EFFECT OF DIVIDEND PAY OUT ON FINANCIAL PERFORMANCE AMONG PUBLIC LIMITED COMPANIES IN KENYA

[1] **Denis K Gwaya**

Lecturer, Jomo Kenyatta University of Agriculture and Technology
dkwaya@gmail.com

[2] **Mwasa D Ishmail**

Lecturer, Machakos University College
mwasa8@gmail.com

Abstract

The Dividend policy is the core component of a firm's overall financial policy. It is comprised of a series of decisions regarding how the firms distribute profits to their shareholders and it mostly includes basic contents about the selection of dividend policy, dividend payout ratio and payout channel. The study sought to examine how the dividend policies of selected public limited companies in Kenya affect their financial performance during the period 2002 to 2011. An attempt was made to examine the nature and history of dividend policies adopted by the selected public limited companies, explain the meaning and types of dividend policies applied and examine the relationship between dividend policy and firms' financial performance. A causal research design was employed in this study and it involved examining the major factors and effects of the various dividend policies and how they affect performance of public limited companies in Kenya. The findings of this research project report established that dividend policy of a firm has an effect on its subsequent financial performance.

Keywords: Divident payout, financial performance

INTRODUCTION

The patterns of corporate dividend policies not only vary over time but also across countries, especially between developed, developing and emerging capital markets. Glen *et al*., (1995), found out that dividend policies in emerging markets differed from those in developed markets. They reported that dividend payout ratios in developing countries were only about two thirds of that of developed countries. Ramcharran (2001) observed that there are low dividend yields for emerging markets. There has been emerging consensus that there is no single explanation of dividends. According to Easterbrook (1984) there is no reason to believe that corporate dividend policy is driven by a single goal. In addition, not much research has been done on the effect of dividend policy on financial performance.

 Baker and Powell (1999) stated that dividend policy is considered to be one of the most important financial decisions that corporate managers encounter. Omran and Pointon (2004) also observed that dividend policy has potential implications for share prices and hence returns to investors, the financing of internal growth and the equity base through retentions together with its gearing and leverage.

Although companies can change their dividend policies it is advisable that each company establishes its own dividend policy and stick to it because frequent changes can inconvenience existing stockholders, send unintended signals, and convey the impression of dividend instability, all of which can have negative implications for stock prices particularly when lower or no dividends are paid. At the same time companies must meet their debt obligations before declaring dividends because interest on borrowed funds must be paid whether the company makes profits or not. However, shareholders are entitled to a share as the reward for the risk they have taken in investing in the company. The Board of Directors may balance up these two demands on the profit, and will then recommend the size of the dividend they think is appropriate (Chebii *et al.,* 2011).

Dividend policy can be of two types: managed and residual. In residual dividend policy the amount of dividend is simply the cash left after the firm makes desirable investments using Net Present Value rule. If the manager believes dividend policy is important to their investors and it positively influences share price valuation, they will adopt managed dividend policy. Firms generally adopt dividend policies that suit the stage of life cycle they are in. Dividend policy is one of the most complex aspects in finance (Black, 1976).

LITERATURE REVIEW

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business to generate revenues and expand its operations (Copisarow, 2000). Financial performance can be measured in many different ways, but all these ways should be aggregated. Revenue from operations, operating income or cash flow from operations can be used as well as total unit sales. According to Demsetz and Lehn (1985), financial ratios from financial statements are a good source of data to measure financial performance. Liquidity is one of the most outstanding financial ratios used a measure of the firm's ability to meet financial obligations as and when they fall due without disrupting the normal business operations. Liquidity can be analysed both structurally and operationally.

According to Maina (2000), there exists a relationship between dividend and investment decisions since both compete for internally sourced funds and given that funds obtained by debt are very expensive and not available to all firms. There are other theories that have been proposed to explain the relevance of dividend policy and it is effect on firm performance, but no universal agreement has been reached (Stulz, 2000; Pandey, 2003; DeAngelo *et al.,* 2006). A group of researchers: Amidu (2007), Lie (2005), Zhou and Ruland (2006), Howatt *et al,* (2009), have come up with different findings about the relationship between dividend payout and financial performance

The market reaction to changes in firm payout policies is of critical importance in determining corporate payout dynamics. Over the years, the literature on payout policy has produced many hypotheses to explain payout rationale. The Dividend Signaling Hypothesis asserts that a dividend increase is a signal of unexpected positive and persistent higher future earnings; the Free-Cash-Flow (FCF) Hypothesis states that a dividend increase reduces the agency problems between shareholders and top management; The Maturity Hypothesis maintains that a dividend increase is an indication of a firm entering a mature life-cycle stage of low systematic risk; Finally, the Catering Hypothesis argues that managers are catering to investors by increasing dividends during times when dividend paying stocks are in high demand and therefore rewarded with a return premium (Amidu, 2007).

Arnott and Asness (2003) observed that the positive relationship between dividend payout and growth in future earnings is that managers are reluctant to cut dividends. A high payout ratio indicates management's confidence in the stability and growth of future earnings and a low payout ratio suggests that management is not confident of the stability of earnings or

sustainability of earnings growth. Managers therefore pay low dividends to avoid dividend cuts when earnings drop.

Aivazian et al, (2003) disclose that corporate payout is dependent on the availability of cash flows rather than profit. According to them, current earnings cannot be used as an indication on corporate ability to pay dividends. In a study conducted in Japan, Kato *et al.,* (2002) showed that dividend changes communicate information about the firm's cash flows.

METHODOLOGY

The population for this study comprises of the firms listed on the Nairobi Securities Exchange. The NSE classified these companies into ten sectors. These include: agricultural, commercial and services, telecommunication and technology, automobiles and accessories, banking, insurance, investment, manufacturing and allied, construction and allied, energy and petroleum (NSE, 2012). The secondary data for regression analysis was obtained from 29 companies listed in the Nairobi Securities exchange. The use of judgmental sampling technique; a total of 29 listed public limited companies operating in high profile industries in the Nairobi Securities Exchange were selected. This represents 48.33% of the total population. This is consistent with the propositions of Krejcie & Morgan (1970) where a minimum of 5% of a defined population is considered as an appropriate sample size in making generalizations.

In order to gain the maximum possible observations, logit regression is applied. The logit regression equation differs from a regular time-series or cross section regression by the double subscript attached to each variable. The general form of the logit data model can be specified more compactly as:

$Y_{it} = \alpha + \beta X_{it} + e_{it}$

The subscript *i* represent the cross-sectional dimension and *t* denote the time-series dimension. The left-hand variable Y_{it}, represents the dependent variable in the model, which is the firm's financial performance. X_{it}, contains the set of independent variables in the estimation model, is taken to be constant over time *t* and specific to the individual cross-sectional unit *i*. If *α* is taken to be the same across all units, Ordinary Least Squares (OLS) provides a consistent and efficient estimate of *α* and *β*. The model takes the following form:

$ROA_{i,t} = \beta_o + \beta_1 POLICY_{i,t} + \beta_2 PAY_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 LEV_{i,t} + \beta_5 GROWTH_{i,t} + e$

$ROE_{i,t} = \beta_o + \beta_1 POLICY_{i,t} + \beta_2 PAY_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 LEV_{i,t} + \beta_5 GROWTH_{i,t} + e$

Where:

$ROA_{i,t}$ = ratio of pre-tax profits to total assets for firm i in period t;

$ROE_{i,t}$ = ratio of post-tax profits to equity for firm i in period t;

$TOBIN'Sq_{i,t}$ = ratio of market value of assets to book value of assets for firm i in period t;

$POLICY_{i,t}$ = dummy variable for dividend policy for firm i in period t;

$PAY_{i,t}$ = dividend per share divided by earning per share for firm i in period t;

$SIZE_{i,t}$ = log of total assets for firm i in period t;

$LEV_{i,t}$ = ratio of total debt to total capital for firm i in period t;

$GROWTH_{i,t}$ = growth in sales for firm i in period t;

e = the error term.

RESULTS AND DISCUSSIONS

The tables 4.1, 4.2 and 4.3 indicate that some of the same patterns in 2008 where the mean dividend was significantly reduced. This pattern is repeated in 2009 and 2010 where the total dividends paid out from this group of firms are only around 20 percent of what was paid out the year before. The reason for the drop in the payout ratio in 2008 to 2010 is a combination of a decrease in the dividends paid out and the fact that firms experienced an increase in operational results in this period due to the world wide recession that was experienced during this period.

In table 4.2, it is observed that on average the firms tend to pay out as much in dividends as they have in operating result. Additionally the mean dividends paid are high, and is almost in all years around Ksh 1,000,000,000. The dividend decreasing firms as presented in table 4.3 also have got a relatively high payout ratio. The mean dividends paid out are beneath the dividends paid out from the dividend increasing firms, but still are relatively high.

Table 4.1: Mean payout ratios and mean dividends paid out for companies that did not change their dividends.

	Observations	Mean payout ratio	Mean dividends "Ksh 000"
2002	3	13%	70,108
2003	3	9%	52,113
2004	3	9%	55,393
2005	3	11%	66,181
2006	2	11%	80,296
2007	3	9%	85,646
2008	2	1%	29,174

2009	3	1%	24,756
2010	3	1%	5,500
2011	2	1%	6,530

Table 4.2: The mean payout ratios and mean dividends for companies that increased their dividends

	Observations	Mean payout ratio	Mean dividends "Ksh 000"
2002	3	118%	679,097
2003	5	87%	631,432
2004	5	125%	745,096
2005	4	155%	915,699
2006	3	136%	876,672
2007	2	138%	978,482
2008	2	90%	1,311,452
2009	3	88%	1,479,399
2010	3	82%	993,361
2011	2	86%	932,700

Table 4.3: The mean payout ratios and mean dividends for companies that decreased their dividends

	Observations	Mean payout ratio	Mean dividends "Ksh 000"
2002	2	92%	576,993
2003	3	73%	545,390
2004	2	97%	684,934
2005	2	117%	760,145
2006	1	114%	728,629
2007	3	117%	786,520
2008	2	66%	948,699
2009	3	82%	1,159,634
2010	3	75%	815,767
2011	2	71%	763,391

In table 4.4, the change in earnings is divided by the book value of equity. The public limited companies that do not change their dividends in year 0 (t=0) have a positive change in earnings in the dividend change year of 3 percent, and experience an increase in earnings in the two years after the dividend change year. Dividend decreasing public limited companies tend to have a decline in earnings in year 0, but a positive change in earnings in the two subsequent years. Finally, it is observed that public limited companies that increase their dividends experience an increase in earnings in the same year, but in the two subsequent years they experience respectively -1 percent change and +1 percent change.

Table 4.4: Mean percentage change in earnings divided by the book value of equity for different dividend changes

$(E[t])-E[t-1]/B[t-1]$							
			Year 0 (t=0)		Year 1(t=1)		Year 2 (t=2)
Div-chg	Mean div-chg	Obs.	Mean	Obs.	Mean	Obs.	Mean
Div-decrease	-43%	2	-3%	2	1%	1	2%
No change	0%	5	3%	6	4%	3	2%
Div-increase	172%	3	6%	3	-1%	2	1%

Table 4.5 gives an indication of how some of the other level characteristics affect firm's profitability in Kenyan public limited companies. The study selected firm size, leverage and future growth opportunity. The results show that the coefficient of firm size and leverage are negative and insignificant for data estimations. The results suggest that for Kenyan public limited companies listed in the NSE, size and leverage do not necessarily influence their ROA. Surprisingly, the negative association of firm's size and ROA indicates that, increasing size is associated with decrease in profitability. This position seems to contradict with the existing literature.

Growth in sales is used as proxy for the firm's future prospects and investment opportunities.The variable was found to have a significant positive relationship with financial performance of

Kenyan public limited companies. This is indicative of the fact that, growing Kenyan public limited companies have a prospect of generating more returns for it owners.

Table 4.5 Regression Model Results (Dependent variable: ROA)

Variable	Coefficient	Std. Error	t-Statistic	Probability
CONSTANT	0.0449	0.01026	4.377015	0.0000
POLICY	0.1044	0.01370	7.620510	0.0000
PAY	-0.0670	0.01946	-3.447654	0.0007
SIZE	-4.32E-16	8.75E-16	-0.494354	06218
LEV	-0.0030	0.00764	-0.392337	0.6954
GROWTH	0.0174	0.00713	2.445936	0.0156
R-squared	0.7419	Mean dependent var.		0.4588
Adjusted R-squared	0.6907	S.D. dependent var.		0.3657
S.E. of regression	0.2034			

Table 4.6 : Regression model results (Dependent variable: ROE)

Variable	Coefficient	Std. Error	t-Statistic	Probability
CONSTANT	0.082966	0.049111	1.689333	0.0932
POLICY	0.374129	0.063084	5.930664	0.0000
PAY	-0.230462	0.059746	-3.857360	0.0002
SIZE	4.79E-15	3.68E-15	1.301732	0.1950
LEV	-0.016899	0.029647	-0.569992	0.5695
GROWTH	0.015629	0.036929	0.423223	0.6727
R-squared	0.842403	Mean dependent var.		0.273715
Adjusted R-squared	0.569683	S.D. dependent var.		0.310017
S.E. of regression	0.203367			

Table 4.7: Regression model results (Dependent variable: Tobin's Q)

Variable	Coefficient	Std. Error	t-Statistic	Probability
CONSTANT	0.888754	0.149329	5.951669	0.0000
POLICY	-0.013534	0.187314	-0.072251	0.9425
PAY	0.231873	0.174130	1.331613	0.1852
SIZE	-1.53E-14	1.08E-14	-1.421181	0.1576
LEV	0.062072	0.087158	0.712176	0.4776
GROWTH	0.105399	0.174208	0.605016	0.5462
R-squared	0.729553	Mean dependent var.		1.019656
Adjusted R-squared	0.400616	S.D. dependent var.		0.740139
S.E. of regression	0.573015			

CONCLUSIONS

The main aim of this study was to find out the effect of dividend policy on financial performance of selected public limited companies in Kenya. Findings from the regression analysis result for the selected public limited companies as depicted in table 4.5 depicts that from the model, the R^2 which is often referred to as the coefficient of determination of the variables was 0.742. This implies that the model explains about 74% of the systematic variation in the dependent variable (financial performance). That is, about 26% of the variations in financial performance of the sampled firms are accounted for by other factors not captured by the model. This result is complimented by the adjusted R^2 (adjusted R-squared) of 0.569, which is the proportion of total variance that is explained by the model.

REFERENCES

Aivazian, V., Booth, I. and Cleary, S. (2003). Do emerging market firms follow different dividend policies from US firms? Journal of Financial Research, 26(3), 371-387.

Amidu, M. (2007). How does dividend policy affect performance of the firm on Ghana stock Exchange? Investment Management and Financial Innovations, 4(2), 104 – 112

Arnott, D. and Asness, S. (2003). Surprise higher dividends are higher earnings growth. Financial Analyst Journal, 70 – 87.

Baker, H. and Powell, G. (1999). How corporate managers view dividend policy? Quarterly Journal of Business and Economics, 38(2), 17-27.

Black, F. (1976). The dividend puzzle. Journal of Portfolio Management, 2, 5-8.

Chebii, E., Kipchumba, S. and Wasike, E. (2011). Relationship between Firm's Capital Structure and Dividend Payout Ratios: Companies Listed at Nairobi Stock Exchange (NSE). Unpublished dissertation for Egerton University and Kabarak University.

Cooper, D. and Schindler, P. (2000). Business Research Methods. McGraw-Hill Higher Education

DeAngelo, H., DeAngelo, L. and Stulz, R. (2006). Dividend Policy and the earned/contributed capital mix: a test of the life-cycle theory. Journal of Financial Economics, 81, 227-254.

Easterbrook, F. (1984). Two agency-cost explanations of dividends. American Economic Review, 74, 650-659.

Glen, J., Karmokolias, Y., Miller, R. and Shah, S. (1995). Dividend policy and behavior in emerging markets. International Financial Corporation, Discussion Paper No. 26.

Howatt, B. (2009). Dividends, earnings, volatility and information. Applied Financial Economics, 19(7), 551 – 562.

Lie, E. (2005). Financial flexibility, performance, and the corporate payout choice. The Journal of Business, 78(6), 2179 – 2202.

Maina, S. (2002). Empirical Relationship between Dividend and Investment Decisions of Firms Quoted in the NSE, Unpublished MBA Thesis, University of Nairobi

Nairobi Security Exchange. (2013). Retrieved January 18, 2013, from www.nse.org

Omran, M. and Pointon, J. (2004). Dividend policy, trading characteristics and share prices: empirical evidence from Egyptian firms. International Journal of Theoretical and Applied finance, 7(2), 121 – 133.

Pandey, M. (2003). Corporate dividend policy and behaviour the Malaysian evidence. Asian Academy of Management Journal, 8(1), 17 – 32.

Ramcharran, H. (2001). An empirical model of dividend policy in emerging equity markets. Emerging Markets Quarterly; 5, 39-49.

Short, H., Zhang, H. and Keasey, K. (2002). The link between dividend policy and institutional ownership. Journal of Corporate Finance, 8, (1) 5-22.

Stulz, R. (2000). Merton Miller and modern finance. Financial Management, 29(4), 119–131.

Zhou, P. and Ruland, W. (2006). Dividend payout and future earnings growth. Financial Analysts Journal, 62(3), 58 – 69.