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GORDON & MM HYPOTHESIS

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GORDON’S MODEL

- Gordon Suggests that the dividend is relevant and it affects the value of firm
- If $r>k$, Market price of share increases when dividend payout is less, Payout is 0%
- If $r<k$, Market price of share increases when dividend payout increases. Payout is 100%
- If $r=k$, The share price is not affected by dividend policy. Hence no optimum pay-out

Assumptions on Gordon's Model

- The firm is an all equity firm. It does not use any debt
- The firm finances its expansion only through retained earnings
- Rate of Return and Cost of Capital remains constant
- The retention ratio once decided remains constant (b)
- Therefore, growth rate is also constant (g=b x r)
- There is no corporate taxes
- The firm has a perpetual life
- Cost of capital (k) is greater than the growth rate (g)

Criticism of Gordon's Model

- It assumes that finances through retained earnings. It is unrealistic. Firm do raise funds through equity and debt
- The assumption rate of return remains constant is also not true.
- The assumption cost of capital remains constant is also not true. It changes according to the risk

Traditional Approach

- According to this approach, divided decision has no effect on the price of the shares
- The earnings available may be retained in the business for re-investment
- But, if the funds are not required in the business they may be distributed as dividends
- Thus, a firm should retain the earnings if it has profitable investment opportunities otherwise it should pay them as dividends

Contd..

- The shareholders basic desire is to earn return
- In case if the firm has profitable opportunity the investor would happy with the firm retaining earnings
- However, it the firm is not in a position to find profitable investment investors would prefer for dividend

Modigliani and Miller Approach

- Modigliani and Miller have expressed the theory of irrelevance
- The dividend policy has no effect on the market price and the value of firm

Assumptions of MM Approach

- The capital market are perfect: Investors behave rationally, information is available to all, no investor is large enough to affect market price of a share
- Taxes do not exist
- There are no flotation costs
- There are no transaction costs

Criticism of MM Approach

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- The model assumes perfect capital markets. But in practice, capital markets are not perfect
- Information about the company is also not freely available to all.
- The assumption that there are no corporate taxes , no floatation costs does not hold good. In the real world, there are corporate taxes