5.1.5

CAPITAL STRUCTURE AND DIVIDEND POLICY

How a company finances itself – the mix of debt and equity it carries – and how it returns capital to shareholders are not routine treasury matters. Together they determine a company's resilience under stress, its capacity to fund strategy and growth, its cost of capital, and the confidence lenders, investors and rating agencies place in it. Capital structure and dividend policy sit directly within the Board's fiduciary oversight: decisions here are strategic choices with legal consequences, not calculations to be left entirely to the finance function.

The role of the Board

The Board's task is to set the framework within which capital structure and distribution decisions are made, and to test management's proposals against it – not to draft them. In practice, this means approving a target capital structure and a dividend policy consistent with the company's strategy and risk appetite.

Usually, the final decision to distribute profit rests with the general meeting of shareholders, acting on the approved annual accounts and the proposal of the Board. That does not reduce the Board's role to a formality. The Board reviews and approves the management's dividend proposal before it reaches shareholders. Either way, the Board's job is to confirm that a proposed distribution is lawful, that it does not compromise the company's solvency or its ability to fund strategy, and that it is consistent with a policy the Board has itself endorsed – rather than an ad hoc figure produced late in the reporting cycle.

What the Board should do

1. **Set and periodically review a target capital structure** – an acceptable range for leverage and the debt/equity mix – aligned with the company's risk appetite and strategy, not simply the lowest available cost of capital or short-term tax optimisation.
2. **Approve a clear, published dividend policy** (a payout ratio range and a stated priority between reinvestment, deleveraging and shareholder returns) so that distributions follow a discipline the Board has set, rather than being decided year to year. The dividend policy also plays an additional role: it explains transparently to the shareholders and all relevant stakeholders how dividends are set. This is particularly important where some shareholders demand high dividends without regard to the financial health of the company.

3. **Verify the statutory distribution tests** before recommending any dividend to shareholders. Estonian law requires that equity remain at least half of share capital and that a distribution not endanger solvency; Latvian law prohibits distribution if own funds would fall below share capital; Lithuanian law restricts distribution that would reduce equity below authorised capital or mandatory reserves. These are Board-level checks, not back-office formalities.[9]
4. **Stress-test the capital structure** against adverse scenarios – a revenue shock, a rise in interest rates, tighter refinancing terms, or a market unwilling to roll over debt – rather than relying solely on the base case.
5. **Assess covenant headroom and refinancing risk** before approving new borrowing or a distribution that would reduce that headroom, and monitor both on an ongoing basis, not only at renewal.
6. **Maintain a predictable, well-communicated policy,** particularly for companies listed on Nasdaq Baltic, where unexplained deviation from stated dividend guidance affects market credibility and share price.
7. **Record the rationale** for capital structure and dividend decisions in Board and shareholder minutes, including the basis for the distributable-profit calculation – closing the same accountability gap this Handbook flags for strategic decisions generally.

Warning signs

- A dividend maintained or increased despite weakening cash flow, rising leverage or narrowing covenant headroom.
- No clearly articulated capital structure or dividend policy – distributions and financing decided ad hoc, year to year, with little Board discussion.
- Distributions approved without documented confirmation that statutory solvency and net-asset tests were met.
- Growing reliance on short-term or refinancing debt to fund distributions or ongoing investment.
- Capital structure decisions driven primarily by tax optimisation, with limited regard to underlying business risk.
- Little or no Board challenge to management's proposed leverage, payout ratio or financing structure.

9 See the provisions on the distribution of profit and the protection of capital in the Estonian Commercial Code, the Latvian Commercial Law and the Lithuanian Law on Companies.

Common pitfalls and drawbacks

- **Treating dividend policy as a technical finance decision,** delegated entirely to the CFO and rubber-stamped by the Board rather than scrutinised as a strategic choice.
- **Protecting a stable or progressive dividend at the expense of strategic investment,** including transition or resilience-related capital expenditure, weakening the company's longer-term position to preserve a short-term signal to the market.
- **Carrying leverage inconsistent with the business's actual risk profile,** either too conservative to fund growth or too aggressive relative to the volatility of the underlying business.
- **Overlooking the statutory distribution tests,** which in each Baltic jurisdiction can expose Board members to personal liability for an unlawful distribution – this is a compliance matter, not only a financial one.
- **An inconsistent or opportunistic dividend policy** that damages market credibility and, for listed companies, raises the cost of capital by increasing perceived uncertainty.
- **Ignoring the tax asymmetry across the Baltic states** when structuring group financing and dividend flows – moving cash between an Estonian or Latvian entity, where reinvested profit is untaxed, and a Lithuanian parent taxed annually, without coordinated group tax planning.
- **Failing to document the Board's reasoning,** leaving no audit trail for why a particular capital structure or distribution was approved – a gap that becomes costly precisely when a decision is later questioned.

As elsewhere in this Handbook, the mechanism of approval differs by structure – the Supervisory Board or Council in the two-tier structures common across Estonia, Latvia and Lithuania, or the non-executive members of a one-tier Board – but the standard does not: a disciplined, documented policy, tested against the law and the company's own risk appetite, before it ever reaches the shareholders who make the final call.

KEY TAKEAWAYS

A. Capital structure and dividend policy are strategic choices with legal consequences, not routine treasury matters. They determine the company's resilience, its capacity to fund strategy and its cost of capital.

B. The Board sets the framework, a target capital structure and a published dividend policy aligned with strategy and risk appetite, and tests management's proposals against it. The final decision on distributions usually rests with the shareholders, acting on the Board's proposal.

C. Before recommending any distribution, the Board must verify the statutory tests in the relevant Baltic jurisdiction; an unlawful distribution can expose directors to personal liability.

D. The different tax treatment of retained and distributed profit in Estonia, Latvia and Lithuania should inform where cash is held and how intra-group distributions are structured.

E. The capital structure should be stress-tested against adverse scenarios, covenant headroom and refinancing risk monitored continuously, and the rationale for every decision recorded in the minutes.

QUESTIONS FOR THE BOARD

1. *Do we have an approved target capital structure and a published dividend policy, and when were they last reviewed against the strategy and risk appetite?*
2. *Is the current dividend proposal consistent with that policy, and if it deviates, has the Board recorded why?*
3. *Who verified that the statutory solvency and minimum-equity tests are met for this distribution, and is that verification documented?*
4. *How would our leverage and liquidity hold up under a revenue shock, higher interest rates or a tighter refinancing market?*
5. *Are we retaining enough capital to fund the strategy without becoming dependent on external financing?*
6. *Does our group financing and distribution structure take account of the differing tax treatment of profit across the Baltic states?*
7. *What is our target leverage range, and why is it the right one for our strategy and risk appetite, not simply the cheapest available financing?*
8. *What covenant headroom do we have today, and how does this financing or distribution decision change it?*
9. *If a lender or rating agency reviewed our capital structure today, what would concern them most?*