

Stability And Role Of Dividends Payout Among Public Firms At Nairobi Securities Exchange

Dennis Bulla, Prof. G.S. Namusonge, Prof. C.L. Kanali

Department of Accounting and Finance, Masinde Muliro University of Science & Technology, P.O.Box 190-50100, Kakamega, Kenya

Jomo Kenyatta University of Agriculture & Technology, P.O. Box 62000-00200, Nairobi, Kenya,

Jomo Kenyatta University of Agriculture & Technology, P.O.Box 62000-00200, Nairobi, Kenya

Corresponding Author: Dennis Bulla

Abstract: Stable dividends reduce uncertainty in the financial market. This reduces cost and in turn enhance shareholder wealth. Scholars have argued that developing stock markets do not follow stable dividend path and the outcome could be depressed stock price. The study investigated the hypothesis of unstable payout in growing stock markets by providing empirical evidence of dividend stability from public firms at the Nairobi Securities Exchange. Panel data for the period of 11 years is used to estimate coefficients of adjustment speed and target ratio which is then interpreted based on the partial adjustment dividend model. The results indicate that dividend payout in this stock market is fairly stable and depends on previously paid dividends although some sectors payout is not consistent with market expectation. In addition, dividends play a signaling role in the market possibly because of asymmetric information and agency cost concerns.

Key words: Dividend stability, Nairobi Securities Exchange, Dividend payout,

Date of Submission: 14-08-2017

Date of acceptance: 05-09-2017

I. Introduction

Profitable companies regularly face three important questions. (1) How much of free cash flow should it pass on to shareholders? (2) Should it provide this cash to stockholders by raising the dividend or by repurchasing stock? (3) Should it maintain a stable, consistent payment policy, or should it let the payments vary as conditions change? [1]. Components of dividend stability are two (i) How dependable is the growth rate and (2) can we count on at least receiving the current dividends in future? Stable dividends is a policy pursued by firms that believe cash payout signal investors in the market about the future earnings and financial strength of a company. While stable dividends previously meant paying the same amount of dividends every period, today it means low dividends which grow steadily over time due to growth expectations and inflation. This school of thought is supported by signaling, bird in hand and agency cost hypotheses championed by [2] and [3] who contend that investors value a dollar of expected dividends more highly than a dollar of expected capital gains. Therefore maintaining a given dividend trend line that is steadily rising maximizes stock value. Stable dividends are kept minimum and do not react to short term changes in earnings. Changes in dividends under this policy only occur after profitability forecast of the firm has been adjusted [4].

The debate about stability of dividends among public companies was first provoked by [5]. He provided the model for computing coefficients that would indicate presence (or not) of dividends stability which is also referred to as smoothing. The theory famously known as the partial adjustment dividend theory which was later modified by [6] is used to determine degree of smoothing or stability of dividends for the public firms at the NSE. Stability of dividends is important to investors and firms because profits and cash flows vary over time while consumption needs are stable and rising. A reduction in dividends could send the wrong signal to the market that may the push down prices of stocks.

Nairobi Securities Exchange (NSE) had sixty two listed firms in eleven sectors by December, 2016. The firms pay dividends that vary by industry or even individual firms in any industry. Scholars continue to differ on payout behavior of firms in different markets. However share prices have been observed to decline more when dividends are reduced or omitted but prices rally when dividends are increased. The hypothesis of irregular payout posited by [7] for developing markets motivates this study in an attempt to provide empirical evidence of dividend stability for public companies at the NSE. This paper attempts to address the issue using panel data from the Nairobi Securities Exchange in the period 2000 to 2010. The paper is organized as follows; the next section describes the problem investigated and is followed by objectives, scope and justification. A discussion of relevant literature and methodology is made in subsequent section. Thereafter results are discussed and conclusion presented to show importance and contribution made to the field of dividend theory.

Problem Statement

Emerging market firms' dividend behavior is irregular compared to that of the developed markets as posited by [7]. They studied dividend payout behavior of large industrial firms in the USA and compared with a sample of public firms in developing economies. Their conclusion that emerging firms pay irregular dividends compared to stable dividends in developed economies require empirical evidence in order to support their theory. The paper therefore seeks to provide empirical support for the hypothesis that emerging market firms' dividend payout is irregular using panel data of 40 qualifying firms. The dividend period spans 2000 to 2010 with analysis conducted for the nine sectors at the NSE.

Objectives

General objective is to determine level of consistency of dividend payment by public firms listed at the NSE.

Specific objectives

1. To examine degree of stability of dividends for firms listed in the nine sectors of the Nairobi Securities Exchange.
2. To determine whether or not dividends play a signaling role at Nairobi Securities Exchange.

Hypotheses

H₀1: Dividend payout by firms listed at the NSE over the study period is irregular across sectors.

H₀2: Dividend payout by firms listed at the NSE does not signal investors in the market.

Scope of Study

The study analyses empirical data of forty listed companies at NSE with a history of dividend payment from the year 2000 to 2010. The companies represent all the sectors of the market although one sector (investment) was underrepresented with only one company. The findings and interpretations are based on computation of coefficients of adjustment speed and target ratio.

Justification of study

The study was necessary because no similar study in the knowledge of the author has been done to determine stability of dividend payment by listed firms at the NSE. This may help investors who prefer dividends to capital gains make better investment decisions while corporate managers improve on their investment and financing decisions to enhance shareholder wealth.

II. Literature Review

Dividend Policy

Dividend policy is a strategy of sharing earnings between the business and stockholders. It is the decision to distribute earnings to shareholders and or retain earnings to finance growth [4]. Therefore dividend policy is part of firm's long term financing strategy. Dividend policy issues have been concerned with "how much" dividend to pay "when" and with what approach for consistency. Three policies emerge as most widely supported in finance literature.

Smoothed Residual Dividend Policy

This policy asserts that dividend payment is kept at minimum. Companies using this policy delay paying dividend and do not react to short term changes in earnings. Dividend per share is kept stable and only altered if long term profitability forecast of the firm has been adjusted [4]. A low dividend adjustment rate relative to target payout ratio characterizes dividend smoothing.

Pure Residual Dividend Policy

This policy compares between a firm's return on equity and the rate of return that an investor could achieve if they invest their dividend in an alternative venture. By achieving a high return on equity than an equally risky investment in the market, a firm would rather reinvest dividends (plowback) rather than pay it out [4]. Dividends can only be paid out as residual funds after the firm's capital needs have been met. Dividends paid out in this policy fluctuate widely since the decision is purely a residual one; also supported by the free cash flow theory.

Constant Payout Residual Dividend Policy

This policy advocates for constant dividend payout. Payout ratio is maintained constant by adjusting dividend paid out in relation to quarterly or annual earnings results [9]. In this policy, the actual level of dividends paid remains the same each year. In case earnings increase, more of it is retained to maintain a flat

payout. Conversely when earnings fall, retentions reduce since drawings are made to meet the shortfall in dividends paid out to maintain the level.

Stable Dividends

Stability of dividends has been explained by [5], [6] and [8] using regression models constructed to determine values of speed of adjustment and target payout ratio. Lintner's partial adjustment model estimates coefficients for adjustment speed and target payout to determine whether dividend policy is stable or not. [5] contends that dividends are adjusted to changes in earnings but only with a lag. He argues that when earnings increase to a new level, a company increases dividends only when it feels it can maintain the increase in earnings (cited in [9]). Smoothing of dividends which also refers to stability has been explained by agency issues or information asymmetry [10]. In order to reduce the agency-principal conflict, dividend stability is pursued so as not to cause unnecessary price volatility for publicly listed firms due to uncertainty. Therefore, reducing uncertainty stemming from unpredictable dividend payouts make managers opt to establish a stable growth path of dividend payments.

When [5] questioned managers on their attitudes toward dividend policy in his seminal paper, he concluded that managers targeted long term payout ratio. Dividend payment was found to be sticky, tied to long term sustainable earnings paid by mature companies and smoothed from year to year. Other scholars have since supported this argument [6] and [11]. While literature has not adequately explained why firms are reluctant to cut dividend or even appear to smooth dividends, one of the reasons that can be attributed to this occurrence is investors' reaction to such announcement. Share value has been observed to decline by a larger magnitude immediately after dividend omission announcement than when dividend payment is announced [12].

Specifically, findings from [5] study of public firms in the USA between 1947 and 1953 indicated a strong and significant correlation between current dividends paid, current earnings and previous dividend. Among public firms, a dividend smoothing behavior is evident by significantly low values of speed of adjustment relative to target ratio. The reverse indicates no smoothing and thus evidence of wide swings in dividend payment. The motivation to smooth out dividend may be attributed to the scrutiny by the capital markets where agency conflict and information asymmetry is prevalent. Low values for adjustment speed mean that with higher earnings shock, more of the surplus funds are retained and vice versa for lower earnings shock.

Elsewhere, [13] investigates how firms grouped into private and public, responded to transitory earnings in the United Kingdom. They discovered that response of dividends to transitory earnings shocks vary significantly across the three groups of firms (private dispersed, private and public firms). They concluded that private firm's dividend policies are significantly more sensitive to transitory earnings shocks in contrast to public firms. Empirical evidence provided by *ibid* shows that public firms follow a unique strategy of paying relatively numerous but small increases in their dividend coupled with a strong aversion to any negative or large changes. In their findings public firms targeted a payout ratio of 21% of any transitory earnings shock followed by an adjustment speed of 41% to smoothen the trend.

Empirical evidence of dividend smoothing has been explained by a strong correlation between current dividend and previous dividends [5]. It is determined using a partial adjustment dividend model regressing current earnings with changes in dividend paid per share. He arrived at value of speed of adjustment and target payout ratio as 30% and 50% respectively for US non-financial firms in 1956. Conversely [6] realized 37% for adjustment speed and a target ratio of 50%. This study used [6] model to estimate the parameters for target payout and speed of adjustment so that with a higher target payout and lower adjustment speed, smoothing motive would be evident. A low payout ratio and high speed of adjustment according to [14] signify low smoothing and hence instability of dividend payout policy.

III. Research Methodology

The framework of study was inspired by [5] partial adjustment model which was later modified by [6] dividend model. A multiple regression technique was used to compute coefficients of speed of adjustment " α " and target payout ratio " β " respectively from panel data of 40 firms for the period 2010 to 2010. Data was obtained from NSE data vendor containing annual after tax earnings, declared dividends, and market prices of shares for each listed company over the duration of study. Firm-year observations for dividends paid per share were regressed against changes in earnings per share and previous dividends. A higher speed of adjustment and lower target payout signifies instability or absence of smoothing. Conversely, a higher target payout and low speed of adjustment coefficient mean that corporate managers of listed firms are motivated by smoothing of dividends. Literature on stability of dividends for public firms has been documented especially for developed markets [7], [15], and [13].

IV. Results And Discussion

Dividend stability

The model (1) below by [6] modifies [5] by regressing dividend paid per share against changes in earnings and absolute levels of previous dividends. This equation was used to determine the coefficients for speed of adjustment and target ratio which explain degree of stability of dividends for the market and the sectors.

$$DPS_{it} = \alpha + \beta_1 \Delta EPS_{it} + \beta_2 DPS_{it-1} + \epsilon_{it} \quad (1)$$

The estimated equation (2) using data from the Securities exchange indicates that the goodness of fit is 77.8 percent. This result implies the model is correctly specified given the F-ratio that is significant. Autocorrelation was not a problem in the model from the Durbin-Watson value of near 2.0

$$DPS_{it} = 0.154 + 0.03 \Delta EPS_{it} + 0.824 DPS_{it-1} \quad (2)$$

| | | | |
|----------------|--|---------|---------|
| Se | (0.034) | (0.003) | (0.023) |
| t | 4.576 | 9.0 | 35.894 |
| P | 0.000 | 0.000 | 0.000 |
| R ² | = 0.778 | | |
| F | = 672.203 (2,382) P = 0.000 DW = 2.155 | | |

The goodness of fit statistic (R²) means that about 78% of the dividend payments by firms for the period are accounted for by changes in earnings and previously paid dividend. A change in previous dividends by a shilling increases current dividend payout by shs. 0.82. This means previously paid dividends to a large extent predict current dividends. That 82% of current dividends are attributable to previous dividends. A change of earnings per share by a shilling would increase current dividends by Kshs.0.03. per share. Therefore earnings change have a small contribution to current dividends of only 3%. The mean DPSt for the market is Kshs.0.154 per share. Prior dividends alone explain 75% of the 78% of the variation in dividends paid per share. According to [6] the two coefficient are computed from; $\sigma = (1-\beta_2)$ and target ratio $\beta_1 / 1 - (1-\beta_2)$. This gives the speed of adjustment toward the target ratio as 18% while the target ratio which is the proportion of earnings change paid out as dividends is 3.65%. This result shows that listed firms at the exchange fairly stabilize dividends arising from positive earnings change. The probable reason for targeting a small fraction of the change in earnings for distribution is high cost of raising external capital so that internal financing is preferred. While USA stock market exhibited evidence of dividend smoothing, the NSE data also provides evidence of some dividend smoothing.

Dividend Stability by Various Sectors

Panel data was analyzed by sector to determine extent of smoothing by firms in the respective industries. A low adjustment speed toward the target pay out signify smoothing otherwise a high speed of adjustment relative to target payout imply absence of smoothing. Smoothing is also inferred from strong relationship between current and previously paid dividends. A summary of the computed coefficients and the implied degree of stability is presented below.

Table 1: Summary of Stability Results by Sector

| Sector | SOA% | TPR% | DPR% | Degree of Stability | R ² | F-STAT |
|---------------|------|------|------|---------------------|----------------|--------|
| Agriculture | 36 | 6 | 32 | Moderate | 0.61 | 50.8 |
| Automobile | 40 | 2 | 7.5 | Moderate | 0.34 | 0.8 |
| Banking | 3 | 5 | 39 | Strong | 0.93 | 565 |
| Commercial | 6 | 0.5 | 28 | Strong | 0.89 | 190.7 |
| Construction | 25 | 8 | 54 | Fairly strong | 0.66 | 48.2 |
| Energy & Pet | 26 | 3 | 21 | Fairly strong | 0.49 | 14.7 |
| Insurance | 38 | 5 | 21 | Moderate | 0.36 | 6.4 |
| Manufacturing | 11 | 0.9 | 68 | Strong | 0.95 | 306 |

Dividend Smoothing at the NSE

Dividend stability is measured by the relationship between two coefficient namely target payout ratio and adjustment speed derived from regression techniques. Thus far results demonstrate that firms at the Nairobi Securities Exchange are motivated by stability of dividends to different degrees. Sectors like banking, commercial, and manufacturing were smoothing dividends more than construction and energy sector where smoothing was fairly strong. Sectors showing moderate smoothing according to data analysed were Agriculture, Automobile and Insurance. Investors looking toward steady dividend returns as their preference would therefore have to select their stocks carefully since payout consistency is not uniform across the sectors. Therefore more smoothing would be necessary to stabilize stock value for high risk sectors and less smoothing for low risk sectors presented in Table 2 based on the price earnings ratio computed.

Table 2: Risk Ranking for the Various Sectors

| No. | Sector | Mean P/E | Risk Level | Rank |
|-----|--------------------------|----------|------------|------|
| 1. | Agriculture | 6.76 | High | 7 |
| 2. | Automobile & Accessories | 0.11 | High | 9 |
| 3. | Banking | 18.5 | Low | 1 |
| 4. | Commercial Services | 17.2 | Low | 2 |
| 5. | Construction | 14.12 | Low | 4 |
| 6. | Energy & Petroleum | 8.11 | High | 6 |
| 7. | Insurance | 3.3 | High | 8 |
| 8. | Investment | 14.2 | Low | 3 |
| 9. | Manufacturing | 10.9 | Low | 5 |

Dividends Relationship with Market Value of Stocks

Is there significant difference in market value between dividend payers and non-payers? The signaling role of dividend mean dividend are used to convey information about quality of a firm in terms of financial strength and future prospects. This is to say there is a strong relationship between dividend and firm value since investors use it to deal with the agency problem and information asymmetry in the capital market. This is the reason managers are usually reluctant to reduce dividend or even omit altogether unless the move is temporary.

An analysis of the relationship between DPS_{it} and market value of a share (MPS) yielded results at the 0.05 level indicating that with 425 observation 2 tailed test, the correlation coefficient between market price per share and dividend per share is 0.701 or 0.7 and $P = 0.000$ (Table 3).

Table 3: Correlation of Dividends and Market value

| | | Current Market price per share |
|----------------------------|----------------------------|--------------------------------|
| Current dividend per share | Pearson Correlation | .701** |
| | Sig. (2-tailed) | .000 |
| | N | 425 |

** . Correlation is significant at the 0.01 level (2-tailed).

The correlation is strong indicating a strong positive association between MPS and DPS. Hence dividends do signal information about the market for investors. Consequently failure to pay dividend would signal problem with a company. This may result in reduced market value of the share. The outcome is consistent with a [18], [17], and [11], Listed companies would improve value by consistently paying dividend since this shall signal better prospects for the company in future and reduce variability in market price.

V. Conclusion

Corporate managers of listed firms are *motivated* by stability to varied degrees. Dividends policy pursued is that of the pure residual which address the investment and financing needs of the firm and to reduce agency costs. [7]posited that emerging market firms’ dividend behavior is irregular compared to that of the developed markets. The findings of this study failed to support this hypothesis. Investors appear to look out for dividends as incomes and the information content conveyed by dividends about future prospects. Managers supported this expectation by stabilizing dividends to different extent. Hence dividends play an important signaling role in the market.

Since wealth maximization is the single fundamental objective of finance managers, public firms at the exchange do not appear to pay dividends in a manner that would steadily enhance value. When it comes to the decision to either increase, decrease or leave dividends uncharged, investors favour dividend changes rather than leaving them unchanged. This was signified by adverse market reaction when dividends are left unchanged compared to value of firms that make changes in dividends.

VI. Recommendations

Results of study showed that dividend payout decisions are made with some level of consideration for stability or smoothing. It was evident that investors are willing to pay a premium for stocks paying dividends. Therefore, corporate managers may need to consider establishing a more steady or consistent dividends path (low SOA) especially for high growth firms/sectors (Banking, Commercial, Construction, and Manufacturing) to signal the market and to mitigate information asymmetry problems. There should be less smoothing (high SOA) in sectors experiencing less growth opportunities (Agriculture, Automobile, Energy and Insurance) to control agency costs. This will most likely improve corporate value by reducing volatility of stock price in the market. On the basis of risk which is a significant predictor of payout, more smoothing should be seen in high risk industries like Agriculture, Automobile, Energy and Insurance to mitigate agency costs due to diminished investment opportunities and information asymmetry between investors and managers. Less smoothing should

be applied to low risk industries like Banking, Commercial, Construction, and Manufacturing sectors due to signaling expectation.

Thus far the study has raised further questions regarding dividend decisions by listed firms at the NSE. The questions would be important to guide further inquiry so as to deepen our understanding of the market and extend literature on determinants and dynamics of dividend policy. These questions are; one why corporate managers do not share a common view toward stabilizing dividends when the market appear to prefer stable dividends? Two is there a difference between dividend payout stability between banking and non- banking firms?

References

- [1]. Ehrhardt, M.C., &Fama, E. (2017). Distributions: dividends and share repurchases. *Corporate Finance (6thed)*. A focused Approach. Cengage, P. 507.
- [2]. Gordon, M.J. (1963). Optimal investment and financing policy. *Journal of finance*, 18 (2) 264-272
- [3]. Lintner, J (1962). Dividends, earnings, leverage, stock prices and the supply of capital to corporations. *Review of Economics and Statistics*, 4 (4), 243-269.
- [4]. Kyle, A.P. & Frank W.B. (2013). Dividend policy and stock price volatility in the US Equity capital market. *ASBBS Annual Conference 20(1)*.219-231.
- [5]. Lintner, J. (1956). Distribution of income of corporations among dividends, retained earnings and taxes. *American Economic Review*, 60: 1-40.
- [6]. Fama, E.F &Babiak, H.(1968). Dividend policy: An empirical analysis.*Journal of the American Statistical Association*, 1132-1161.
- [7]. Aivazian, V., Booth, L., &Clearly, S.(2003). Do emerging market firms follow different dividend policies from U.S. firms? *Journal of Financial Research*,26(3), 371- 387.
- [8]. Wolmaran, H.P. (2003). Does Lintner's dividend model explain South African dividend payments? *Meditari Accountancy Research*, 11, 243-254.NewYork: HarperCollins.
- [9]. Van Horne, J. &Dhamija, S. (2012). *Financial management and policy* (12ed). Pearson, pp 374-376.
- [10]. Servaes, H. &Tufano, P. (2006). The theory and practice of corporate dividend and share repurchase policy (ed). *Liability Strategies Group. Deutsche Bank*, 1-73.
- [11]. Brav, A, Graham, J, Harvey, C &Michaely, R. (2005). Payout Policy in the 21st Century, *Journal of Financial Economics*, 77, 383-527.
- [12]. Michaely,R., Thaler,R.H.&Womack,K.(1995).Shareholder heterogeneity, adverse selection, and payout policy. *Journal of Finance*, 50, 573-608.
- [13]. Michaely, R. & Roberts, M.R. (2012).*Corporate Dividend Policies: Lessons from Private firms*. Available from www.oxfordjournals.org.
- [14]. Ahmed,H&Attiya,J.Y.(2009).Determinants of dividend policy of Pakistan. *International Research Journal of Finance and Economics*, (29) 110-125.
- [15]. Stulz, R. M. (2000). Merton Miller and modern finance. *Financial Management*, 29(4), 119-131.
- [16]. Dhanani, A. (2005). Corporate dividend policy: The views of British financial managers. *Journal of Business Finance & Accounting*, 37(7) & (8), 1625 - 1672.
- [17]. Ochieng, D. &Kinyua, W.H. (2013). Relationship between inflation and dividend payout for companies at the NSE. *International Journal of Education and Research*,(6) 1-8.
- [18]. Maniagi, G.M., Ondieki, B.A., Musiega,D., Maokomba, O.C., &Egessa,R.(2013)Determinants of dividend policy among non-financial firms at Nairobi Securities Exchange. *International journal of scientific & Technology Research*, 2 (10) 253-266.

Dennis Bulla. "Stability And Role Of Dividends Payout Among Public Firms At Nairobi Securities Exchange." *IOSR Journal of Economics and Finance (IOSR-JEF)* , vol. 8, no. 4, 2017, pp. 72-77.