Chapter 1: Introduction

1.1 Nature of the Problem

Each operating enterprise is interested in running a profitable business. This might be achieved only by exploiting different factors of complex nature. Dividend among other factors can be regarded as a cause of variation in a firm’s value. Dividends are payments made by a company to its shareholders. Dividend are those cash distribution that companies may pay out regularly to shareholders from earnings, sending a clear and powerful message about future prospects and performance. A company’s willingness and ability to pay steady dividend overtime and its power to increase them provide good clues about its fundamentals. Discretely introduced strategy regarding dividend may contribute significantly to the firm value. Dividend is one of the most important financial policies not only from the viewpoint of the company, but also from that of the stakeholders. Like for investors, dividends – whether declared today or accumulated and provided at a later date - are not only a means of regular income, but also an important input in valuation of a firm. Lenders may also have interest in the amount of dividend a firm declares, as more the dividend paid less would be the amount available for servicing and redemption of their claims. Similarly, managers’ flexibility to invest in projects is also dependant on the amount of dividend that they can offer to shareholders as more dividends may mean lesser funds available for investment. Company has to decide whether to pay out dividends or reinvest them into the business. It is one option to pay out dividends and in this way attract potential shareholders. The second option is to promote the business
by reinvesting the undistributed profits into it. Both strategies may be favourable depending on preferences of the managers of the company. Here we assume that managers' work is to maximize the wealth of the firm's shareholders. In the process of running business, managers have always kept in mind that the dividend decisions impact their firm's shares. Share price is critical determinant of shareholders' wealth. So, manager's dividend decisions affect common share price and therefore, the wealth of shareholders.

Before corporation were required by law to disclose financial information in 1930's, a company's ability to pay dividend was one of the signs to its financial health. Despite the Securities and Exchange Act of 1934 and the increased transparency it brought to the industry, dividends still remain a worthwhile yardstick of a company's prospect. Dividends are referred as reward for providing finances to a firm as without any dividend payout, shares would not have any value. For a company, it is a pivotal policy around which other financial policies rotate. All the corporate finance is built on three principles, which we title, as the Investment principle, the Financing principle and the Dividend policy. The Investment principle determines where businesses invest their resources, the Financing principle governs the mix of funding used to fund these investment and the Dividend principle answers the question of how much earnings should be reinvested back into the business and how much returned to the owners of the business. The objective in corporate financial theory when making decisions is to maximize the value of the firm. Consequently any decision (investment, financing, dividend) that
increase the value of a firm is considered as ‘good’ one where as that reduces firm value is considered ‘poor’ one. Company inter-alias the three decisions pertaining to investment, financing and dividends simultaneously as these three decisions are interrelated. Dividend policy decision influences the financing decision of the firm through retained earnings. Financing decision would relate to the amount of funds to be raised from external sources as the investment needs of a firm can be fulfilled by a combination of retained earnings and external financing. Therefore, higher the amount of retained earnings given the investment needs, lower will be the need for external finance and vice-versa. Value of the corporate securities depends to a great extent on dividend and, therefore, in deciding upon the financial structure of a company dividend has to be assigned due weightage.

So, a thorough exploratory study on dividend and value of the firm is beneficial to the company, shareholders, government and the economy as a whole, since the business is expanding by leaps and bounds. Thus present study is undertaken to analyze impact of dividend payment on the value of the firm, the trend of dividend in context of Indian firms, relation of dividend with other important variables of the firm.

1.2 Literature Review

Linter (1956) observed that dividend policy is important to managers and that the market reacts positively to dividend increase announcements and negatively to decreases.

Gordon (1959) in his seminal work proposed that even in presence of perfect capital market, the existence of uncertainty about the
future cash flow, suffice to make the price of shares depended upon the 
dividend policy.

Miller and Modigliani (1961) in their seminal work analyzed the effect of dividend policy on the current price of its shares.

Fama and Babiak (1968) explored that the firms, a prior, set their target dividend level and try to stick to it.

Fama (1974) provided empirical relationship between the dividend and investment decision of the firms.


Black (1976) tried to answer the dividend puzzle.

Miller and Scholes (1982) re-examined whether shareholders with high dividend yield receive higher risk adjusted rate of return.

Kalay (1982) investigated a large sample of bond pay-out policy and agency cost of market equilibrium to explain why firms that maximize the value of their shares pay dividends.

Miller and Rock (1985) extended the standard finance model of the firms dividend by allowing the firms manager ‘insider’ to know more about the firm’s financial health than ‘outside’ investors. They explored that a consistent signaling equilibrium exists under asymmetric information.

Jensen (1986) studied that in presence of free cash flows, the firms pay dividends or retire their debts to reduce the agency cost of free cash flow.
Marsh and Merton (1987) developed a model of the dividend process for aggregate stock market.

Healy and Paleup (1988) investigated whether dividend policy changes convey information about the future earnings substantiated by cash. They found that investors interpret announcements of dividend initiations and omissions as manager’s forecast of future earnings changes.

Lang and Litzenberger (1989) explored the cash flow signaling and free cash flow explanation of the impact of dividend announcements on stock prices.

Brennan and Thakor (1990) developed a theory of choice for distribution of cash from firm to shareholders. They showed that a majority of a firm’s shareholders may support a dividend payment for small distribution, despite the preferential tax treatment of capital gains for individual investors. For larger distributions as open market stock repurchase, and for the largest distributions tender offer re-purchase is likely to be preferred by a majority of shareholders.

Jensen et al. (1992) investigated the determinant of cross-sectional differences in insider ownership, debt and dividend policy. The authors found that firms with higher insider ownership choose lower level of debt and dividends.

Kevin (1992) concluded in his study that dividend stability is primary determinant of payout while profitability is only of secondary importance.
Mahapatra and Sahu (1993) did not find evidence in support of Linter’s model whereas Mishra and Narender (1996) found support for the Linter’s model.

DeAngelo et al. (1996) studied the signaling content of manager’s dividend decisions.

Han et al. (1999) tested the agency cost based hypothesis, which predicts dividend payout to be inversely related to the degree of institutional ownership and the tax based hypothesis, predicting the dividends to be positively related with institutional ownership. They provided support for the tax-based hypothesis, suggesting a ‘dividend clientele’ for the institution’s preference for higher dividends.

Narasimham and Vijayalakshmi (2002) analyzed the influence of ownership structure on dividend payout.

Gugler and Yurtoglu (2003) found large shareholding of the largest owner reduces the dividends payout ratio, while shareholding by the second larger owner increases it.

Manos (2003) found government ownership, insider ownership, debt, risk and growth opportunities have a negative impact on dividend payout ratio, whereas institutional ownership, foreign ownership and dispersed ownership have a positive impact on the payout ratio.

Omran and Pointon (2004) studied about Egyptian firms, showed that for non-actively traded firms, the accounting book value is important determinant for dividend policy. But, for actively traded firms,
gearing ratio and the market to book value are more important determinant of dividend policy.

Hu and Liu (2005) concluded that there is a positive relationship between the current earnings of a company and the cash dividend they pay, and a significant negative relationship between the debt to total assets and dividends.

Dhanani (2005) provided clear evidence that those companies in the financial and utility sectors support the dividend signalling hypothesis more than their counterparts in other industrial, consumer and service industries.

Docking and Koch (2005) discovered that there is a direct relationship between dividend announcement and equity price behavior.

Rahman et al. (2006) found that negative correlation between the beta and stock return, which is reason for inefficiency of market where the assumptions behind the CAPM model is not supported.

Kowalewski et al. (2007) suggested that large and more profitable companies have a higher dividend payout ratio. Furthermore, riskier and more indebted firms prefer to pay lower dividends.

Andres et al. (2008) employed partial adjustment model on dynamic panel data and found that German firms do not seem to base their dividend decisions on long term target dividend payout ratios based on public earnings. Regarding the speed of adjustment of dividends towards the long term target payout ratio, the authors found that UK and US companies slowly adjust their dividend policy whereas German companies tend to be
more willing to cut the dividend in the wake of a consistent decrease in profitability.

Hedensted and Raaballe (2008) based on a total sample largely uncontaminated by share repurchases in Denmark found that the characteristics of dividend payers are: Positive earnings, high ROE (net earnings to book equity), low volatility in ROE, high retained earnings, large firm size, and whether the firm paid out dividends in the previous year. MV/BV, leverage and owner structure play no role in whether a firm pays dividends or not.

Ahmed and Javid (2009) proposed in their study that whenever the non-financial companies of Pakistan quoted on Karachi Stock Exchange set their dividend payments, these firms consider the existing earning per share and past dividend patterns. But, the tendency of dividend should be more responsive to current earnings than previous dividends. The listed non-financial companies having high momentum of modification and low target payout ratio, show instability in smoothing their dividend payments.

The results of the investigations by Hafeez and Attiya (2009) identified that non-financial companies listed with KSE adopt the policy of relying not only upon current earnings per share but also upon past dividend per share payments.

Das and Jain (2009) concluded that dividend payout depends on indebtedness, growth, investment opportunities, profitability. Among all only profitability has a positive relationship with dividend payout.
Connelly et al. (2010) found families seem to use dividends as a device to signal to outside shareholders that they are willing to forego their private benefits of control.

Akbar and Baig (2010) showed that announcement of dividends either cash dividend or stock dividend or both have positive effect on stock prices.

Nazir et al. (2010) found that dividend payout and dividend yield have significant affect on stock prices while size and leverage have negative insignificant affect and earning and growth have positive significant affect on stock prices.

Khan et al. (2011) studied the effect of dividend payment on stock prices. Results showed that dividend yield, earnings per share, return on equity and profit after tax are positively related to stock prices while retention ratio has negative relation with stock prices.

Hussainey et al. (2011) found that positive relation between dividend yield and stock price changes and negative relation between dividend payout ratio and stock price changes. Their results further indicated that the firms' earnings, growth rate, level of debt and size also cause the change in stock price of UK.

Mustafa and Al-Qudah (2011) study examined the determinants of capital structure of Jordanian mining and extraction industries.

Nirmala et al. (2011) showed that the variables dividend, price-earnings ratio and leverage are significant determinants of share prices. Bose and Husain (2011) found that Indian firms are reluctant to reduce dividend.
Baker and Powell (2012) has used survey technique to take the opinion of Indonesian managers about the factors influencing dividend policy, dividend issues and explanations for paying dividends. Results of their survey show that Indonesian managers consider stability of earnings and level of current and expected future earnings are the most important determinants of dividend policy. Their results further indicate that dividend policy affects firm value and Indonesian managers consider different dividend theories like signaling, catering, and life cycle theories in designing their dividend policies.

1.3 Objectives of the Study

This study emphasize on one of the principle of corporate finance – dividend principle. In this study an attempt has been made to show the impact of dividend on the value of the firm. Although dividend is not a new area of research, it is still attracting the attention of many researchers. It remains one of the most interesting and puzzling topics in modern corporate finance. The topic of dividend remains one of the most controversial issues in corporate finance. For more than half a century financial economists have engaged in modelling and examining corporate payout policy. Long ago Black (1976) wrote that, “The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that don’t fit together”. Since then a vast amount of literature has been produced examining dividend. Recently, however, Frankfurter et al. (2002) concluded same as Black (1976) did i.e, The dividend “puzzle,” both as a share value enhancing feature and as a matter of policy is one of the most challenging topics of modern finance/financial economics. Forty years of research ... has not been able to resolve it. Also Allen et al. (2000) summarized the current
consensus view when they concluded “Although a number of theories have been put forward in the literature to explain their pervasive presence, dividends remain one of the thorniest puzzles in corporate finance”.

However, the primary objective of every firm is to maximise the value of the firm. How payment of dividend influences value of the firm is still an unresolved issue. This empirical study will try to establish linkage between dividend payment and firm’s value.

Therefore the principal objective of this research study is to analyze impact of dividend payment on the value of the firm (chapter -4). However this thesis would also try to analyze the following objectives

1. To study the trends in the dividend pattern of Indian firms. (chapter - 3)
2. To analyze industry-wise dividend payment pattern. (chapter - 3)
3. To identify the relation between dividend and other important variables of the firm such as Age, Profit etc. (chapter - 4)
4. To analyze the relation between dividend payment and change in the amount of fixed assets for computing the impact of expansion of the firm on dividend payment. (chapter - 5)

1.4 Research Methodology

This study is exploratory and empirical in nature. The study examines the various factors that affect the value of the firm with special emphasis on dividend. For theoretical and conceptual study we shall mainly depend on literature available on this field in the form of books, published articles and websites. This study is based on information available from companies in India. The firms’ data for our study will be primarily obtained
from the corporate database (PROWESS) maintained by CMIE, the Center for Monitoring the Indian Economy. Moreover, available information on this context published in annual reports of the firms and these firm's websites are taken into consideration for this study as secondary source. We confine our analysis to BSE listed firms only because all the listed firms are required to follow the norms set by SEBI for announcing the financial accounts. It is also observed that BSE listed firms dominate Indian Stock Market and they represent different industrial sectors. We restrict our analysis to firms which have no missing data. Suitable statistical and financial techniques like financial ratios, descriptive statistics, graphs & charts, correlation & regression analysis, time series analysis, testing of hypothesis, analysis of variance etc. have been used to extract inferences from data of selected BSE 500 index companies. The process of measurement is central to quantitative research because it provides the fundamental connection between empirical observation and mathematical expression of quantitative relationships. In this study, the selection of explanatory variables is based on theories related to dividend payout and previous research work that were studied in reported empirical work. 263 listed firms has been sorted for analysing our study period 2000-01 to 2009-10. Only for analyzing trend, we need longer period of study therefore dividend of 157 listed firms data has been sorted for the period 1991-92 to 2009-10.

1.5 Plan of Work

To achieve the objectives as stated earlier, the entire work is divided into the following chapters:-
1. **Introduction:** It includes problem identification, literature review, objectives, methodology and plan of work.

2. **Dividend and Value of the Firm - Conceptual Framework:** This chapter includes different theories, concepts related to dividend and value of the firm.

3. **Dividend Pattern of Indian Companies - A Macro View:** It includes types of dividend pattern overall as well as industry wise in selected sample study. This chapter also includes the application of Lintner's model in Indian companies.

4. **Dividend and Value of the Firm – An Empirical Study:** It includes the factors affecting dividend and value of firm.

5. **Role of Retained Earning in Financing Fixed Assets:** This chapter tries to establish link between internal generated and fixed assets and also how financial decision vary with firms characteristic.

6. **Conclusions and Suggestions:** Based on the findings of the research work, conclusions and recommendations are made. Further limitations of study and prospect for further researches are also outlined.