

The effect of dividend policy finance essay



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The issue of how much a company should pay its stockholders as dividend is been of concern to managers. The optimal dividend policy of a firm depends on investor's desire for capital gains as opposed to income, willingness to forgo dividends for future returns, and perception of risk associated with postponement of returns. Management is often in a dilemma; whether to pay dividends or to retain them for future investments with implications on share value. The study sought to determine the effects of dividend policy on the market share value in the banking industry in Kenya, using National Bank Kenya (NBK) as case for the study. The study applied an explanatory research design covering a proportionate sample of 100 shareholders drawn from a target population of 47, 000 shareholders of National Bank of Kenya. Data was collected using a structured questionnaire. Both descriptive and inferential statistics were used to analyze data. The hypotheses were tested by use of Pearson's Moment Correlation. With a response rate of 68%, the study established that NBK had a dividend policy as confirmed by 91% of the respondents. The study established a strong and positive correlation (0. 850) between dividend payout and market share value, with a P-value of 0. 000. There was a positive correlation (0. 299) between dividend growth rate and market value of shares with a p-value is 0. 013; hence establishing a significant relationship between variables. There was a positive correlation (0. 502) between regularity of dividend declaration and market share value with a P-value was 0. 000. Dividend policy had a significant effect on the market share value. The study recommends that management in banks and specifically National Bank Kenya must adjust the dividend policy in tandem with interests and requirements of shareholders to improve the market share value.

Key Terms: Dividend policy, dividend payout, dividend declaration, share value

Background to the Study

Dividend policy has been a puzzle in corporate finance for several decades. Among numerous research subjects about dividend policy, the most popular one is the relationship between the dividend level and the share price of a firm. According to the dividend discount model (Gordon, 1959); it is feasible to derive that dividend payment augmentation should be accompanied by the value increase in a firm. Miller and Modigliani (1961) however, point out that the value of a firm is not influenced by current and future dividend decisions, which is well recognized as the dividend irrelevance theory.

According to Kapoor (2009) dividend policy connotes to the payout policy, which managers pursue in deciding the size and pattern of cash distribution to shareholders over time. Therefore, managements' primary goal is shareholders' wealth maximization, which translates into maximizing the value of the company as measured by the price of its common stock. This goal can be achieved by giving the shareholders a fair payment on their investments. Gordon (1963) found that dividend policy of the company did affect the market prices of its shares.

Share value is represented by the market price of the company's common stock, which, in turn, is the function of the company's investment, financing and dividend decisions. Dividend decisions are recognized as centrally important because of increasingly significant role of the finances in the firm's overall growth strategy. Bishop et al., (2000) contends that managers must

not only consider the question of how much of the company's earnings are needed for investment, but also take into consideration the possible effect of their decisions on share prices. According to Kapoor (2009), share prices of a firm tend to be reduced whenever there is a reduction in dividend payments. An announcement of dividend increase generates abnormal positive security returns and an announcement of dividend decrease generates abnormal negative security returns. A drop in share prices occurs because dividends have a signaling effect.

The Research Problem

Dividend policy is an integral part of financial management decision of a firm. There is adequate empirical evidence pointing to a strong relationship between dividend policy and stock market prices. However, managers are in a dilemma as to whether to pay large, small or zero percentage of their earnings as dividends or to retain them for future investments. This situation is occasioned by the different shareholder interests which management has to satisfy. For instance, some shareholders prefer to be paid dividends every year for investing in other profitable businesses while other shareholders would like to invest in the future and thus, prefer that the dividends be retained by the company for re-investment. However, most investors prefer companies with high pay outs because they are less risky than potential future capital gains. Since the bank management is dealing with competing interests of various shareholders, the kind of dividend policy they adopt may have either positive or negative effects on the share prices of the company. According to Miller and Modigliani (1961), the effect of a firm's dividend policy on the current price of its shares is a matter of considerable

importance, not only to management who must set the policy, but also to investors planning portfolios and to economists seeking to understand and appraise the functioning of the capital market. It is this basis that the study sought to establish the effects of dividend policy on market share value in the banking industry in Kenya, using National Bank of Kenya as a case for the study.

Purpose of the Study

The purpose of the study the study was to determine the effects of dividend policy on the market share value in the banking industry in Kenya, using case study of National Bank of Kenya. The constructs of dividend policy that were correlated with market share value were dividend growth rate, dividend payout, and regularity of dividend declaration.

Research Methodology

The study adopted an explanatory research design. The design allowed description of the variable characteristics and systematic explanation of the relationships amongst them as supported by Mugenda and Mugenda (2003) and Kothari (2004). The study covered a sample of 100 respondents from a population of 47, 000 general public shareholders. The sample was selected through proportionate stratified sampling method; where the population was divided into five strata; shareholders with 1 to 100, 000 shares, shareholders with shares between 100, 001 and 200, 000 shares, shareholders with 20001 to 30000 shares, shareholders with 300, 001 to 400, 000 shares and shareholders with over 400, 000 shares. A structured, self-administered questionnaire was used to collect data from the respondents. Descriptive statistics including frequencies, percentages and mean were used to

describe variable characteristics while inferential statistics (correlation and regression) were used to determine and explain variable relationships. The research hypotheses were tested using Pearson's Moment Correlation was used to test the research hypotheses. The study also tested the working of the postulated model using ANOVA while regression analysis was applied to test the test model in explaining the variable relationships.

Results and Analysis

The study achieved a response rate of 68%. Among the respondents, 32% were female while 68% were male; implying that majority of the National Bank of Kenya (NBK) shareholders is male.

Dividend Policy

The respondents were given a set of statements regarding NBK's dividend policy and asked to indicate extent to which they agreed with each one of them. According to the results (Table 1), 91% of the respondents were aware that National Bank of Kenya had a dividend policy. However, 59% indicated that the Dividend Policy was not well communicated to and understood by the shareholders.

Table 1: Status of Dividend Policy

Statement/ item

Strongly Disagree

Disagree

Agree

Strongly Agree

Mean

Frq

%

Frq

%

Frq

%

Frq

%

National Bank of Kenya has a Dividend Policy

5

7.4

1

1.5

29

42.6

33

48.5

3. 32

NBK dividends policy is well understood by its shareholders

19

27. 9

21

30. 9

14

20. 6

14

20. 6

2. 34

Dividend policy has been and continues to be important factor driving NBK share value

1

1. 5

12

17. 6

19

27. 9

36

52. 9

3. 32

Formal dividend policy gives shareholders the assurance of predictable dividend payments

0

0

22

32. 4

32

47. 1

14

20. 6

2. 88

The study revealed that the dividend policy has been and continues to be an important factor driving NBK share value as supported by 80% of the respondents. Respondents were of the view that a formal dividend policy gives shareholders the assurance of predictable dividend payments (68%).

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The importance of the dividend policy to shareholders was clearly underscored as demonstrated by above average mean scores on all the constructs on which it was measured except the understanding of the policy by shareholders.

Dividend Payments on Share Value

Objective one sought to assess the effects of dividend payout on the market share value of National Bank of Kenya. An assessment of the effects of dividend payments on share value involved a set of statement which the respondents were required to indicate the extent to which they agreed with them. As shown in Table 2, 90% of the respondents pointed out that they considered payment of dividends a major element in the value of shares, meaning that an increase in a dividend payout causes an increase in share price as supported by 88% of the respondents. However, 79% felt that dividend payment did not remove excess cash flows that could be invested in unprofitable projects.

Majority of the respondents (98%) strongly submitted that dividend paying firms are more closely scrutinized by financial analysts to assess managements' role in building share value. Further they felt that dividend payments should satisfy shareholders' dividend preference rather than depend on the firms' investing or financing decisions. The study also revealed that dividend payments are better signals of confidential information than other media forms (98%); thus raising share value. The respondents were also of the view that payment of dividends is a demonstration that that the firm is strong enough and can pass up profitable investments (98%). Moreover, most of the respondents (78%) agreed that <https://assignbuster.com/the-effect-of-dividend-policy-finance-essay/>

they valued their shares at NBK because of the regular dividend payments they received. Out of eight items used to measure the effect of dividend payment on share value, five of them received above average mean scores ranging between 2.97 to 3.76; a demonstration that that indeed dividend payment is a major determinant of share value.

Table 2: Effects of Dividend Payments on Market Share Value

Statement/ item

Strongly Disagree

Disagree

Agree

Strongly Agree

Mean

Fre

%

Fre

%

Fre

%

Fre

0%

I consider payment of dividends a major element in the value of shares I hold at National Bank of Kenya

2

2.9

5

7.4

29

42.6

32

47.1

3.34

An increase in a dividend payout causes an increase in share price

0

0

8

11.8

28

41. 2

32

47. 1

2. 18

Dividend payment removes excess cash flows that could be invested in unprofitable projects

0

0

54

79. 4

14

20. 6

0

0

2. 21

Dividend paying firms are more closely scrutinized by financial analysts to assess managements' role in building share value

0

0

1

1. 5

41

60. 3

26

38. 2

2. 97

Dividend payments should satisfy shareholders' dividend preference rather than depend on the firms' investing or financing decisions

0

0

1

1. 5

41

60. 3

26

38. 2

3. 37

Dividend payments are better signals of confidential information than other media forms; thus raising share value

0

0

1

1. 5

14

20. 6

53

77. 9

3. 76

In my view, payment of dividends is a demonstration that that the firm is strong enough and can pass up profitable investments.

0

0

1

1. 5

14

20. 6

53

77. 9

3. 76

I value my shares at NBK because of the regular dividend payments I receive.

5

7. 4

10

14. 7

20

29. 4

33

48. 5

2. 21

The study tested a hypothesis which stated that Dividend payout does not significantly affect the market value of National Bank of Kenya shares. The

hypothesis was tested using Pearson's Moment Correlation Coefficient. The test was conducted to establish the relationship between dividend payout and market value of shares. The study (Table 3) revealed a positive correlation (0.850) between dividend payout and market value of NBK shares with a P-value of 0.000, less than the alpha of 0.01; hence establishing a strong and significant relationship between variables.

Table 3: Correlation Analysis on Dividend Payout and Market Share Value

Dividend payout

Market value of NBK shares

Dividend pay out

Pearson Correlation

1

0.850(**)

Sig. (2-tailed)

•

.000

N

68

68

Market value of NBK shares

Pearson Correlation

0.850(**)

1

Sig. (2-tailed)

.000

•

N

68

68

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

Dividend Growth Rate and Share Value

Objective two sought to determine the effects of dividend growth rate on market value of National Bank of Kenya shares. This was measured on a number of statements in which respondents were asked to indicate the extent to which they agreed with them. As shown in Table 4, all the respondents disagreed with the statement that dividend payments at National Bank of Kenya have been experiencing steady growth over the years. However, they (98%) pointed that maintenance of steady and growing dividend payments increases a firm's share value. Further, 98% of the respondents were of the view that adjusting dividend payments towards a

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target payout ratio will increase a firm's share value. The study also established that 78% of the respondents valued the shares they held with National Bank of Kenya because of steady growth in dividend payments; contradicting Levinsohn (2003) who observes that paying dividends will influence how a company finances its growth but will not have a lasting effect on its value in the marketplace. Though majority of the respondents disagreed with the contention that the dividend payments have been experiencing steady growth over the years, all the others attributes used to measure the effect of dividend growth rate on market share value all the other attributes were favourably rated with mean scores of over 3.3 out of 5; demonstrating that dividend growth is a major determinant in market share value.

Table 4: Effects of Dividend Growth Rate on Market Share Value

Statement/ item

Strongly Disagree

Disagree

Agree

Strongly Agree

Mean

Fre

%

Fre

%

Fre

%

Fre

%

NBK dividend payments have been experiencing steady growth over the years

14

20. 6

54

79. 4

0

0

0

0

1. 79

Maintenance of steady and growing dividend payments increases a firm's share value

0

0

1

1.5

14

20.6

53

77.9

3.76

Adjusting dividend payments towards a target payout ratio will increase a firm's share value

0

0

1

1.5

40

58. 8

27

39. 7

3. 38

I value the shares I hold with National Bank of Kenya because of steady growth in dividend payments

3

4. 4

12

17. 6

20

29. 4

33

48. 5

3. 32

The study tested a hypothesis which stated that Dividend growth rate does not significantly affect the market value of National Bank of Kenya shares, using Pearson's Moment Correlation. As shown in Table 5, there is a positive correlation (0. 299) between dividend growth rate and market value of NBK

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shares with a P-value of 0.013 less than the alpha of 0.05; hence establishing a high significant relationship between the study variables. This shows that dividend growth rate has a significant effect on market value of NBK shares.

Table 5: Correlation Analysis on Dividend Growth Rate and Market Share Value

Dividend growth rate

Market value of NBK shares

Dividend growth rate

Pearson Correlation

1

.299(*)

Sig. (2-tailed)

•

.013

N

68

68

Market value of NBK shares

Pearson Correlation

.299(*)

1

Sig. (2-tailed)

.013

•

N

68

68

* Correlation is significant at the 0.05 level (2-tailed).

Regularity of Dividend Declaration and Market Share Value

Objective three sought to establish the effects of regularity of dividend declaration on the market share value through a set of statements.

According to the study findings (Table 6), 77% of the respondents considered regularity of dividend declaration as major element in the value of shares they owned whereas 88% felt that regular dividend declaration caused an increase in share price. Further, 90% of the respondents submitted that regular dividend declaring firms have more shareholders and their share value is high.

Table 6: Effects of Regularity of Dividend Declaration on Market Share Value

Statement/ item

Strongly Disagree

Disagree

Agree

Strongly Agree

Mean

Fre

%

Fre

%

Fre

%

Fre

%

I consider regularity of dividend declaration a major element in the value of shares I hold at National Bank of Kenya

1

1. 5

14

20. 6

29

42. 6

24

35. 3

3. 12

Regularity of dividend declaration causes an increase in share price

2

2. 9

6

8. 8

28

41. 2

32

47. 1

3. 32

Regular dividend declaring firms have more shareholders and their share value is high.

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0

0

7

10.3

7

10.3

54

79.4

3.69

I value my shares at NBK because of the regular dividend payments I receive

26

38.2

28

41.2

0

0

14

20. 6

2. 03

The results further revealed that majority of the respondents (79%) disagreed with the contention that they valued their shares because of the regularity of dividend declaration with a mean score of 2. 03 out of a maximum of 5. In general, three out of the four attributes measuring the effect of regularity of dividend payments on share value received high mean scores of over 3 out of 5; implying that regularity of dividend payments is positively related to share price. It follows thereof that when dividends are not regular, the share value drops and vice versa.

The study tested a hypothesis which stated that regularity of dividend declaration does not significantly affect the market value of National Bank of Kenya shares using Pearson's Moment Correlation. As shown in Table 7, the study established a positive correlation of 0. 502 with P-value of 0. 000, less than the alpha of 0. 01; hence demonstrating a high and significant relationship between the two variables. Therefore, regularity of dividend declaration has a significant effect on market value of shares. The results agrees with Pettit (1972) observations that announcements of dividend increases are followed by significant price increases and that announcements of dividend decreases are followed by significant price drops.

Table 7: Correlation Analysis on Regularity of Dividend Declaration and Market Share Value

Regularity of dividend declaration

Market value of NBK shares

Regularity of dividend declaration

Pearson Correlation

1

0.502(**)

Sig. (2-tailed)

•

0.000

N

68

68

Market value of NBK shares

Pearson Correlation

0.502(**)

1

Sig. (2-tailed)

0.000

-

N

68

68

** Correlation is significant at the 0. 01 level (2-tailed).

When asked to rate the level of market share value (Figure 1), 3% rated the value as very low, 57% rated it low, with 36% rating the value as high and 4% as very high. This shows that majority (60%) of the shareholders considered the market value of the shares as low.

Figure 1: Level of market share value

Model Testing

The model had hypothesized that regularity of dividend declaration, dividend growth rate and dividend payouts were responsible for variation in the market share value. To test this model multiple regression was run with market share value as the dependent variable and regularity of dividend declaration, dividend growth rate and dividend payouts as the independent variables. According to the study results in Table 8, the three independent variables account for 68% (R Square, 0. 679) of the variations in market share value.

Table 8: Regression Model Summary

Model

R

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R Square

Adjusted R Square

Std. Error of the Estimate

1

. 824(a)

. 679

. 664

. 530

Predictors: (Constant), regularity of dividend declaration, dividend growth rate and dividend payouts.

The study conducted ANOVA to test determine whether the model works. As shown in Table 9, the F value was 45. 110 at significance level of 0. 00. Since the significance level (0. 00) was far much less than the alpha level 0. 05, it implies that the three independent variables (dividend payout, dividend growth rate and regularity of dividend declaration) contributed significantly to variations in the dependent variable (market share value).

Table 9: ANOVA Results

Model

Sum of Squares

df

Mean Square

F

Sig.

1

Regression

38.060

3

12.687

45.110

.000(a)

Residual

17.999

64

.281

Total

56.059

67

a. Predictors: (Constant): regularity of dividend declaration, dividend growth rate and dividend payouts; b. Dependent Variable: market value of NBK shares

Regression analysis was conducted to determine the effects of dividend payout, dividend growth rate and regularity of dividend declaration on market share value. The study established that an increase in regularity of dividend payout, dividend growth rate and regularity of dividend declaration by one unit would increase market value of NBK shares by 0. 615, 0. 393 and 0. 217 respectively. This implies that all the three independent variables significantly affect market share value, though dividend payout is more significant than the other two variables.

Table 10: Regression Coefficient

Model

Un standardized Coefficients

Standardized Coefficients

t

Sig.

B

Std. Error

Beta

(Constant)

. 463

. 239

1. 939

. 057

Dividend payout

. 615

. 075

. 758

8. 161

. 000

Dividend growth rate

. 393

. 130

. 218

3. 015

. 004

Regularity of dividend declaration

. 217

. 057

. 223

3. 793

. 000

a. Dependent Variable: market value of NBK shares

Conclusions

It is palpable that National Bank of Kenya had a dividend policy, which has been and continues to be important factor driving NBK share value.

However, it was not well understood by the most of the shareholders. The NBK shareholders considered payment of dividends is as major element in the value of shares as it demonstrated that that the firm is strong enough and can pass up profitable investments. It is also evident that that an increase in a dividend payout causes an increase in share price. It is also clear from the results that dividend payments have been experiencing declining over the last five years. Although, maintenance of steady and growing dividend payments has been confirmed to increase the firm's share value, adjusting dividend payments towards a target payout ratio will also increase a firm's share value. Consequently, steady growth in dividend payments makes the shareholders value their shares more. Regularity of dividend declaration was also viewed as a major element with regards to the value of shares as shareholders believed that regular dividend declaration caused an increase in share price. Based on the results, dividend payout,

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dividend growth rate and regularity of dividend declaration significantly influenced the market value of National Bank of Kenya shares.

Recommendations

Based on the findings, the study made the following recommendation;

Dividend policy has proven to be of paramount importance with regards to the market share value and thus NBK's management should avail the policy to its shareholders. This grants them an opportunity to contribute to the improvement of the policy. NBK must adjust its dividend policy to improve the market value of its shares. For an optimal dividend policy to be achieved and maintained, the bank management should maintain regular dividend payment, and also pay a special dividend or initiate a share repurchase programme. Any changes in policy should be shared with the shareholders.