Determinants and Motivators of Dividend Policy: A Study of Cement Industry of Pakistan

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Doi:10.5901/mjss.2012.v3n2.103

Abstract: *Dividend is one of the most debatable topics for the researchers. Many researchers explore the factors of dividend policy. The aim of the study is to find out the factors that motivate the dividend policy among the cement industry. For the purpose data of eight firms was collected from Karachi Stock exchange and State bank of Pakistan. SPSS 17 was used to analyze the data and it was found that PE ratio, EPS growth and sale growth are positively associated with the dividend payout while profitability and debt to equity were found to have negative association with dividend payout.*

Key words: *Dividend policies; Determinants of dividend; Dividend payout; Cement industry;*

1. Introduction

Dividend policy is one of the most researchable topics for the finance researchers. Numerous researchers have studied on this topic to give the answer that whether companies should pay dividend to its shareholders or not?. Many of them have developed different models to explain the dividend behavior (Baker & Powell, 1999) and some of them have surveyed personally to the top executives of the multinational organizations to determine their views about the dividend (Baker, Veit & Powell, 2001). Despite extensive research of the researchers, motivation for paying dividend is still a question mark (Baker & Powell, 1999).

Dividend plays a vital role in traditional stock valuation model, and motivation for dividend could betterly be understood after understanding this stock valuation model. In such dividend models, stocks have value because they hold future cash payouts. Dividend represent s the primary payments in the form of cash to the shareholders of the organization, and the value of the stockholder's share will be greater as there will be greater expected future flow of dividends (Carlson, 2001).

Researchers have found controversial results regarding dividends impact on the shareholders wealth. Some researchers argued that dividend and shareholders wealth are directly related i.e. dividend increase the shareholders wealth (Gordon, 1959), some believed that dividend are irrelevant with the shareholders wealth (Miller & Scholes, 1978), and some argued that dividend and shareholder's wealth are inversely related i.e. dividend decreases the shareholder's wealth (Litzenberger & Ramaswamy, 1979).

The purpose of this study is to find out all the factors that motivate the dividend decisions. Simply dividend policy is the determination that what portion of the earning should be kept by the firms for their further investment and what portion should be distributed among the shareholders of the firm.

2. Literature review

2.1 Dividend Signal future success

Investors psychologically prefer to invest in those companies whose dividend stream is constant and positive. This favorable behavior of the investors and the dividend policy suggests the value of the dividends. The management's choice of rising or declining the yield of dividends does not impact the value of the firm. Thus, these changes have impact on the stock prices of the company in the markets.

Constant dividends are the indicator of company's present and future success and this also increase the company's market creditability and reduces the risk level from the investor's point of view. Stability in the dividends eliminates the poor market valuation of the firm from the investors and on the other side decline in the dividend results decrease in the firm's stock price. Thus the decrease in the firm's stock price is the result of decline in the dividend (Shapiro 537).

In summing up managements should maximize the shareholders value, and dividends work to accomplish this task that firm should not offer dividends at that point where they reject the investment with positive net present value. Droms (1990) argued that dividends are necessary for the prosperity of the firm in present as well as in future and normally a company's prosperity leads to dividend yield and this also increases the value of the stock.

2.2 Dividend Theories

The literature explains four dividend theories i.e.

2.2.1 Pure residual dividend policy

This policy states that when the firms return on equity capital exceeds then the rate of return, the investors could reinvest those dividends in another equallent risk's investment. Firm could reinvest the dividends on the behalf of investors rather than issuing the dividends. The firm determines the best option available to benefit the investors after determining its budget (Droms 218). Thus dividends are a function of fluctuations in earning of the firm. This policy results change in dividend from year to year and equity finance must be commenced to create a left over when the equity investment is greater than earning (Droms, 1990).

2.2.2 Smoothed residual dividend policy

This theory explains that dividend fluctuations are kept to a minimum level. According to Shapiro "Dividends are set equal to the long-run residual between forecasted earnings and investment requirements. Dividend changes, in turn, are made only when this long run residual is expected to change; earning fluctuations believed to be temporary are ignored in setting dividend payments. The clear preference is for a stable, but increasing, dividend per share" (Shapiro 532-533). Thus if earnings are low then dividends exceed the residual.

2.2.3 Constant Payout Residual Dividend Policy

This theory of dividend is very simple and this suggests maintaining a constant dividends payout ratio because this tends dividends to fluctuate directly with the earnings of the firm (Kania & Bacon,2005).

2.2.4 Small Quarterly Dividend with Annual Bonus

This theory suggests dividends to the investors only when the earning explains the expectations and according to this theory dividends are given to the investors periodically along with the annual bonus. Usually large scale firms work with this policy as they earn beyond their expectations. This policy is benefited to both the management (they have flexibility in earning) and to the investors (they get guaranteed dividend) (Kania & Bacon,2005).

2.3 Related Studies

Primarily dividends are based on the net income level of the organization and gradually adjusted to the change in income level. Literature shows that increase in the tax rate encourages corporate savings in the form of dividends. This is because retained earnings are not taxed without delay as compared to dividends. Capital gain is paid by the stock holders at the time of the sale of their stocks (Lintner, 1956). In addition to Lintner, Malkiel (1999) found that long term capital gain reduces the tax to a maximum of 20% and upper level tax rate on the dividends is 39.6%.

According to Baker and Powell (1999) dividends policy affect the firm's value. According to (Malkiel, 1999) cash dividends convey about the future profitability of the firm. Survey indicates that most of the big invertors use to announce dividends to know about the to access the firm's stock prices. For example steep drop in the company's dividends indicate bad about the future of the firm. Respondents were also uncertain about the bird in hand theory of the dividend. This theory indicates that high yield of dividends higher will be the firms value. Dividend represents increase in the share price of the firm because dividends are slightly less risky as compared to capital gain. A firms continuity in dividend suggests stability and consistent growth of the firm and this give investors confidence to invest in that firms stocks.

Hexter, Langrehr, and Holder (1998), found that there is negative correlation between corporate focus and the dividend payout ratio. This means that more corporate focus will reduces the dividend payout ratio of the firm. Smaller firms tend to have low dividend payout ratio as compared to the larger firms because they are corporate focused. It is also found that insider ownership and dividend payout ratios are inversely related to each other i.e. higher the insider ownership of the firm reduces its dividend payout ratio. Larger the number of shareholders and the greater cash flow leads to the greater dividend payout ratios.

Lazo's survey (1999) argued that most of the dividend paying companies (almost 87%) are of the view that dividends signal the future earning of the organization. On the other side of the same findings 93% of the respondents were of the view that stock buyback program is more effective as raising the dividends of the company.

Carlson (2001) has discussed few variables that affect the dividend decisions. Stock repurchase only explains a small part of the decline in dividend yield. Increase in the retained earnings and investment might also be the reason of the decline in the dividend yield. According to him the third reason for the decline in the dividend yield might be the rapid acceleration of stock prices. In crux if the stock prices of the organization accelerate then the dividend yield declines.

Kumar and Lee (2001) studied the determinants of dividend smoothing. Dividend smoothing is the method of choreography the time profile of earnings. He concluded that constant dividend payments do not disappoint the shareholders of the organization. While bankrupt, return on capital and investment have impact on the dividend policy.

2.4 Justification of variables

Banerjee, Gatchev & Spindt (2002), argued that there is inverse relation between shares turnover and dividend payout i.e. firms having lower share turnover are more likely to pay the dividends and vice versa. External financing is greater needed by the highly growth firms. Thus, most of the companies have established good reputation among the shareholders. Firms increase their reputation by issuing the dividends (LaPorta, Silanes, Schliefer & Vishny, 2000). We measure the growth with the estimated five years sale growth rate of the firm.

H1: sale growth is positively associated with dividend payout.

Higher stock price and higher price earning ratio (PE) leads to high dividend payout. In crux future cash flows can be secured by increasing the dividends which results increase the PE ratio and stock price. Puckett (1964), argued that a dollar given as dividend has almost four times greater impact on the stock price of the firm as compared to the retained earnings. High price earnings may be associated with the less risk and high dividend payout ratios, while low price earnings may be associated with the high or more risks and low dividend payout ratios. Thus,

H2: Price to earnings ratio is positively associated with dividend payout.

DeAngelo, DeAngelo, and Skinner (1992), argued that current income is another determinant of the dividend payout. Because most of the managers reduce their dividends when their earnings are poor and increase dividends when current earnings are better. This suggests that dividends are related to the earnings of the firm. However it is also reasonable to accept that all the all the firms with low income does not reduce dividends. We measure current earnings with earnings per share growth for the last five years. Thus,

H3: Last five years earning per share growth is positively associated with dividend payout.

Usually the firms with the huge profits likely to pay more dividends to its stock holders (Banerjee, Gatchev & Spindt, 2002). According to Lintner (1956) firms are traditional in their policies, as a result their dividend payout activity is characterized by degree of inertia. Moreover all the companies which are uncertain about their future profits, likely to hedge the risks by paying low dividend payouts (Friend & Puckett, 1964). Corporate dividend policy usually change with the change in its past profits, current profits and expected future profits (Darling, 1957). In the present study profitability is measured as the ratio of net income to equity. Thus

H4: There is negative association between profitability and dividend payout.

All the companies having high cash flows are less likely to cut off their dividends, and on the other hand high leverage increase the chances to cut the dividends. Such companies should not borrow more from the external parties to increase their debt financing; they should invest more to increase their equity financing (Benito & Young, 2001). High rate of retention are associated with heavy external financing. According to Friend & Puckett, (1964) rate of retention is positively associated with the external financing. Therefore higher the retention rate, the lower the dividend payout. Level of external financing is measured with debt to equity ratio. Hence

H5 : Debt to equity ratio is negatively associated with dividend payout.

3. Methodology

To select the determinants of decision making policy, all the listed companies with the web of Karachi Stock Exchange (www.kse.com.pk) were selected as population. There are 661 companies registered with the web of Karachi Stock Exchange according to the year 2009. Twenty one among the registered companies are belonging to the cement industry. Out of which 2 companies have been declared as defaulter by the state bank of Pakistan, so there are 19 registered working cement companies. Out of these 19 companies eight were chosen for analysis as sample on the basis of simple random sampling technique. Data was collected from the web of state bank of Pakistan and Karachi stock exchange from 2004-2009. To analyze the determinants of selected companies (OLS) ordinary Least Square regression was applied. We imperially test the independent variables on the firm's dividend payout ratio. Thus,

Dividend Decision (dividend payout) = f (profitability, price to earning ration, debt to equity ratio and estimated five years growth sale)

Table 1 : Variables and Hypothesis Supported by the Literature

Factor	Definition	Hypothesis Sign
Dividend payout ratio	Dividend / EPS	Dependent variable
Profitability	Net income / equity	Negative
Price to earnings ratio	Market value/ earnings per share	Positive
Debt to equity ratio	Long term debts/ equity	Negative
Five years EPS growth	Five years EPS growth	Positive
Five years growth sale	5 years growth rate	Positive

4. Data Analysis and Discussion

Table 2: Regression Results

Variables	BETA Coefficient	Hypothesized Sign	P Value
Profitability	-2.29	Negative	0.00
PE Ratio	0.189	Positive	0.21
Debt to Equity ratio	-2.33	Negative	0.34
EPS growth	0.048	Positive	0.004
Sales growth	0.294	Positive	0.09

R = 0.317
R Square = 0.100
N= 48

The results of regression are shown in the table 2; the value of R square of the table is 10%. This indicates that 10% of the change in dividend payout is due to the explained variables. From the early studies these variables were found to have 25-30% change in the dividend payouts but, those studies were conducted on the textile sector of European countries while the present study shows the results of cement sector of Pakistan. The results of the table also revealed that profitability is negatively related to the dividend payout at a significant level of 1%. Similarly debt to equity ratio is also negatively related with the dividend payout as was hypothesized. The results indicate a positive relationship of price earning ratio, earning per share growth and sales growth with the dividend payout. As observed earlier that high dividend payout is associated with the high price to earning ratio. Raising the amount of dividend reduces the future risks and this increases PE and stock price as well. Furthermore it was also found in literature that high growth firms need more external financing and for this they try to increase their good will among the external parties to attract them for more equity through higher dividend payout (LaPorta et al., 2000).

4.1 Limitation and direction for future studies

This present study was an attempt to find the determinants of dividend policy among the cement industries of Pakistan. In future other sectors (i.e. textile, automobile etc.) should be kept in mind. In the present study only five explained variables were selected other factors (i.e. current ratio, leverage etc.) also been explored by the future researchers.

5. Conclusion

The aim of this study was to find out the factors of dividend policy among cement sector of Pakistan. To analyze the factors a sample of eight cement companies (2004-2009) was taken from the web of Karachi Stock Exchange and State Bank of Pakistan. It was found that higher the PE of an organization, lower the risks and higher is its dividend payout ratio. Similarly earning per share growth and sale growth also leads to dividend payout.

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