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Factors Affecting the Firm Dividend Policy: An Empirical Evidence from Textile Sector of Pakistan

Mula Nazar Khan [1], Muhammad Umair Naeem[2], Muhammad Rizwan [3] and Muhammad Salman [4]

[1,2,3,4] Hailey College of Commerce, University of the Punjab, Lahore, Pakistan

Abstract

The Decision regarding the dividend policy is a controversial issue in the area of finance. The questions that arise are that when and how firm pay dividend. The main purpose of the study is to investigate the factors that determine the dividend payout ratio and to examine the relationship between these factors and dividend payout ratio. The study also investigates the impact of these factors on dividend policy of the firm. The results indicate that there is a high significant negative relation between profitability and dividend payout ratio. There is the high significant negative relation between leverage and dividend payout ratio. Firm Size and P/E ratio does not have any impact on the dividend payout ratio. The study is helpful for corporate managers in making the optimal decisions.

Keywords: *Corporate, Dividend policy, Payout ratio, Stock exchange*

1. Introduction

The belief that dividend policy is an important attribute of corporate finance and its practical implications for many groups of companies and stakeholders (investors, managers, lenders) is not new. It was examined that companies which are performing well and generating more income they have different ways where they put such generated income for better use. The residual theory of dividend described that there is a common tendency to reinvest the profit of the companies in the business due to the clientele effect because there have been a great pressure on companies to pay dividends.

"The harder we look at the dividend picture the more it seems like a puzzle, with pieces that just do not fit together" (Black, 1976). Dividend policy is one of the most arguable topics and researched area of corporate finance.

There are three different beliefs in this consideration. On the right, there are some believers who believe that the value of the firm's will increase when we increase the dividend payout they are known as conservative group. On the left, there is a radical group that believes the value of the firms will be reduced due to the increase in the dividend payout ratio. And, in the center, there are some theorist who believed that the payout policy makes no difference which are known as Miller and Modigliani (MM) (Myers & Majluf, 1984). In a hypothetical paper MM showed the irrelevance of the dividend decision in the world without taxes, transaction cost or other market fault. (Miller & Modigliani, 1961).

It is beneficial to note that most of the studies on dividend policy have been conducted in the developed economies. There are very limited studies which have been done in the developing/ emerging economies (especially in Pakistan), as a result creating a huge knowledge gap.

Objective of the study

The main objective of this study is

1-To examine the factors that determine the dividend policy decision

2-To investigate the relationship between these factors and Dividend payout ratio

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2. Literature Review

2.1 Theoretical Literature Review

2.1.1 MM Irrelevance Hypothesis

MM reported in his publication since 1961 that with regard to the assumption of perfect capital market, yield rate and market value will not be affected by the decisions of the firm regarding dividend policy. They claimed that the distribution of income doesn't affect the value of business because it is decided on 2 factors: one is its ability of earning and the second one is its investment decision

2.1.2 Bird-in-hand Hypothesis

. This hypothesis describes that if the large amount is circulating among shareholder in the form of dividend then it will affect the worth of a firm positively. Scholars and specialists have strongly believe on it until the MM publication of 1961. The protagonists of this hypothesis said that perfect capital market assumptions are exactly not possible in reality that why dividends and capital gains can't be valued identically. Therefore, investors consider cash dividends also called "bird-in-hand" better than future capital gains also called "two-in-the-bush".

2.1.3 Clientele Effects Theory

This theory recommended that company decisions of dividend policy don't have the same impact on all the investors. Though some investor's choices are those companies which will pay more cash dividend, while other investors may like those companies which kept their profit portions for investment purpose. Sometimes tax rate is different in case of dividend and capital gain, which influence directly investor choice and their behaviors.

2.1.4 Agency Cost Hypothesis

Now a day in the corporate world, the relationship between shareholders (owner) and managers (agents) are considered very important and refer towards an important issue called agency problems. The managers are hired with believe that their actions will always be in the preeminent concern of the shareholders. The hypothesis advocated that in two forms, dividend payment lessen agency costs. Firstly, a number of additional investors can be attracted by the policy of dividend payment. Secondly, a lot of funds are not invested which becomes a cause of loss due to time value of money. Signaling Hypothesis: This hypothesis explain that dividend declarations are significant information, connecting to upcoming earnings of the organization. A surge in the ratio of dividend payout acquires a positive signal to the investors and the general public that the earnings of the firm in the future are bright. The situation is opposite in the case of firms who have a low ratio of dividend payout or doesn't have the policy to pay dividend.

2.2 Empirical Literature Review

2.2.1 Leverage

The Leverage of a company has been analyzed in the literature as a very important factor for the decision making regarding dividend policy (Rozeff, 1982) argues that risk and transaction cost can be increased due to high leverage.

Firm's fixed payments increase due to increase in the level of leverage for utilizing external financing. There is the negative association between leverage ratio and dividend payment, when firm fixed cost increase, firm net earning decrease in return which reduces the amount for distribution among shareholder. Theory of agency cost in reference with dividend policy stayed with this concept.

(Kowalewski, Stetsyuk, & Talavera, 2007) discusses the behavior of firms who take a lot of debt, the desire to pay worse dividends. Also, (Al-Kuwari, 2009) approves the negative association between dividend policy and leverage ratios of a firm. Conversely, (Mollah, 2011) scrutinized an evolving market and establish a direct and clear connection between financial leverage and the level of debt burden that escalate transaction costs. Accordingly, transaction costs are high for the firms who go with high leverage level, and likely to pay less dividends due to high expense in the form of high leverage.Equally (Nizar Al-Malkawi, 2007) inveterate that the firm's leverage is pointedly and adversely allied to its dividend plan.

(Rozeff, 1982) plugs out firms with high level of financial leverage incline to have squat payout ratios, to curtail the operation costs of leverage due to outer financing.(Nizar Al-Malkawi, 2007) also explain the phenomena of the firm's high level of financial leverage negative association with dividend policy, while (Demirguc-Kunt & Maksimovic, 2001) have found a dominant positive correlation, bringing out the fact that the firms have higher debt funds to pay off.

2.2.2 Liquidity

Liquidity condition matters a lot and strongly affect the various decision specially dividend decision. Firms who have enough cash reserve are more convenient to pay the dividend to its shareholder than those who have less reserve amount as a cash. Consequently, the possibility that a firm will pay out dividends in the form of cash is positively correlated to liquidity. This positive association is buoyed by the theory of signaling with regard to dividend policy (Ho, 2003) . (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000) discussed that managers will involve in uneconomical performs when they have adequate cash reserve even firm have strict rules, check and balance for investor benefits. A significant percentage of researcher has suggested that firms having a larger portion of “cash flow” should increase dividend payments to curtail the agency costs for accumulated reserve (La Porta et al., 2000) . Above studies concluded that there is a positive relationship between the cash flow and the dividend payout ratio.

On the divergent, (Marfo-Yiadom & Agyei, 2011) explain adverse relationship in dividend policy and cash, the effects were not substantial. In exploring the elements of dividend policy (Ben Naceur, Goaied, & Belanes, 2006) find that the great lucrative firms with more constant incomes can manage the greater amount of cash flows and pay dividends in larger quantity. Furthermore, the growing firms dispense the more dividends the purpose is to attract the investors. A measure liquidity situation means the firm is unable to pay its short-term liabilities than how it can pay dividend. (Mehta, 2012); (Ahmed & Javid, 2009) .

2.2.3 Profitability

Dividend policy orientation depends dominantly on Profitability. The pecking order theory, enlightens companies prioritize behavior for sources of finance, tells that firms select to use inside reserves. When inside reserves are inadequate to encounter financial requirements, firms choose debt option (riskless, then risky debt), and at the end towards equity (Myers & Majluf, 1984),. (Myers & Majluf, 1984) put forward that this conduct may be in the practical research (Kester, 1986) investigate the negative relationship between profitability and leverage in USA and Japan.

(Titman & Wessels, 1988) produce identical results for US firms. (Reddy, Locke, & Scrimgeour, 2010) demonstrates that firms with the attitude of paying debt are supplementary lucrative. (Amidu & Abor, 2006) agreed with prevailing theories that all the firms listed in PakistanStock Exchange decide their dividend policy according to their profitability. (Kowalewski et al., 2007) keenly observes that whenever a firm invest, the less amount in investment opportunities, will have sufficient amount to pay dividend. (Lintner, 1956) explains in his study, that a serious cause of dividend policy selection mainly depends on net earnings of the firm. Profitability influence principally, powerfully and openly the dividend policy of firm (Al-Kuwari, 2009) . (Aivazian, Booth, & Cleary, 2003) and (Li & Lie, 2006), all sustained this view that firms of great and lucrative nature usually pay more dividend.

Size

(Rajan & Zingales, 1995) said that greater firms have a tendency to be more varied than minor firms, bankruptcy risk is more in case of less diversified business because of lack of portfolio management. Trade theory elaborates, the rapport between firm magnitude and leverage level is positive. (Harris & Raviv, 1991), (Rajan & Zingales, 1995), (Aivazian et al., 2003), (Demirguc-Kunt & Maksimovic, 2001) disclosed a positive link between company scope and level of efficiency of utilizing fixed asset also called leverage. On the other hand (Titman & Wessels, 1988) inveterate the negative connection between company scope and level of efficiency of utilizing fixed asset. They elucidate it on the source of the pecking order theory. Large firms can easily approach to capital markets and are convenient for the payment of dividends (Ho, 2003); (Aivazian et al., 2003)

The preceding literature presumed connection between the company scope and its dividend plan and policies of the firm. The gigantic size companies circulate higher dividend amounts among their shareholder and smaller size corporations circulate less dividends amounts among their shareholder, because their capacity for cash generation is less, as matched with gigantic size companies who have relaxed entree to the capital market and also less reliant on on the inside reserves due to credibility and goodwill of firm, that’s why show more capability to pay dividends (Denis & Osobov, 2008)

2.2.4 Risk

Payout policy shows noteworthy negative correlation with business risk (Jensen, Solberg, & Zorn, 1992); (Aivazian et al., 2003). The price earnings ratio subtly includes the risk of a business's future earnings. Argument of (Fama & French, 1998) elaborate that the investor see surge in P/E ratio as the indicator of good performance as well as an expectation of higher profits. Surge in P/E ratio also indicate low risk, whereas plunge in P/E ratio indicates high risk and lesser disbursement ratios. This result ratifies the concept agency theory with regard to dividend policy. The P/E ratio subtly includes the apparent risk of a certain company's upcoming earnings.

3 Research Methodology

Study population includes companies from textile sector, which are listed in the Pakistan stock exchange. There are 156 textile companies consisting textile composite, weaving and spinning, which are listed with the Pakistan stock exchange. So, the researcher has conducted a sample of 60 listed companies out of total 156 and random sampling technique has been used for this purpose. The criteria regarding the selection of companies also subject to the availability of data and their proxies for data collection. Data have been collected for a five year period ranging from 2010 to 2014.

3.1 Sources of data collection

The Researcher has collected the data from different sources like annual financial reports of textile companies which are listed in the Pakistan stock exchange and publications of state bank of Pakistan.

3.2 Variables and Proxies

Table: 1 Variable and Proxies

Variables	Proxies
LEV- leverage ratio	Total debt/Total assets
LIQ –liquidity	Current assets/ Currents liability
ROE -return on equity ratio	Net profit/ Owners' capital
LOG (TA) -size of a company	The natural logarithm of total assets
P/E -risk of a company's future earnings	Price of a share/ earnings per share

3.3 Hypothesis of the Study

In the study there is five Hypothesis which are described below:
H1: The relationship between Leverage and dividend payout ratio is negative.
H2: The relationship between Liquidity and dividend payout ratio is positive.
H3: The relationship between profitability and dividend payout ratio is negative.
H4: The relationship between firm size and dividend payout ratio is positive.
H5: The relationship between P/E ratio and dividend payout ratio is positive.

4 Empirical Results and Findings

In order to investigate the above Mentioned modal Two regression techniques Fixed effect modal and Random effect Modal are used. Hausman Test indicates that the fixed effect model is appropriate for our study. Table 2 shows the results of fixed effect model

Table: 2 Results of fixed effect model

Variable	Coefficients	Std.Error
LEV	-0.145654***	0.075432
LIQ	-0.356543*	0.087643
ROE	-0.398754***	1.167543
LOG (TA)	0.016543	0.023456
P/E	0.014325	0.045632
Number of observations	300	
R-Squared	0.045643	
Adjusted R-Squared	0.035632	

***, **, * Significant at 1%, 5%, 10%

In the above table our dependent variable is the dividend payout ratio and the independent variables are leverage, Liquidity, Return on equity, Size, P/E.
The Results of the fixed effect model show that there is a high significant negative relation between profitability and dividend payout ratio. This result means that highly profitable firms retain their internal earnings in order to invest in high profitable firms and

they cannot distribute earnings in the form of cash dividends. These results are consistent king order theory and empirical literature.

Results indicate that there is the high significant negative relation between leverage and dividend payout ratio Which means that highly leveraged firms do not pay dividend, but they retain the internal earnings to fulfill the high profitable investment opportunities.

There is a negative relation between liquidity and dividend payout ratio, which means that high liquid firms retain funds and does not distribute earnings in the form of cash dividends.Firm size and P/E ratio does not have any impact on the dividend payout ratio.

R-Squared means that on the basis of independent variables 4% variation is explained in the dependent variable. Adjusted R-Squared is used instead of R-Squared when there are a large number of variables.

5. Conclusions

The main purpose of the study is to investigate the factors that determine the dividend policy of Textile firms listed on the Pakistan Stock Exchange. Data is collected from the annual reports of companies listed in PSE. In order to estimate the panel data analysis fixed effect model is used. The results indicate that there is a high significant negative relation between profitability and dividend payout ratio. There is the high significant negative relation between leverage and dividend payout ratio, which means that highly leveraged firms do not pay dividend, but they retain the internal earnings to fulfill the high profitable investment opportunities. There is a negative relation between liquidity and dividend payout ratio. There is no relation between firm size, P/E ratio and Dividend payout ratio.

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