Don't let dividend traps trip you up

Can't see the return on your investment? You need to unlock value and release trapped cash to shareholders, says Blaise Jenner, PwC Middle East Partner in Capital Markets and Advisory Services

In the last 24 months the regional and global economies have shown signs of recovery – despite the recent slump in oil prices we have seen growth of 97% in the Dubai Financial Market, 22% in the Tadawul and the London FTSE recently broke the 7,000 points barrier for the first time.

As groups return to profitability, this often triggers an expectation from shareholders to start receiving these profits in the form of cash dividends. Often, however, a "dividend trap" will be a fundamental barrier that prevents a group from returning value to its shareholders.

Firstly what is a "dividend trap" and what causes it? The recent financial crisis resulted in financial pain for many regional and global investors. Falling asset values often triggered accounting impairment of assets – especially of those assets acquired at the peak of the market. Companies ordinarily need positive retained earnings in order to pay dividends and where these impairments depleted those retained earnings it forced a number of groups to suspend dividends payments.

Whilst many of these groups have recently returned to net cash and profit generation, the recent profits are often not sufficient to fully absorb those previously accumulated accounting losses. This scenario is known as a "dividend trap" where a group is net cash and profit generative but cannot lawfully pay a dividend due to accumulated accounting losses.

Dividend traps impact a variety of stakeholders. Firstly it may be a source of frustration and confusion for shareholders - whether individuals, corporates, family businesses, private equity investors or governments. Having waited through the financial down turn they can now see positive cash and profits generation but they cannot directly access this value. Depending on their objectives, this may disrupt the shareholders ability to redeploy cash for other opportunities or requirements.

This scenario will also invariably place pressure on the group's senior management team to turn profits into cash dividends and meet expectations of those shareholders on a timely basis. Additionally, deal makers may also have to think twice about entering a structure where dividend traps are presenting a medium to long term barrier to cash extraction.

Clearly dividend traps impact the ability of shareholders to realise value and require immediate attention. Fortunately there are a number of restructuring options that can unlock the value of a company and facilitate the payment of dividends. These include:

Capital reduction – this is a legal mechanism whereby an entity reduces a portion of its issued share capital in order to offset historic accumulated accounting losses, thus eliminating the dividend trap. This mechanism is well understood and frequently applied in established territories, such as the United Kingdom. We have recently seen increased use of capital reductions in a number of companies in the region.

Insertion of new holding company
– a new holding company is often inserted as part of group reorganisation exercise or required for external transactions such as Initial Public Offerings. They can also be used to structure around dividend traps.

A new holding company will start off life with a clean slate (i.e. no accumulated accounting losses) within its entity financial statements and it may also be possible to create a pool of positive reserves available for distribution as part of the insertion of the holding company.

It should be noted that the historic losses of the group will still be reflected in the consolidated accounts of the group; however the payment of dividends is ordinarily made by reference to the standalone entity accounts of a holding company as opposed to its consolidated position.

Shareholder loans – often the simplest and quickest mechanism to get around a dividend trap is to lend any excess cash to shareholders.

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Whilst this mechanism enables immediate cash extraction it will leave the recipient shareholder with a liability to the company. Special consideration must be placed on how such loans would be settled or unwound going forward.

Crystallisation of unrecognised value –many groups record assets at historic book values within their financial statements. For a number of assets, including property and other fixed assets, International Financial Reporting Standards ("IFRS") permits these assets to be recorded at fair value.

Accordingly, it may be possible to crystallise unrecognised value where assets are re-measured to their fair value. Any such uplift of asset value will typically also result in a corresponding increase to equity and reserves which may assist in structuring around a dividend trap.

It is important to note that there is not a one size fits all solution to this issue.

Some of the above mechanisms will potentially not be viable in specific circumstances – for example inserting a new parent company or undertaking shareholder loans may not be appropriate solutions for a listed group.

As a result, relevant options should be considered in the context of a groups specific fact pattern and include consideration of the related accounting, legal and tax (if relevant) implications.

As companies in the region continue to return to profitability we expect cash extraction to gain momentum and to see more groups implementing restructuring options to unlock trapped cash.

Otherwise, as seen in the past, the inability to address dividend traps can act as a deal breaker in financial transactions – reflecting both the critical requirement of some investors to extract cash on a timely basis as well as the clear value derived from developing solutions to address dividend traps.

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