THE INFLUENCE OF DIVIDEND POLICY ON FIRM’S VALUE

Author: Modoran Alexandru
Coordinator: prof. Laura Obreja

Abstract
This paper attempts to explore the possible links between dividend policy and stock price behaviour in Romanian corporate sector. A sample of 6 listed companies from Bucharest Stock Exchange are examined for the years 2005-2012. Dividend policy has always been a source of controversy despite years of theoretical and empirical research both in developed countries and emerging economies. The present paper features a panel data approach to analyze the relationship between dividend ratio and stock-price behaviour while controlling variables like leverage, real GDP growth, market return. This paper also addresses the impact that dividend reports carry on trading prices.

Keywords: dividends, dividend policy, stock price, return, investors.

Introduction
Dividend policy has been an issue of interest in financial literature since Joint Stock Companies came into existence. Dividends are commonly defined as the distribution of earnings (past or present) in real assets among the shareholders of the firm in proportion to their ownership. Dividend policy connotes to the payout policy, which managers pursue in deciding the size and pattern of cash distribution to shareholders over time. Managements’ primary goal is shareholders’ wealth maximization, which translates into maximizing the value of the company as measured by the price of the company’s common stock. This goal can be achieved by giving the shareholders a “fair” payment on their investments. However, the impact of firm’s dividend policy on shareholders wealth is still a debatable issue.

Dividends are commonly defined as the distribution of earnings (past or present) in real assets among the shareholders of the firm in proportion to their ownership. There are three parts of this definition. The first is that dividends can be distributed only from earnings and not from any another source of equity. The second is that dividends must be in the form of a real asset. It is common practice to pay dividends in cash because of the convenience of the matter. Regardless, evidence shows that some firms during high levels of inflation have
paid dividends in the form of the product they were producing. The third part of the definition states that all stockholders share in dividends relative to their holding in the corporation. This part of the definition accounts for what are the least desirable characteristics of dividends.

**Dividend Policy & Share prices**

The dividend policy of a firm becomes the choice of financial strategy when investment decisions are taken as given. It is also imperative to know whether the firm will go for internal or external source of financing for its investment project. There are a number of factors affecting the dividend policy decisions of a firm such as investor’s preference, earnings, investment opportunities; annual vs. target capital structure, flotation costs, signaling, stability & Government policies and taxation. In the presence of asymmetric information, signaling is one of the crucial factors that influence the market. Dividends may convey information about the company, so it suggests the possibility of its influence on the stock market. Paying large dividends reduces risk and thus influence stock price (Gordon, 1963) and is a proxy for the future earnings (Baskin, 1989).

Baskin (1989) takes a slightly different approach and examines the influence of dividend policy on stock price volatility, as opposed to that on stock returns. He advances four basic models which relate dividends to stock price risk. He terms these as the duration effect, the rate of return effect, the arbitrage pricing effect and the informational effect. The difficulty in many empirical works examining the linkage between dividend policy and stock volatility or returns lies in the setting up of adequate control over the factors that influence both. For example, the accounting system generates information on several relationships that are considered by many to be measures of risk. Baskin (1989) suggests the use of the following control variables in testing the significance of the relationship between dividend yield and price volatility are operating earnings, the size of the firm, the level of debt, the payout ratio and the level of growth. So he had tried to explain the underlying linkage between dividend policies (dividend yield and dividend payout ratio) and stock price risk in his empirical work on USA.

A number of theoretical mechanisms have been suggested that cause dividend yield and payout ratios to vary inversely with common stock volatility. As dividends can be cash dividends, stock dividends, stock splits & share repurchases, the question comes about the nature of the dividend & its impact on the share price and whether market is more volatile to high dividend yield share than normal share comes into the picture. There is a need to study
the sensitivity of market to the nature of dividends. The linkage between dividends & share price should be examined by controlling other factors which are responsible for affecting the dividend policy of a firm.

**Dividend irrelevance proposition: Modigliani & Miller approach (1961)**

In 1961, two noble laureates, Merton Miller and Franco Modigliani (M&M) showed that under certain simplifying assumptions, a firms’ dividend policy does not affect its value. The basic premise of their argument is that firm value is determined by choosing optimal investments. The net payout is the difference between earnings and investments, and simply a residual. Because the net payout comprises dividends and share repurchases, a firm can adjust its dividends to any level with an offsetting change in share outstanding. From the perspective of investors, dividends policy is irrelevant, because any desired stream of payments can be replicated by appropriate purchases and sales of equity. Thus, investors will not pay a premium for any particular dividend policy.

M&M concluded that given firms optimal investment policy, the firm’s choice of dividend policy has no impact on shareholders wealth. In other words, all dividend policies are equivalent. The most important insight of Miller and Modigliani’s analysis is that it identifies the situations in which dividend policy can affect the firm value. It could matter, not because dividends are “safer” than capital gains, as was traditionally argued, but because one of the assumptions underlying the result is violated. The propositions rest on the following four assumptions:

- Information is costless and available to everyone equally.
- No distorting taxes exist
- Flotation and transportation costs are non-existent
- Non contracting or agency cost exists

**Dividend policy and agency problems**

The level of dividend payments is in part determined by shareholders preference as implemented by their management representatives. However, the impact of dividend payments is borne by a variety of claim holders, including debt holders, managers, and supplier. The agency relationship exists between

- The shareholders versus debt holders conflict, and
• The shareholder versus management conflict

Shareholders are the sole receipts of dividends, prefer to have large dividend payments, all else being equal; conversely, creditors prefer to restrict dividend payments to maximize the firm’s resources that are available to repay their claims. The empirical evidence discussed is consistent with the view that dividends transfer assets from the corporate pool to the exclusive ownership of the shareholders, which negatively affects the safety of claims of debt holders.

In terms of shareholder-manager relationships, all else being equal, managers, whose compensation (pecuniary and otherwise) is tied to firm profitability and size, are interested in low dividend payout levels. A low dividend payout maximizes the size of the assets under management control, maximizes management flexibility in choosing investments, and reduces the need to turn to capital markets to finance investments. Shareholders, desiring managerial efficiency in investment decisions, prefer to leave little discretionary cash in management’s hands and to force managers to turn to capital markets to fund investments. These markets provide monitoring services that discipline managers. Accordingly, shareholders can use dividend policy to encourage managers to look after their owners’ best interests; higher payouts provide more monitoring by the capital markets and more managerial discipline.

Research on corporate dividend policy determinants

Black (1976) in his study concluded with the following question: “What should the corporation do about dividend policy? We don’t know.” A number of factors have been identified in previous empirical studies to influence the dividend policy decisions of the firm. Profits have long been regarded as the primary indicator of the firm’s capacity to pay dividends. Lintner (1956) conducted a classic study on how U.S. managers make dividend decisions. He developed a compact mathematical model based on survey of 28 established industrial U.S. firms which is considered to be a finance classic. According to him the current year earnings and previous year dividends influence the dividend payment pattern of a firm. Fama and Babiak (1968) studied the determinants of dividend payments by individual firms during 1946-64. The study concluded that net income seems to provide a better measure of dividend than either cash flows or net income and depreciation included as separate variables in the model. Baker, Farrelly and Edelman (1986) surveyed 318 New York stock exchange
firms and concluded that the major determinants of dividend payments are anticipated level of future earnings and pattern of past dividends.

Pruitt and Gitman (1991) asked financial managers of the 1000 largest U.S. and reported that, current and past year’s profits are important factors influencing dividend payments and found that risk (year to year variability of earnings) also determine the firms’ dividend policy. Baker and Powell (2000) concluded from their survey of NYSE-listed firms that dividend determinants are industry specific and anticipated level of future earnings is the major determinant.

In other studies, Rozeff (1982), Lloyd et. al. (1985), and Collins et. al. (1996) used beta value of a firm as an indicator of its market risk. They found statistically significant and negative relationship between beta and dividend payout. D’Souza (1999) also found statistically significant and negative relationship between beta and dividend payout.

D’Souza (1999) however showed a positive but insignificant relationship in the case of growth and negative but insignificant relationship in case of market to book value. Alli et.al (1993) reveal that dividend payments depend more on cash flows, which reflect the company’s ability to pay dividends, than on current earnings, which are less heavily influenced by accounting practices. Green et. al.(1993) questioned the irrelevance argument and investigated the relationship between the dividends and investment and financing decisions. Their study showed that Dividend decision is taken along with investment and financing decisions. The results however do not support the views of Miller and Modigliani (1961). Dhrymes and Kurz (1967) and McCabe (1979) found that the firm’s investment decision is linked to its financing decision. Higgins (1972), Fama (1974), and Smirlock and Marshall (1983) documented no interdependence between investments and dividends.

Higgins (1981) indicated a direct link between growth and financing needs: rapidly growing firms have external financing needs because working capital needs normally exceed the incremental cash flows from new sales. Rozeff (1982), Lloyd et.al.(1985) and Collins et al .(1996) all show significantly negative relationship between historical sales growth and dividend payout.

Arnott and Asness (2003) based their study on American stock markets (S&P500) and found that higher aggregate dividend payout ratios were associated with higher future earnings growth. Both Zhou and Ruland (2006) and Gwilym et.al. (2006) supported the findings of Arnot and Asness. Zhou and Ruland examined the possible impact of dividend payouts on future earning growth. Their study used a sample of active and inactive stocks
listed on NYSE and NASDAQ with positive, non-zero payout ratio companies covering the period from 1950-2003. Their regression results showed a strong positive relation between payout ratio and future earnings growth. Mancinelli and Ozkan (2006) undertook an empirical investigation of the relationship between the ownership structure of companies and dividend policy using 139 firms listed in Italian exchange. Their results suggested that the dividend payout ratio is negatively associated with the voting rights of the largest shareholders.

Mohammed Amidu and Joshua Abor (2006) examined the factors affecting dividend payout ratios of listed companies in Ghana. The results of their study showed that payout ratios were positively related to profitability, cash flow and tax but are negatively related risk and growth.

CONCLUSION

The objective of this study is to determine the impact of dividend policy on stock price return in Pakistan. A sample of 6 listed companies in Bucharest Stock Exchange is examined for a period from 2005 to 2012. The empirical estimation is based on a cross-sectional regression analysis of the relationship between stock price return and dividend policy after controlling variables like leverage, real GDP growth, market return.

Both dividend yield and market return have significant impact on the share price return. This suggests that dividend policy affects stock price return and it provides evidence supporting the arbitrage realization effect, duration effect and information effect in Romania. Although the results are not robust enough as in the case of developed markets but are consistent with the behaviour of emerging markets.

Dividend policy has evolved and adjusted in response to changing business conditions, market parameters and regulations. By understanding that dividend policy has evolved and did not just appear in its current form provides important perspectives about why dividend policies vary widely across firms and over time.
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