ABSTRACT

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.

Dividend policy is one of the most complex aspects in finance. Three decades ago, Black (1976) in his study on dividend wrote, “The harder we look at the dividend picture the more it seems like a puzzle, with pieces that just don’t fit together”. Why shareholders like dividends and why they reward managers who pay regular increasing dividends is still unanswered.

Dividend policy can be of two types: managed and residual. In residual dividend policy the amount of dividend is simply the cash left after the firm makes desirable investments using NPV rule. Normally, the amount of dividend is highly variable and often zero. If the manager believes dividend policy is important to their investors and it positively influences share price valuation, they will adopt managed dividend policy.

Firms generally adopt dividend policies that suit the stage of life cycle they are in. For instance, high- growth firms with larger cash flows and fewer projects tend to pay more of their earnings out as dividends. The dividend policies of firms may follow several interesting patterns adding further to the complexity of such decisions. Also, there are distinct differences in dividend policy over the life cycle of a firm, resulting from changes in growth rates, cash flows, and project investments in hand.

Shareholders wealth is represented in the market price of the company’s common stock, which, in turn, is the function of the company’s investment, financing and dividend decisions. Among the most crucial decisions to be taken for efficient
performance and attainment of objectives in any organization are the decisions relating to dividend. Dividend decisions are recognised as centrally important because of increasingly significant role of the finances in the firm’s overall growth strategy. The objective of the finance manager should be to find out an optimal dividend policy that will enhance value of the firm. Like other important policy decisions dividend policy too has a signalling effect on the firm’s share prices. Generally, announcements of dividend increases generate abnormal positive security returns, and announcements of dividend decreases generate abnormal negative security returns. This is due to the fact that the company’s management has access to private and superior information about future prospects and choose a dividend level to signal that private information. Such a calculation, on the part of the management of the firm may lead to a stable dividend payout ratio.

Dividend policy of a firm has implications for investors, managers and lenders and other stakeholders, specifically the claim holders. 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. Similarly, managers’ flexibility to invest in projects is also dependent on the amount of dividend that they can offer to shareholders as more dividends may mean fewer funds available for future investments. Lenders may also have interest in the amount of dividends a firm declares, as more the dividend paid less would be the amount available for servicing and redemption of their claims. The dividend payments present an example of the classic agency situation as its impact is borne by various claim holders. Accordingly dividend policy can be used as a mechanism to reduce agency costs. The payment of dividends reduces the discretionary funds available with the management for perquisite consumption and investment opportunities and requires them to seek financing in capital markets. This monitoring by the external capital markets compels the managers to be more disciplined and act in owners’ best interest.

Companies generally prefer a stable dividend payout ratio because the shareholders expect it and reveal a preference for it. Shareholders may want a stable rate of dividend payment for a variety of reasons. Risk averse shareholders would be willing to invest only in those companies which pay high current returns on shares. Similarly, educational institutions and charity firms prefer stable dividends, because they will not
be able to carry on their current operations otherwise. Such investors would therefore, prefer companies, which pay a regular dividend every year. This clustering of stockholders in companies with dividend policies that match their preference is called clientele effect.

The study undertaken looks at the issue from emerging markets perspective by focusing exclusively on Indian Information Technology, FMCG and Services sector respectively. The FMCG sector is an evergreen sector, which has shown an upward trend after 2004 due to enhanced purchasing power of the consumers in India. The IT and the Services sectors became active majorly after liberalisation. The sample period (2000-2008) has been chosen to cover a complete business cycle.

One of the objectives of this research is to empirically examine rationale for stable dividend payments by testing the validity of Lintner Model in Indian scenario. The research also seeks to examine and identify the relative importance of known determinants of dividend policy in Indian context. It endeavors to bring to light the influence of ownership groups of a firm on dividend payout behavior. The study also tries to unfold the relationship between the shareholders wealth and the dividend payout, whether the dividend payout announcements affects the wealth of the shareholders.

The research has attempted to test two big market imperfections on which relevance of dividend decisions rests i.e. Agency costs and Information asymmetry. For the achievement of aforesaid four research objectives sophisticated statistical tools of Multiple linear regression analysis, Factor analysis, Quadratic polynomial regression analysis and Event study have been used. The sample includes companies, which are constituents of CNX IT Index, CNX FMCG Index, and CNX Service Index respectively.

The findings bring forth interesting insights of the Indian capital market. The FMCG sector scores highest in terms of dividend stability. Sectoral differences were found in the various determinants of dividend policy decisions. Results also revealed that the impact of ownership groups on dividend payout is heterogeneous. Institutional holding holds a non-monotonic relationship with dividend payout in the IT sector. However no major influence of ownership groups on dividend payout was observed in FMCG
sector. In Services sector FII holding has emerged as an influencing ownership group. The event study results highlighted semi-strong form of market efficiency in all three sectors. The findings in the Services sector to some extent support the signalling hypothesis.

Given the diversity in corporate objectives and environments, it is conceivable to have divergent dividend policies that are specific to firms, industries, markets or geographies. Corporate Finance managers would be able to examine how the various market frictions such as asymmetric information, agency costs, taxes, and transaction costs affect their firms, as well as their current claimholders, to arrive at suitable dividend policies. Previous researches have focused on dividend payment patterns and policies of developed markets, which may not hold true for emerging markets like India. Few studies have analysed the dividend behavior of corporate firms in Indian context. The focus of earlier studies has been on Indian cotton textile Industry and Manufacturing sector. Most of these studies have paid attention on influence of cash flows or earnings on the dividend payments of a firm. However, it is still not apparent what the dividend payment pattern of firms in India is. So, far to the best of the researcher’s knowledge this is the first attempt to study the dividend payout patterns, trends, determinants of firms in IT, FMCG and Services sector respectively.

Further, for the dividend policy makers of the Indian IT, FMCG & Services Industry, the study may prove to be useful for re-sketching their dividend policy keeping in view the analysis, results and discussions presented. The study would enable the researchers to have a better understanding of the factors that should systematically affect firms’ payout decisions. It also gives insight into what kind of ownership structure is beneficial for the shareholders.