CHAPTER ONE
INTRODUCTION
Dividend in the normal use of word refers to that portion of the net earnings which is distributed by the company among its shareholders. The shareholders, as investors, are interested in maximizing their returns at a given level of risk or minimizing their risk at a given level of returns, and together wants to maximize returns with minimizing risk and thereby to maximize their wealth. This is the essence of desirability of dividends from the investor's point of view.

On the other hand, a company needs to provide funds to finance its long-term growth. If a company pays out most of the profit it earns, then for business requirements and further expansions, it will have to depend upon outside sources such as issues of debts or new equity shares. So, dividends in a firm are paid according to the policies and decisions of the management regarding the retrained earning of the firm.

Among all the corporate financial decisions few are as strategically important as dividend decisions. Corporate dividend policy plays an important role and affects the capital structure as well future dividends. From the micro concept, as long as there are investment projects with returns exceeding those that are required (in general, mostly, Weighted Average Cost of Capital) it will use retained earnings and the amount of senior serenities will support to finance these projects. If the firm has retained earnings left over after financing all acceptable investment opportunities these earnings then will be distributed to the shareholders in the form of cash dividends. If otherwise there won't be any dividends. The treatment of dividend policy as a passive residual determined solely by the availability of acceptable investment proposals implies that the dividends are immaterial and irrelevant; the investors are rather indifferent between dividends and retention by the firm.
From the macro standpoint, dividend decisions have implications not only at the level of individual firms, but at the macro economic level as well. At the individual firm level, dividend is the first, if not the only indicator of the firm’s performance. Indeed, the objective of modern joint Stock Company is to generate a steady stream of dividends to its shareholders. Higher and regular dividend payment are sure to enhance the market value of the firm and the reputation of its management.

On the other hand, such a policy may mean less availability of internal funds and more dependence on external sources for reinvestment and expansion purposes. Thus while determining dividend payments, a prudent management strikes a balance between shareholders preference and the firm’s long-term interest, safeguarding the firms control.

Again from the macro economic point of view, dividend policies of individual firms when combined together play a significant role in determining overall rates of saving and investment as well as patterns of flow of funds in the economy. Further, dividend policies also level other social economic implications. If shareholders are concentrated only in a few economic brackets, these changes in the dividend income will affect the overall income distribution as well as factor shares.. Exceptionally high dividend payments or abnormally low dividend payments under such conditions might lead to less efficient resource allocation in the economy as a result of changed consumption patterns.

Recognizing the importance of dividend policies of corporations and their bearing on resource allocation and income distribution in the economy, this project attempts to explore the possible factors that determine the dividend behavior in the Indian corporate sector.
BASIC THEORETICAL PREMISE

Basically both theoretical and empirical researchers in dividends are struggling to answer this so called “dividend puzzle” expressed in the study carried out by Black (1976) asking questions like “why do corporates pay dividends?” and “why do investors pay attention to dividends?” this investigation is based on certain general and specific theoretical premises and considerations as summarized hereunder:

A. Theories

1) Dividend Irrelevance Theory

Modigliani and Miller (1961) are of the view that the dividend policy of a company has no effect on the value of shares and value of the firm because its effects on the price of shares is offset exactly by other means of financing and is therefore irrelevant, of course in a world without market imperfections like taxes, transactions costs and asymmetric information.

However, since the capital market is neither perfect nor complete, this dividend irrelevance proposition needs to be researched vigorously, especially focusing on the effects of taxes, information contents, agency cost and institutional constraints.

Inertia Theory

According to Lintner (1956) corporate managements generally believe that most stock holders prefer a reasonably stable rate of dividend and that markets put a premium on stability and gradual growth in rate. The principal device used to achieve this stable pattern was a practice or policy of changing dividends in any given period by only a part of the amount, which were indicated by changes in
current financial figures. Further partial adjustments in dividend rates were made in subsequent years if still warranted. This policy of progressive, continuing partial adoption tends to stabilize dividend distribution, thereby minimizing adverse stockholders reaction together with avoiding uncertainty regarding future developments.

**The ‘Bird In Hand’ Theory**

Bhattacharya (1979) in his theory holds that the dividends i.e., bird in hand is preferred to retained earnings i.e., a bird in the bush, because the later might never materialize as future dividends and, as such, it may fly away.

This ‘bird in hand’ theory also argues that the expected stream of future dividends will be discounted at a lower rate than the expected capital gains, and this proposition led to the Gordon’s model of dividends valuation. ‘Bird in hand’, theory, in essence conveys that dividends are certain and capital gains are uncertain, risk averse investors will therefore prefer dividends and this preference adds value to the firm.

**The Market Value Maximization Theory**

According to Fama and Babjak (1968); Fisher and Jensen; Richard Rok (1969) and French (2000) modern finance theory is built on the belief that firms should be managed to create the maximum value i.e., some of the values and Equity and Debt. In theory value maximization is appealing because it is associated with efficient allocation of resource, provided of course that the capital market operates efficiently enough That is, it rewards the most those firms, which channel their resources to their best uses.
Theory Of Signaling Or Information Content Effect

Ramasasty, Kose and Joseph Williams (1987); Benartizi, Michaely and Thaler (1997) and Sant & Cowan (1994) in the end of 1980s analyzed the issue of signaling effect of dividends in stock price. Some theorists and analyst realized and showed empirically that the price of a firm’s stock would generally rise when its current dividend was unexpectedly increased and conversely that the price would fall when its current dividends are cut. Based on these facts, firms would only raise their dividends when future earnings are expected to rise enough, otherwise they have to be reduced to the original level. Thus a dividend increase signals to the market that the firm is expected to do well.

Theory of Information Asymmetry

Asquith, Paul and Mullins (1983); Healey, and Palepu (1988) propounded that managers often have greater information about the value of their companies than investors because they spend much of their time analyzing the firm’s products, markets, strategies and investment opportunities. After all they have more timely information about current operating performance and better access to the firm’s specific information useful to forecasting earnings.

If a company announces a change in dividends, investors will draw some inference from this announcement about the profitability of the firm’s investment opportunities and adjust the stock prices accordingly, because managers only raise there dividend when future earnings are expected to rise, dividend increase indicates good information about the firm. Therefore, dividend serves as a signal to investors regarding the firm’s current and future performance.
Agency Cost Theory

Jensen, Michael and Meckling (1976); and John & William (1985) theorized agency cost models which begins with the agency problem emphasized by Jensen Meckling (1976). This theory has roots in manager’s prerogative to information. Dividend payments yield a non-monetary benefit by reducing agency cost. One important agency problem is that managers are better informed about the firm’s prospects than share holders. As a result of this information imbalance, managers may divert corporate assets for their perquisite consumption or other benefits or over invest to build empires.

As emphasized by Easterbrook (1984), dividends provides the definite benefits of taking cash out of the hands of managers and are thus a potentially powerful tool for agency problems. For a given level of investment, dividends force firm’s to obtain funds from financial intermediaries or capital market where monitoring is arguably more effective. The agency cost theory of dividends is based on an informational hierarchy rising from stockholders to commercial banks, investment banks, and other external financiers to the firm.

Management Agency Objective Theory

Deangelo, Deangelo and Skinner (1992); Barclay, Michael, Smith and Watts (1995) propounded that the inter play of managerial and shareholders perceptions and motivation in distributing dividends when taken into consideration by Sarma (1990). The sole motive of an entrepreneurial activity is maximization of rate of return gross of taxes. But with the increasing dominance of the joint stock corporations and the associated characteristics of separation of ownership and control, it is now fairly recognized that there exist other equally
important motives such as sales maximization and expansion of business and thereby increasing the market value of the firm.

The latter’s objectives are also in line with the managing agency system of operation identified as a characteristic feature of Indian companies. The separation of ownership and control also means that the objectives and performances of the firm’s management need not coincide with those of its shareholders. From the shareholders point of view, their performances depend mainly on their income level and their degree of understanding of corporate stock dealing and associate tax implications.

**Theory of Behavioural Finance**

Kalay (1992) developed a model based on behavioural theory professing that investors want dividends because of self-control i.e., to restrict themselves from consuming too much in the present.

So to say, investors don’t want to dip into the capital and therefore only allow them to consume current income such as dividends. This tendency is especially strong among elderly or retired investors having less or no income from profession. It is a matter of behavioural life cycle and they rely heavily on their income from securities holdings.

**Theory of Investment Imperatives and Free Cash Flow**

Rozell (1994); Reddy, Subba (2002) and Gugler (2003) professed free cash flow theory stating that free cash is that flow which remains after all positive NPV projects are undertaken. Increasing dividends by a firm with this over investment problem will reduce the cash that would otherwise be wanted in negative NPV projects.
Similarly reducing dividends by such firms will be considered as increasing the probability that more negative NPV projects are undertaken. Market considers increasing dividends as value adding while decreasing dividends as reducing value of the firm.

**Theory of Transparency Versus Manipulations**

Brealey (1994); Dewenter, Kathryn and Warther, Vincent (1998) and Fluck, Zsuzsanna (1998) propounded that an important reason for companies to pay dividends may be that companies that pay healthy dividends are relatively honest and transparent and less subject to accounting manipulations. Healthy dividend payments do indicate that companies are generating real earnings rather than cooking up the books.

**Theory of Contractual Constraints**

Raghuram and Zingales (1995); Zingales (1995); Jaffrey6 1986) and Kunt, Asli & Maksimovic (1998) professed that when a company obtained loans funds from debenture holders or term lending institution this terms of issue or contract of loan may contain restrictions on dividend payments designed to ensure that the firm will have enough funds to meet its obligations to the loan providers.

**B) Considerations**

**Consideration Of Transaction Cost**

Kevin (1992); Mahapatra, Sahu (1993), Allen & Michaely (1997) and Mohanty (1999) advanced a rational argument in favour of dividend in terms of transaction costs. An investor who wants to receive a regular income from his security holding has a choice between buying dividend-paying stocks and cashing...
in the dividends and buying non-dividend paying stocks and regularly selling a part of his portfolio.

For a small individual investor, the transaction cost of cashing in the dividends may be significantly smaller than the transaction cost associated in selling a part of the stocks.

Consideration of Differential Taxes

Poterba & Summers (1984); John & Williams (1985) and Narasimhan & Asha (1997) professed that in some capitalist countries including U.S dividends are taxed higher than capital gains and thereby encouraging capital gain rather than dividends. On the other hand, tax system in India till recently was favourable for dividends vis-à-vis capital gains. So in countries where tax system favours dividends than capital gain, the investor prefers to get dividends rather than capital gains.

Consideration of Diversification of Investment Portfolio

Mervyn (1977); Mohanty (1999) and Pandey (2002) propounded that investors may have a desire to diversify their investment portfolios. As such, they would like the firm to distribute earnings that they may be able to invest in other firms. So the value of the firm will be higher if it pays dividends rather than retains it.

Consideration of Operational and Structural Compulsions

Aharony, Josepy & Swary (1980); Paul & Mullins (1983) and Brennan, Michael & Thakor (1990) propounded the concept of dividend policy in terms of investor's preference, taste and perception, market value maximization, macro-
economic implication, signaling of financial health, surplus generation, transparency, etc. All these factors are by and large, outside the firm.

Nevertheless, there are, of course, certain inside-the-firm operational and structural compulsions that dictate continuity of dividend payments or alternatively earning retentions, the outside implications notwithstanding. Understandably these factors are sector, industry and firm specific, albeit some kind of generalization can be attempted.

One school of thought suggests that current dividends are primarily determined by past dividends and also by current earnings. This model identifies fifteen variables like firm size, capital and recurring cost for plant and equipments, external financing, stock dividend, earning stability and ownership by control groups. Primarily the issue is whether there should be a change in dividend payments at all, and if there should be how large the change should be.

Moreover, dividend is determined by net profit after tax, amortization recoveries, sales changes, liquidity index and past profits, shift in anticipation of future earnings and will inversely relate to 'persistent changes' in the volume of sales.

For manufacturing industries, apart from cash flow net of taxes and past years dividend as common factors, we have to contend with depreciation, investment demand, individual taxes, interest rates, sales changes and corporate liquidity as the main factors effecting dividend.

Even during the time of financial distress, corporations with good track records of dividend payment tend to cut dividends rather than omitting dividends in order not to alter the image of the corporation. Consequently, due to sticky
dividend policy, any change in the dividend policies is interpreted as a change in the management's expectations of futures earnings.

Pertinent to mention here that, a study based on aggregate time series analysis on RBI data covering the periods 55-56 and 65-66 and four major industrial groups i.e., agriculture and allied activities, mining and quarrying, processing and manufacturing of metals and chemicals and their products as well as to selected industries in the public limited sector finds that variables determining dividends are:

i. With profits net of taxes and lagged dividends as explanatory variables.

ii. With net cash flow substituting net profits.

iii. With depreciation entered as a separate explanatory variables rather than as part of capacity variables.

Cash flow is found to be a more appropriate approximation of the capacity variables for industries such as cotton textiles, iron and steel, paper, electricity generation and supply, where as depreciation has a separate effect in the case of jute textiles and engineering industries.

One more study conducted in 1985, covered 68 companies – 12 each in chemicals and electrical goods, 14 in general engineering and 15 each in sugar and cotton textiles. Majority of companies considered the dividend decisions to be primary and active, decision variable in their financial policymaking.

The study also revealed that only half of the companies under examination were able to follow a stable dividend policy. The dividend decision of most companies was mainly governed by net current earnings after tax and 'lagged
Curiously enough, the study pointed out that none of the companies were following the policy of paying a fixed percentage of net current earnings after tax as dividend to shareholders.

The present study is specifically concerned with the dividend practices trend and the rationale in the engineering sector in particular. From the foregoing discussions pertaining to manufacturing industries in general, we can crystallize the compulsions of engineering industries in particular.

Engineering industries are characterized by high-fixed cost structure and high break-even level of operation, lower operating leverage, high depreciation, longer operating cycle, longer cash cycle, lower receivable turnover and high capital gearings. In this light, the study will concentrate on the dividend decisions in engineering sector.