MOSCOW EXCHANGE

Moscow Exchange Methodological Recommendations for Drafting and Implementing Dividend Policies by Public Companies

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Introduction

One of the key indicators of company's investment attractiveness is the total shareholder return (TSR) which consists of the stock price growth and dividends. The dividend policy directly influences the total profits of shareholders. In practice, the number of investors giving preference, everything else being equal, to stable dividend payments is growing, which increases these companies' shareholder value.

There is no single dividend policy standard acceptable for all companies, but amending the company's by-laws to provide for a clear and understandable approach to determining the amount of such payments may be an evidence of maturity of the corporate governance system, its focus on increasing shareholder value and commitment to transparency for shareholders and investors.

The availability of a formalized approach to dividends is especially important for the domestic market given the high concentration of ownership in Russia. Most of the Russian public companies have a majority shareholder: according to a survey[1] by Deloitte published in 2016, 73% of the 120 Russian public companies had shareholders with stakes exceeding 50%. Given that majority shareholders and the management do not always have the same interests as the other shareholders (including minority shareholders), a public benchmark for dividend payments declared by the company could, in a way, guarantee minority shareholders a balanced approach to the profit distribution.

The aim of these recommendations is to define the elements, which, if included in the dividend policy, may improve the company's investment appeal and ensure transparency of the mechanism for determining the amount of dividends and procedures accompanying dividend payment-related decisions. This document contains a set of recommendations for identifying approaches to implementing the dividend policy.

The document primarily targets issuers whose shares are included in first-level or second-level quotation lists as these issuers are primarily subject to the Listing Rules[2] requirement to have a dividend policy. Other issuers[3] may also adopt the following recommendations.

For the purpose of these recommendations, the dividend policy means a document[4] approved by the Board of Directors (Supervisory Board) of the issuer and describing the principles and approaches used by the issuer in determining and making dividend payments; besides, it means the actual practice of profit distribution and dividend payments.

This document was developed taking into account the Russian legislation, Corporate Governance Code[5] guidelines, recommendations from Russia's Federal Agency for State Property Management (Rosimushchestvo)[6], and best international practices. The recommendations were prepared with the participation of the Association of Institutional Investors (API) and include the opinion of the most active institutional portfolio investors, particularly API members, on dividend policy implementation.

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[1] Deloitte's selection of issuers for the survey *"Corporate Governance Structures of Public Russian Companies 2015"* includes both issuers incorporated in Russia and foreign-incorporated companies with most of assets in Russia.

[2] The Moscow Exchange Listing Rules approved by the Supervisory Board of Moscow Exchange

[3] Joint-stock companies listed on the organized securities market

[4] Such document may be titled, for example, "Dividend policy regulation" or "Dividend policy".

[5] The Corporate Governance Code recommended for application by the Bank of Russia's letter no. 06-52/2463 "On the Corporate Governance Code" dated April 10, 2014 (http://www.cbr.ru/publ/Vestnik/ves140418040.pdf)

[6] Methodological recommendations for the drawing-up of dividend policies at publicly owned joint-stock companies approved by Order 524 dated December 29, 2014 (http://www.rosim.ru/documents/246827)

Recommendations for drafting and implementing dividend policies

1. Dividend policy principles

It is considered a good practice to include in the dividend policy the underlying principles it is based on.

1.1 The following may be considered as underlying dividend policy principles:

- observance of the rights and interests of shareholders;
- increasing the company's investment attractiveness;
- ensuring transparency of the mechanism for determining the amount of dividends;
- commitment to making economically sound dividend payment decisions taking into account the need to balance the short-term and long-term interests of the shareholders and the company's investment demands;
- keeping the management motivated to increase the total shareholder return (TSR).

1.2 In addition to the basic dividend policy principles relevant for all companies, the company may also specify principles related to and determined by the specifics of the economic sector the company is operating in, as exemplified by regulatory aspects (for instance, it is important for banks to ensure capital adequacy when determining the amount of dividends), or the intention to match peers in the amount of dividends paid.

2. Dividend policy time scope

Companies are recommended to specify the time scope of their dividend policy (up to 3 years for a short-term policy, 3-5 years for a medium-term policy, more than 5 years for a long-term policy). **Investors** traditionally holding shares for a long period of time **give preference**, everything else being equal, **to a dividend policy intended to be effective over a medium to long-term horizon**.

3. Frequency of dividend payments

The dividend policy should state the company's intention to pay dividends at certain time intervals. Companies are recommended to include information on the frequency of dividend payments (only annual or annual and interim dividends) in the dividend policy.

In practice, the **payment of quarterly and/or semi-annual dividends** make the company's shares **more attractive** to investors **and less volatile as predictability of dividend flows increases**.

4. Description of procedural matters

The process of making and implementing a dividend payment decision involves various procedural matters: for example, restrictions on making a decision to pay dividends; the procedure for determining the record date for dividend payment; the dividend payment timeframe; the dividend payment procedure; restrictions on the payment of dividends. The above-mentioned matters are typically governed by the legislation. Many companies also refer to them in their dividend policies, but their approaches differ:

1) a number of issuers do not precisely specify the timeframe and other procedural matters, while making a general reference to the law;
2) other issuers provide for specific timeframes and other procedural matters in the dividend policies, adding a clause that the law shall prevail over the policy in case of legal changes resulting in discrepancies.

The second approach looks more "investor-friendly", as all relevant aspects, including procedural matters, are available to investors in a single document. This may be of special importance to foreign investors. At the same time, in case of legal changes in a certain aspect, the policy can potentially mislead investors during a certain period of time. In the event such legal changes occur, it is therefore recommended that companies post a message warning investors of non-conformity of their dividend policy with the law in that aspect, indicating the updated procedures in question and containing an obligation to amend the dividend policy within a certain period of time on their websites.

In case the issuer chooses the first approach making a general reference to the law, it should ensure additional disclosure on the website (by creating a sub-section on the dividend payment timeframe and related procedures in the dividends section). Companies are recommended to promptly update this section should changes in the legal regulation occur.

5. Company's approach to preparation of profit distribution recommendations

It is advisable that the description of the **company's approach to preparing profit distribution recommendations be included in the dividend policy**. This approach can imply the following stages:

- preparation of recommendations for the amount of dividends by the management (including a rationale for the proposed net profit distribution);
- submission of recommendations on the agenda and their discussion at a in-person meeting of the Board of Directors (taking into account the opinion of the relevant Board of Directors committee in case of preliminary consideration of this issue at a committee meeting);
- submission of recommendations on the agenda of the upcoming general shareholders meeting.

6. Role of the Board of Directors in decision making on dividends

The Board of Directors is the main collegial body of the company responsible for the development and implementation of key dividend policy aspects. The Board should play a significant role in the drafting of recommendations on the amount of dividends. It is the Board of Directors – the governing board representing shareholders' interests and supervising the activities of executive bodies – that should scrutinize the management's proposals for dividend payments, correlate them with the company's strategic goals (and financial strategy) and adjust the proposals as necessary before submission them on the agenda of the general shareholders meeting.

One of the Board's main tasks is to take a balanced decision on allocating some of the net profit for dividends and retaining a portion of it for reinvestment, taking into account interests of the shareholders, the company and the creditors.

The Board of Directors is responsible for the quality of disclosed information as regards the rationale for and comment on the proposed profit distribution and the amount of dividends paid to the shareholders.

7. Key aspects of dividend policy implementation

7.1 Calculation basis for the specific amount allocated for dividends

Companies are recommended to choose the standard of financial reporting to be taken as a basis for calculating the amount of dividend payments and to define the chosen standard in the dividend policy. The **preferred form of reporting** for dividend payment calculation purposes is the **consolidated financial reporting under International Financial Reporting Standards (IFRS)**[7]. The advantage of IFRS statements for dividend calculation is that such statements aim at providing investors and creditors with financial information for investment decisions and therefore, reflect the economic substance of the group's operations to the fullest extent possible. Accordingly, all recommendations as regards indicators for dividend base calculation purposes hereinafter imply the use of IFRS.

[7] For issuers that do not form a group identified according to IFRS, the use of individual financial statements under IFRS is possible.

Free cash flow to firm (FCFF) is the **priority basic indicator** for calculating dividends at non-financial companies, as it reflects the company's cash inflows in real terms best of all. That said, the Board of Directors may opt for the company's net profit, net profit adjusted for non-cash items[8], EBITDA or adjusted EBITDA as the basic indicator.

For **financial organizations**, the **free cash flow to equity (FCFE)** or **net profit** should be considered as a more relevant indicator.

The calculation procedure for the financial indicators used to determine the dividend base should be disclosed with the maximum possible degree of transparency to avoid discrepancies in forecasts and expectations (see **clause 10.4** of recommendation on inclusion of the glossary in the dividend policy).

7.2 Establishment of a target for the basic ratio used for calculation

The company is recommended to disclose the targeted portion of its free cash flow/net profit[9] allocated for dividends (the payout ratio) in the dividend policy. This aspect is one of the fundamental elements of a dividend policy. The target should contain **clear-cut parameters defined as fully as possible, without broad ranges. The company is recommended to disclose the target level of dividend payments it aims at and to set the minimum level of dividend payments.**

The establishment of a specific procedure for determining the percentage of free cash flow/net profit allocated for dividends depends on the type of dividend policy and is very individual for every company. In practice, several targeted levels can be specified for different time periods (the short, medium, or long-term prospect) or different leverage scenarios. The availability of such a benchmark in the dividend policy is critical for investors as it enables them to forecast cash flows from investing in shares of a specific Issuer. The absence or incomplete disclosure of such a benchmark makes the dividend policy a pure formality.

7.3 Use of benchmarking in the dividend policy implementation

The dividend policy implies the active comparative analysis (benchmarking) of the share of profit and the share of free cash flow earmarked for dividends (the payout ratio) at the national and international levels.

The management and the Board of Directors are recommended to consider and take account of the results of benchmarking (comparative analysis) of domestic and international peers as regards the share of profit and the share of free cash flow earmarked for dividends (the payout ratio) when discussing the profit distribution and the amount of dividends payable.

Benchmarking is absolutely critical at the initial dividend policy development stage and should also be conducted regularly at later stages. The resolution on allocating profit for dividends should take into account both the results of benchmarking and external factors affecting the competitiveness of the company's shares on capital markets.

The company is recommended to disclose the results of benchmarking used for comparing companies, as well as a description of approaches and an analysis of the results of benchmarking in making a decision on the distribution of profit in the annual report or dividend payment-related materials.

[8] By a resolution by the Board of Directors, the company's profit may be adjusted when calculating dividends. The list of adjustments can be revised by a resolution of the Board of Directors subject to a discussion of specifics of the issuer's accounting policy with the management team (for details, see **Annex 1**). The Company is recommended to disclose the adjustments used for adjusted net income calculation in the annual report or dividend payment-related materials.

[9] Or other financial metrics used for calculation purposes

7.4 Main factors influencing the distribution of profits

The company distributes profits subject to the target levels of return on invested capital (ROIC), net debt, and weighted average cost of capital (WACC).

The company's profit can be allocated for dividends or retained for reinvestment in its activities. Reinvesting net profit only makes sense if ROIC exceeds WACC. It is recommended that the Board of Directors approves a minimum threshold for return on investment projects and the company discloses it.

The company is recommended to avoid paying dividends out of leftovers. The leftover principle implies that the company pays dividends to the extent of the profit remaining after all capital expenditure and debt repayment.

If there are not enough free cash and equivalents on the company's balance sheet for paying the target amount of dividends, the Board of Directors may decide to increase leverage – although the company's net debt must not exceed the maximum target level.

The company is recommended to include the target net debt, ROIC and WACC levels used by the Board of Directors to prepare sound profit distribution recommendations to shareholders and the logic behind the resolution taken by the Board of Directors in materials for the shareholders meeting concerning the dividend payment issue.

7.5 Prerequisites for the use of retained earnings of previous years

The dividends paid out of the company's IFRS net profit should not be limited to the amount of profit under Russian accounting standards (RAS) in case retained earnings of previous years are available.

In case the target amount and cost of debt, ROIC, the dividend calculation base and the comparative analysis of payments by peers (benchmarking) allow the payment of dividends in excess of the company's net profit under RAS, the Board of Directors may recommend that the shareholders decide to pay dividends out of the company's retained earnings.

7.6 Ensuring the payment of dividends on common and preferred shares on a parity basis

The Company is recommended to avoid setting a lower dividend per preferred share than the dividend on share of common stock (to ensure parity of dividends per ruble of par value).
Companies are recommended to recognize in their charters and dividend policies the parity of dividends principle according to which the dividend per share of common stock shall not exceed the dividend per preferred share if the common share and preferred share are equal in par value. **Given that preferred shares do not carry a voting right, their economic sense implies the need to ensure parity of dividend payments.**

8. Conditions making the payment of dividends inexpedient

Companies are recommended to set in their respective dividend policies conditions under which payment of dividends in the amount indicated in the dividend policy may be inexpedient. Some of the potential conditions are:

- excess of the target leverage level;
- failure to achieve the target liquidity ratios[10];
- breach of covenants on large loans raised by the issuer.

[10] The target ratios are set by the issuers at their discretion as part of their dividend policy

9. Form of dividend payments

Companies are recommended to provide for the payment of dividends in cash in their dividend policies.

10. Availability of dividend policy-related documents for interested parties

10.1 The Company is recommended to make its dividend policy available to stakeholders and interested parties by placing this document, including related amendments and supplements, on the official website. Another recommendation is to have the dividend policy published on the website of a relevant information agency[11].

10.2 It is recommended that the dividend policy contain the company's obligation to provide its shareholders with detailed explanation of the reasons and prerequisites for changes in the dividend policy (in case of significant changes).

10.3 The company's website section covering dividends should be used for convenient disclosure (e.g. by means of tables) of dividend payments made in previous years (the dividend history), particularly, the total amount of dividends, the dividend per share, the share of profit/free cash flow actually allocated for dividends (the payout ratio), and the indicative dividend yield, including the approach to th calculation of this yield.

10.4 The Company is recommended to include a glossary of terms and financial metrics used in it in the dividend policy.

[11] This means information agencies duly authorized to carry out disclosure of information on securities and other financial instruments

Annex 1: Possible adjustments to the amount of IFRS net profit in calculating dividends

Even though the free cash flow to firm is the priority indicator for dividend base calculation, the Board of Directors may instead decide to use the IFRS net profit adjusted for non-cash items as the basic indicator. The following is a list of possible adjustments (which can be amended by a resolution of the Board of Directors subject to a discussion of specifics of the company's accounting policy with the management team):

- Exchange rate differences related to operating items, balance of exchange rate differences within the financial income and expenditure
- Profit or loss from changes in the fair value of financial derivatives
- Revaluation of financial assets at fair value
- Revaluation of financial assets available for sale
- Change in provisions for impairment of financial assets assessed at fair value
- Change in provisions for impairment of financial assets available for sale
- Change in provisions for impairment of materials and stocks
- Profit / loss from the disposal of financial assets available for sale
- Profit / loss from the impairment of investments in affiliates
- Change in provisions for impairment of fixed assets
- Profit / loss from the disposal of fixed assets
- Profit / loss from the revaluation of fixed assets
- Profit from the gratuitous receipt of fixed assets
- Loss from goodwill impairment
- Profit / loss from financial derivatives
- Change in provisions for upcoming payments in relation to financial guarantees
- Change in provisions for impairment of investments
- Change in other provisions
- Profit / loss from changes in the group's structure
- Non-cash profit/loss from acquisitions (net)

A profit or reduction in provisions for the above items means a decline in adjusted net profit.

A loss or increase in provisions for the above items means an increase in adjusted net profit.