets are not sufficient to cover the short term obligations, operating profits seem to be enough to cover them. But the 26.44 days sales are always outstanding showing that the company is inefficient in collecting its dues. Demandware, Inc. is currently having a high financial risk because of its capital structure hence it does not rely on leveraging. Collection of receivables is at a good position because its day's receivables outstanding is 0.53 with an uncollected base of receivables at the end of 2014 worth 42.4 USD. When considering the case of InterXion, the significance of debt in the capital structure has increased in 2014 to 56.29% but still it is within the industry norms.

Company is effective in cash collection and at the end of 2014, the amount of receivables uncollected was 104.3 Euros with having a day's sales outstanding ration of 98.57.

Part 1 (b) - The dividend per share and the earnings per share

Dividend per share

This means the amount of dividends received by the ordinary shareholders. It is calculated as total dividends divided by the number of ordinary shares.
In Telecity, an interim dividend of 4.5p per ordinary share was paid in September 2014 but is proposing a final dividend of 9.0p per ordinary share.

Telecity Dividend history overview

Year ending:	31/12/2010	31/12/2011	31/12/2012	31/12/2013	31/12/2014	31/12/2015
Dividend payments						
Final:	-	-	5.00p	7.00p	9.00p	-
Interim:	-	-	2.50p	3.50p	4.50p	5.00p
Total dividend for year:	-	-	**7.50p**	**10.50p**	**13.50p**	-
Dividend metrics						
Dividend growth:	n/a	n/a	n/a	40.00%	28.57%	n/a
Dividend yield:	n/a	n/a	1.00%	1.40%	1.70%	n/a
Dividend cover:	n/a	n/a	4.23	3.5	2.91	n/a

Table 1 - Dividend per share

Intra industry analysis

Dividend per Share	31-Dec-10	31-Dec-11	31-Dec-12	31-Dec-13	31-Dec-14
Telecity	0	0	7.5	10.5	13.5
Demandware	0	0	0	0	0
Interxion	0	0	0	0	0

Table 2 - Intra industry analysis

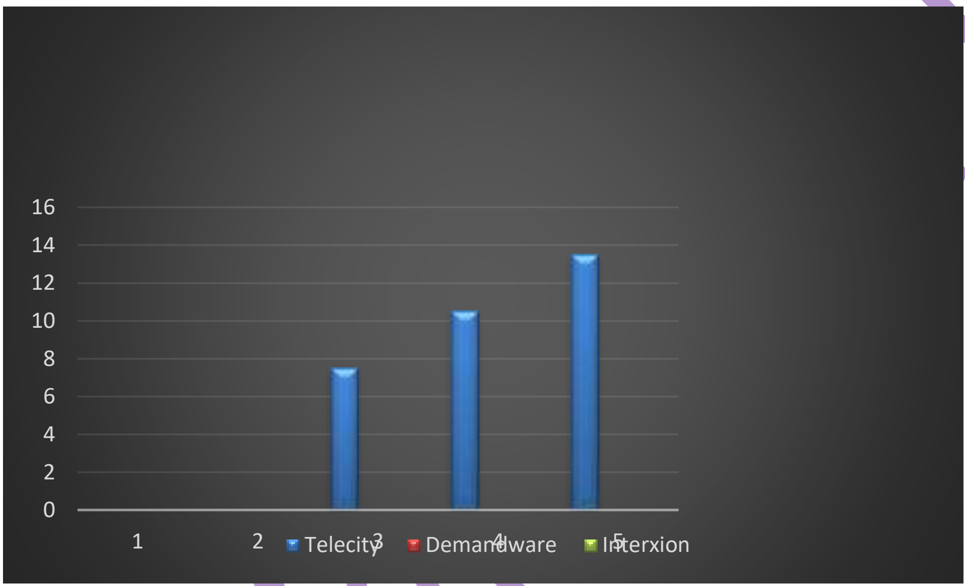

Figure 1 - Intra industry analysis

Earnings per Share

This is the amount of profits attributable to each ordinary shareholder. EPS is calculated as the total earnings divided by the number of shares. (Telecity Group, 2015)

Earnings per Share: Diluted					
	31/12/2010	**31/12/2011**	**31/12/2012**	**31/12/2013**	**31/12/2014**
Telecity	19	21.1	28.5	32.1	29.4
Demandware	n/a	-0.24	-0.39	-0.58	-0.77
InterXion	n/a	0.41	0.46	0.1	0.5
SolarWinds Inc	n/a	0.85	1.07	1.2	1.16

Table 3 - Earnings per Share

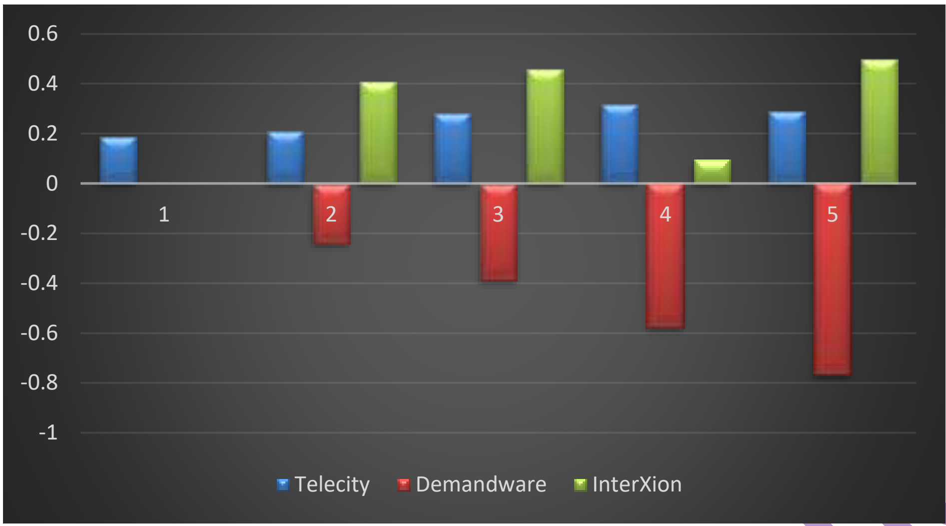

Figure 2 - Earnings per Share

Telecity has recorded increasing EPS over the years and in the most recent year, the EPS has declined due to the reduction in the earnings. The EPS of Demandware is negative owing to the negative earnings that it has been earning over the years. When considering the EPS of InterXion, it has been stable up to 2013 and then has experienced a sudden drop due to market shocks and then again stabilized into the normal range as before.

Part 1 (c) - The share price of the company

Price per Share

All prices had been stated in USD and this shows high variations in the share price of Telecity and Demandware and very less variations in that of InterXion.

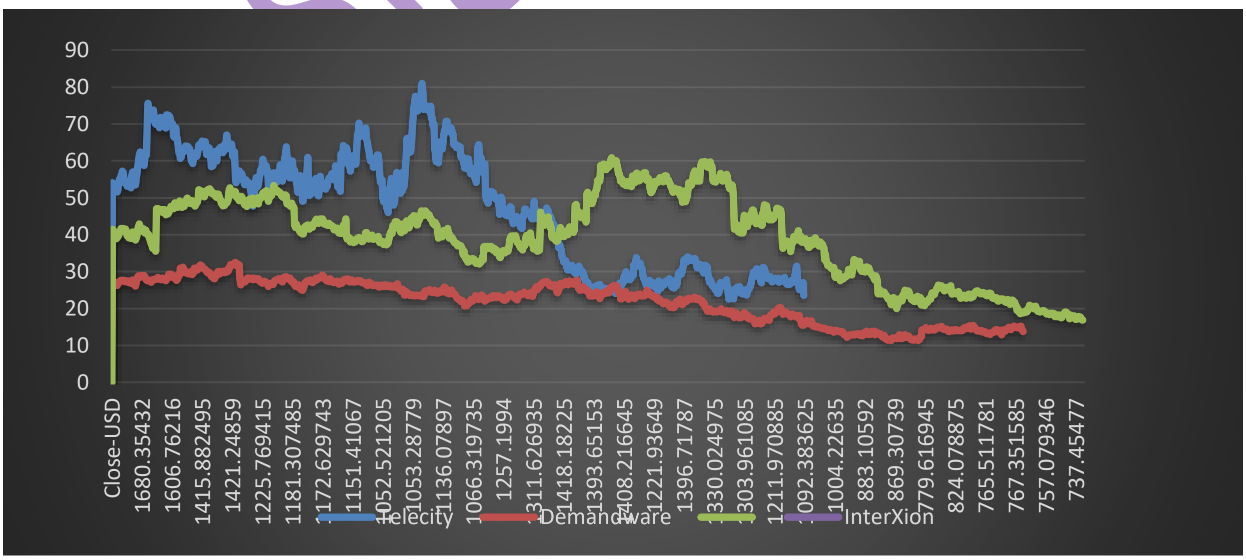

Figure 3 - Price per Share

Part 2 - Main theories of dividend payments

Theories of dividend payment

Dividends are paid to the shareholders as the return on their funds invested in the company. Some companies pay low or no dividends while some other companies pay very high dividends. Many factors could become the reasons behind this discrepancy. The stage of the life cycle is one important determinant of the amount of dividends paid. A company that is in the introductory stage would not pay any dividends because their cash flows are anyway negative. A company in the growth stage would pay a very low or no dividend because much of the returns are re invested in the growth opportunities. Only a company that is surpassing the maturity would pay a higher dividend to the shareholders. (Aswath, Damodaran, 2011)

The main theories of dividends could be re visited as follows.

Dividend Irrelevance Theory

Modigliani and Miller have come to the conclusion in their studies that given a market with no taxes or bankruptcy costs, the payment of dividends is irrelevant. They argue that the payment of dividends has no value adding effect upon the capital structure of the company or the share price of the company and hence they came up with the theory called "Dividend Irrelevance Theory". (Amaro, Matos, 2001)

They further argue that the investors in a tax free market could only affect the total returns on a stock and not the dividends. This could be explained with an example. If the company pays a very high dividend, then the shareholders would be able to buy many more shares of the same company. That is defined as buying over expectations. If the dividend paid by the company is too low, this would deteriorate the investors' cash flow and investors would be inclined to sell their shares. The empirical research by Black and Scholes on this area showed that the expected return on high or low stocks is the same and thus dividends are irrelevant.

The dividend irrelevance argument of Modigliani and Miller was based on the assumption that the investors are always rational in their decisions and the existence of a perfect capital market. In arguing that dividends are irrelevant, they assumed that there are no differences between taxes on dividends and capital gains tax. Further they assumed there are no transaction costs or floatation costs in the trading of securities. Since there is a perfect capital market, the participants have free and quick access to every information. There are no

conflicts of interest between managers and the investors in shares and other securities. Modigliani and Miller further argued that the participants in the market have to accept the prices determined by the market forces and hence are price takers.
That means the adoption of homemade dividend policy by individual investors rather than being influenced by the company dividend policy makes the company policy on dividend payment to be irrelevant.

Bird in the hand Theory

This theory states that dividends are relevant for the investors as well as to the company. Myron Gordon and John Lintner have explained this theory with incorporating equation models. They have argued based on the fundamental that total return is equal to the capital gain plus the dividend and the total return would necessarily increase if the dividends are paid by the company. But this again imply to the existing and potential investors that the company would be in short of funds for future capital investments since it pays out much now and therefore the future growth would be low and thereby result in decreasing the future capital gains. (Amaro, Matos, 2001)

The scholars argue that as same as a bird in the hand worth two in the bush, payment of dividends is important than thinking about future capital gains.
There are reasons why investors would prefer dividends to be received in the near future than in the distant future. (Aswath, Damodaran, 2011)

- The discounted value of dividends received in the near future is higher than the dividends received in the long term.
- A company with a higher payout ratio would generally sell at a higher price.
- Investors' desire for current income
- As a resolution of uncertainty. According to Myron Gordon, the forecasts of the dividends to be received in the future have high uncertainty than the forecasts of the near future.
- And also according to Friend and Puckett,1964, and Diamond, 1967, dividends are measured more precisely than earnings retained because the estimated retained earnings depend on the accounting procedure followed to measure total earnings.

In the past, the financial managers understood the importance of paying dividends that are high and stable. This was understood from a comparison done with bonds that pay regular and stable interest. This was shown by the incidence that Bank of North America paying dividends after only six months of operation and then there was discretion to pay dividends regularly.

"Paying consistent dividends remained of paramount importance to managers during the first half of the 19th century" (Frankfurter and Wood, 1997, p.24).

Bhattacharya (1979) has indicated that the reasons behind the Bird in the Hand theory are fallacious. And also they suggested that the level of risk faced by a company would affect the level of dividend and not the dividend has an impact upon the risk. Therefore he expressed that the riskiness associated with a firm's cash flows would influence the level of dividends that could be paid and the risk could not be reduced by increasing dividends. Therefore firms with lower expected cashflows wuld decide to pay lower dividends. Friend and Puckett, 1964 has further studied this and indicated in findings. The empirical research by Rozeff (1982) found the existence of an inverse relationship between dividends and risk of the firm. This was also proved in the papers of Jensen, Solberg, and Zorn, 1992. Therefore payment of dividends would not ensure risk reduction and hence dividend irrelevance theory is supported. (Aswath, Damodaran, 2011)

Tax Preference Theory

A tax free environment as suggested by Modigliani and Miller is not a real condition. Since capital gains are taxed at a lower rate than dividends, mostly the investors prefer capital gains rather than dividends. This rational has given rise to "Tax preference theory". And also capital gains taxes can be waived until the investment or the shares are actually sold and the gains realized. This cannot be applied for dividends and hence investors have less control over it.

Part 3 - Pattern of dividend payment and relative performance analysis

Companies could pay out the dividends in following ways.

1.) **Regular dividend policy:** The investors in this type of a dividend policy would be assured of a usual pattern of dividends. This becomes important when the investors are usually retired people or a minor section of the society who always seek for a continuous return on their investment. This type of a payment policy would be suitable for companies with regular income generation pattern.

The payment of regular dividends would create confidence among shareholders about the going concern and financial stability of the company thereby assuring the safety of their investment. This information helps to keep the share prices constant and hence effects to keep up the market capitalization of the company without fluctuating. It also indirectly affects the goodwill of the company while empowering shareholders.

2) Stable dividend policy: In this type of dividend payment, a certain sum of money is being paid to the shareholders on a regular basis. It could take one of the following types.

a) Constant dividend per share: Here in each and every year, a fixed dividend would be paid per each share. This is suitable for companies that have constant earnings and in case if the company has no enough earnings and it is adopting a constant dividend per share, the company would utilize its retained earnings to pay off dividends as promised.

b) Constant payout ratio: This means the company would declare a fixed percentage of its earnings as dividends in each year.

c) Stable rupee dividend + extra dividend: This means the company adopts a lower dividend to be paid in each of the years in a continuous manner and pay an extra dividend if the financial performance of the company becomes good which is at the discretion of the management. (Aswath, Damodaran, 2011)

A stable dividend policy has several merits where it stabilizes the share price in the market through increasing investor confidence. It then affects the company's goodwill and strengthens the shareholders with paying a regular income to them.

3) Irregular dividend: This is the situation where the company has no stable dividend policy and in each year, the board of directors chooses the amount of dividends to be paid for shareholders. This type of a dividend payment pattern could be seen in companies where the pattern of earnings generation is unstable and the inability to pay dividends due to the lack of cash and cash equivalents. Overall this shows the unsuccessful financial performance of the business.

4) No dividend: A company may choose not to pay dividends to its shareholders in the case that it thinks it should reinvest its earnings in the pursuit of future capital gains through capital investments and strengthening working capital condition.

<u>Logical Dividend Policy</u>

The term 'dividend policy' could be defined as "the practice that management follows in making dividend payout decisions or, in other words, the size and pattern of cash distributions over time to shareholders" (Lease et al., 2000, p.29).
Logical dividend policy of a company depends on the life cycle of the product. That means, in a launch stage of a product, there is no capability to pay dividends. When the company passes its life cycle to achieve a growth, that generates cash flows and have an ability to pay dividend. This can be shown as follows, (Aswath, Damodaran, 2011)

Growth **Business Risk → High** **Financial Risk → Low** • **Funding through equity** • **Nominal dividend payout ratio**	**Launch** **Business Risk → Very high** **Financial Risk → Very Low** • **Funding through equity** • **Nil dividend payout ratio**
Maturity **Business Risk → Medium** **Financial Risk → Medium** • **Funding through debt** • **High dividend payout ratio**	**Decline** Business Risk → Low Financial Risk → High • Funding through debt • Total dividend payout ratio

Table 4 - Logical Dividend Policy

Dividend payment leads to motivate ordinary shareholders of a company. Because they can only receive their return in two ways, either the company pays a dividend or the value of their shares increase. That can be shown as follows,

Return = Dividend Yield + Capital Gain

Telecity Company has ability to maintain a high dividend payout. Because of that, Telecity Company now reaches to its **Maturity level** of the life cycle. In order to maintain a high dividend payout, companies require both Cash and Distributable profits. When considering Telecity Company, it has recorded 59.7 GBP net profit in the year 2014 and dividend per share was Rs: 10.5 within the same year. It could be proved that because Telecity Company is one of the largest listed companies on the London stock Exchange in terms of the market capitalization of LSE. Also Telecity Company accounts for approximately majority of data subscribers in Europe and non-Europe area.

Once the maturity stage of the life cycle is reached, the dividend policy should change for a number of reasons.

- Cash Flows from the business are strongly positive.
- Debt financing can be used to raise capital.
- Accounting profits should be high and relatively stable so that a high dividend payout can be properly supported.

Given above reasons can be justified by looking the following performance highlights of quarter 1 in year 2015 of Telecity Company.

- Free Cash Flows from operations positive at 92.7 GBP which is an improvement over the last years.
- Telecity group continues to maintain a strong balance sheet with Net Debt at the end of the first half being GBP 307 million and having a net debt to EBITDA multiple of 1.9.
- The group's cash and cash equivalents balance increased to 23.2 to 27.2 GBP as at the end of Q1 in 2014 on the back of strong profits.

Telecity Company would become a success today and in the future as well by using the given above logical dividend policy. This policy creates shareholder value by giving a higher present value of income received today than receiving in the long run, maintaining high share price with very low fluctuations, giving a source of income to shareholders and resolving uncertainty. (Amaro, Matos, 2001)

It was clear from the above diagram that only Telecity has paid out dividends in recent years. The net income had been increasing over the recent years on average and the company's financial position is favorable to pay off dividends. It could be expected that the company would continue the stable dividend policy. Normally companies in the growth and maturity stages would continue to pay dividends. This situation confirms with the bird in the hand theory.

InterXion and Demandware have not paid any of the dividends in the history of the company. This could be proved from analyzing the financial performance and position of the company. In Demandware, the net loss had been increased in the recent periods from 18 to 27.1 USD. Since the company has no enough earnings, it cannot pay out dividends. The company relies on equity capital and it has paid out all its long term debt. This shows that the company is still in the initial step of growth stage and hence it faces a very high business risk and a low financial risk due to less reliance on debt. Therefore the nil dividend policy of the company could be justified. (Amaro, Matos, 2001)

InterXion company's profits had been increased from 6.5- 35.1 USD in 2014 but the company pays no dividends at all. The reason behind this is the management's decision of reinvesting profits earned in expecting future capital gains by increasing the value for shareholders. Hence this is confirming with the dividend irrelevance theory.

Hence the no dividend policy of InterXion and Demandware would generate shareholder value by giving expectations of the future through capital re investments done for the future.

Conclusion

The choice of the dividend policy differs from company to company according to its earnings capacity and the decisions of the board of directors. There is a paradox in this case where the shareholders prefer dividends and the companies wanting to re-invest the earnings for future growth. There are three main theories of dividend payment and some of them assume the dividends are relevant and some of them assume dividends are irrelevant in the case of no taxes. The tax consideration is also an important matter in preferring dividends because the dividends are taxed immediately whereas capital gains are not. These theories had been backed by empirical research and those are elaborated in this report.

Finally, the dividend policies of the Telecity Group and its two main competitors had been analyzed and the analysis shows that the company with high earnings would pay high dividends and the companies with lower earnings pay no dividends. The lifecycle stage at which the company currently exists is also matters the payment of dividends. It could be concluded that as Telecity is in the maturity stage, it pays out a very high dividend compared to its competitors who are re investing for the future. And also the payment of high dividends that increase shareholder value by generating a good income, creating investment confidence and maintaining good share prices. And the no dividend paying companies create shareholder value by re investing the earnings for future growth and thus giving shareholders expectations of future dividends and capital gains.

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