

# Factors Considered in Dividend Payout Decisions – The Case For Listed Companies in Kenya

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## Abstract

The dividend decision is one of the fundamental financial decisions in the management of a firm. To most investors, the value of an investment is assessed primarily on the basis of returns received usually in form of dividend and interest. Thus, a firm's dividend decision carries significant information value to investors.

On the other hand, the expanding investment market in Kenya has placed an increased challenge on managers to accumulate sufficient funds for growth. This situation has further limited managers' discretion on the dividend payment. A balance between the various competing interests is critical for sustainable growth of a firm.

Considering that quoted companies in Kenya enjoy public trust and investor confidence due to the stringent governance and reporting requirements, which in most cases are reflected in the positive earnings and growth that they generate for their shareholders, it would be useful to study the key factors that drive their dividend policies. These considerations may be replicated in other firms and sectors so that they too may achieve sustainable growth while addressing the needs of their diversified investors.

This study therefore seeks to examine the factors considered by management of quoted companies in Kenya in determining the dividend payout ratios. The study goes further to assess whether the ranking of these factors is influenced by the nature of industry, size and age of a company.

The research is exploratory in nature and adopts a survey approach. For this purpose, primary data is obtained through a questionnaire administered on the management of the companies while secondary data is obtained from published financial statements over an eight year period from January 1998 to December 2005. The results indicate that the current and future profitability of a company, the cash flow position, the financing requirements and the availability of profitable investments, in that order are the main considerations in the dividend payout decision of a firm. On the other hand, the size of a firm, the number of years of operation (age) and the nature of the industry do not significantly affect a company's dividend policy in relation to payout.

**Keywords:** Dividends, payout, determinants, dividend theories, Nairobi Securities Exchange.

## 1. Introduction

Dividends represent the return that shareholders expect to receive on their individual capital investment in a company. The dividend decision involves the determination of the proportion of earnings that a company pays out to shareholders, and is one of the major decisions that managers make in addition to capital structure and budgeting decisions. Where the dividend decision is pre-determined from one year to another, it represents the dividend policy of the company.

The dividend decision usually involves a tradeoff between the interests of shareholders and those of the company. This is because retained earnings, from which dividends are paid, are the most important internal sources of capital to a firm (Barclay, 1995). Thus, a company distributing a high proportion of its earnings as dividend may, while pleasing the investors who have a preference for cash dividends, reduce the amount of earnings retained in the firm thus affecting the total amount of internal financing. A balance has therefore to be established between the interests of the company and that of investors.

Figuring out why companies pay dividends and investors pay attention to the dividends continues to be a puzzle today. According to Amidu and Abor (2006), setting corporate dividend policy remains controversial and involves judgement by decision makers. There has been emerging consensus that there is no single explanation of dividends. According to Brook *et al.* (1998), there is no reason to believe that dividend policy is driven by a single goal. Previous empirical studies have focused mainly on companies operating in established financial markets in developed countries. The last comprehensive study on dividend policies covering the broad range of listed companies in the Kenyan context was undertaken in 1987. Since then, a number of changes have been witnessed including a tremendous increase in the number of quoted companies, enhanced investor awareness and interest on the dividend decision, increased alternative investment opportunities in the market, closer regulation by the relevant authorities including on profitability, liquidity and dividend payouts and the opening up of the regional markets giving investors an opportunity to participate in different financial markets in the region.

This study revisits the issue of dividend payout and its determinants in the changed market environment. Dividend payout is defined in the context of this study as the percentage of profits paid as cash dividend to the shareholders. This study further examines the effects of industry type, size and age of a company

on the rankings of the various factors that affect dividend policy. The findings from this study will guide managers in their dividend decision making, by highlighting the key factors that stable companies quoted on the Nairobi Securities Exchange consider in making their dividend decisions. The study will also inform the dividend expectations of investors, by showing the dividend decision as dependent on a number of factors both within and without the control of managers.

The rest of the article is organised as follows: Section two gives a review of the theoretical and empirical literature, Section three discusses the methodology, Section four presents and discusses the results of the empirical analysis and Section five gives the summary and conclusions.

## 2. Literature review

### 2.1 Theoretical overview

Different theories have been advanced either arguing for or against dividend payments by firms. These arguments are of scholarly importance since they determine whether it is indeed worthwhile to study the dividend decision in a firm and further the factors that affect the dividend decision.

Those arguing the case for dividends postulate that firms should first and foremost provide for regular dividends, and then address the other operational challenges from the dividend payout. Theories against dividends mainly provide that firms should prioritize utilization of funds in other projects and only consider dividends if surplus funds remain. The two schools of thought determine the importance that a manager would attach to the various factors that influence the dividend decision.

Various researchers and scholars have argued the case for dividend payments. Myron Gordon (1963) in his bird in hand theory argued for the relevance of dividends in firm valuation, theorizing that shareholders are risk averse and prefer certainty. The information signaling effect theory as advanced by Stephen Ross in 1976 also argued that dividends are relevant and that in an efficient market, management can use dividend policy to signal important information to the market which is only known to them. For example, if management pays high dividends, it signals high expected profits in future to maintain the high dividend level. The clientele effect theory as advanced by Richardson Petit in 1977 also argued for the relevance of dividends in firm valuation. The theory states that different groups of shareholders (clientele) have different preferences for dividends depending on their level of income from other sources. Low income earners prefer high dividends to meet their daily consumption while high income earners prefer low dividend to avoid payment of more taxes. At equilibrium, dividend policy will be consistent with the clientele that the firm has. Dividend decisions at equilibrium are irrelevant since they cannot cause any shifting by investors (Pandey, 2006).

The tax differential theory advanced by Litzenger and Ramaswamy in 1979 further supported the dividend relevance position. According to this theory, dividends are relevant in firm valuation. They argued that tax rate on dividends is higher than tax rate on capital. Therefore, a firm that pays dividends has lower value since shareholders pay more dividends. In Kenya, dividends attract withholding tax of 5% which is final, and capital gains are tax exempt.

Another dimension in which dividends are viewed as relevant is with regard to their reduction of the agency conflict. Easterbrook (1984) and Hansen, Kumar and Shome (1984) argued that when companies pay cash dividends and at the same time finance externally, they reduce the agency conflict between managers and shareholders. The agency cost paradigm was first studied by Jensen and Mecklin (1976) and then extended explicitly to dividends by Roseff (1982). It suggests that when firms are profitable, managers finance their investment from retained earnings.

Allen, Bernado and Welch (2000) argue that, to increase value, firms need larger shareholders to monitor management or facilitate takeovers of badly managed firms. Large shareholders prefer dividends because of comparative tax advantage that some shareholders have for dividend.

Van Horne (2001) argues that investors have started to put pressure on firms to declare dividends, thus paying attention to the health of companies' bottom lines instead of focusing solely on growth opportunities and gains.

The case for dividend irrelevance is also strong. Modigliani and Miller (M and M, 1961) advanced the dividend irrelevance theory and argued that in ideal circumstances, the level of a firm's dividends will not affect the value of the firm with shareholders being indifferent to an announcement of high or low levels of dividends. M and M further argued that the value of a company depends solely upon the investment opportunities available to it. They also argued that finance for investment is always available for worthwhile projects, that is, for a given set of investment opportunities, the firm can raise sufficient capital internally and externally to fund both its investment programmes and dividends. The implication of M and M (1961) proposition on managers is that they should spend more time managing the firm's assets. The residual dividend theory was advanced by Stewart Myers in 1984 and further argued for the irrelevance of dividends. The essence of the theory is that the firm will only pay dividends from residual earnings, that is, from earnings left over after all suitable investment opportunities have been financed. Managers will prefer to utilize retained earnings as the primary source of

investment financing before issuing debt or equity.

From a theoretical perspective, the case for the relevance of dividends appears stronger. It is thus worthwhile to study in detail the factors that influence the dividend decision.

## 2.2 Empirical Literature

The literature on dividend payout ratios provides firms with no generally accepted prescription for the level of dividend payment that will maximize share value (Amidu and Abor, 2006).

The relationship between the dividend decision and investment decision was brought to the fore by Miller and Modigliani (1961) who established that in a perfect capital market, optimal investment decisions by a firm are independent of how such decisions are financed. In this case, then there should be no correlation between dividends and investment decisions. These findings were supported by Fama (1974), Miller (1986) and Farida (1993). Farida (1993) suggests that further research be carried out to determine the relationship between dividends and investments as her study was inconclusive. A contradictory finding was by Maina (2001) whose investigation on the empirical relationship between investment and dividend decisions concluded that investment decisions significantly affected a firm's dividend decision.

Higgins (1972) investigated the relationship between the dividend decision and shareholder wealth maximization. He started working from the assumption that capital gains are superior to dividends as a source of shareholder income and that the optimal strategy for the shareholder wealth maximization is to maximize share price appreciation relative to dividends. Higgins (1972) found that shareholders prefer retention of earnings for wealth maximization, rather than payment of earnings as dividends. He also found dividends to be independent of size of the company.

The aspect of the nature of industry was examined by Baker, Farelly and Edelman (1985) whose study focused on three industries; utilities, manufacturing and wholesale/retail. They did not find any industry effects to the dividend decision.

The liquidity and cash flow dimension in Kenya was investigated by Karanja (1987). His study found three factors to be most critical in the dividend payout decision; the cash and liquidity position, the current and prospective profitability and the company's level of distributable reserves. He also observed that the foreign controlled companies had more liberal dividend policies than locally controlled companies.

Seitz (1990) identified inflation as having an influence on the dividend payout, suggesting that a case can be made for companies retaining earnings simply to preserve the earnings power of the company.

Kuria (2001) looked at dividend policies in relation to a company's growth in assets, return on assets and return on equity. He found an inverse relationship between payout ratios and growth assets concluding that managers used retained earnings as a source of funds to finance company growth. He also concluded that an investor who is especially interested in cash dividends rather than capital gains will be able to distinguish those companies with a high dividend payout ratio from those with high capital gains.

Fama and French (2001) provide evidence that although cash dividends appear to be gradually disappearing, those firms still paying dividends tend to be large, highly profitable and have fewer investment opportunities. DeAngelo et al (2006) confirm the Fama and French (2001) results regarding firm size, profitability and growth opportunities.

Bitok (2004) studied the effect of dividend policy on the value of firms quoted on the Nairobi Securities Exchange. He observed a weak positive relationship between payout and the value of quoted firms. He attributed this finding to the information signaling effect theory as advanced by Stephen Ross in 1977.

The empirical findings converge on two key factors in the dividend payout decision; profitability and liquidity. There are conflicting findings with regard to the impact of size, availability of investments and economic factors. In addition, most of these studies have been conducted in the developed world and the findings may not necessarily apply to the developing countries like Kenya. Furthermore, the financial market environment keeps changing as investor awareness increases accompanied by changes in the level of competition, investment alternatives, management attitude, regulatory changes and globalisation.

Arising from the conflicts in research findings and the constantly changing market dynamics, this study aims at investigating a range of variables over a broader period covering eight years with a view to determining how the variables influence the dividend payout decisions of companies operating in the current Kenyan environment.

## 3. Data and empirical methods

This study examines the determinants of dividend payout among listed companies in Kenya. The study further examines the effect of the industry type, size of the company and age of the company in terms of years of operation on the importance attached to the various factors influencing dividend payout.

Information was sourced from a sample of 43 listed companies which had maintained positive earnings per share (EPS) over the eight year period commencing 1998 to 2005. Primary data was obtained from the

companies through a survey which involved the administration of a questionnaire to the 43 companies. Responses were received from 32 companies which represented a response rate of 74%. Secondary data on the size and age of companies was obtained from the published annual financial statements of the companies for the period of study. Additional data was obtained from quarterly publications by the Nairobi Securities Exchange.

For purposes of industry analysis, the companies were categorized into four industries; agriculture, commercial and services, finance and investment and industrial and allied. Further, the factors were grouped into three; those relating to company circumstances, those relating to the nature of shareholders and those relating to the industry and economy.

For size analysis, the companies were categorized as either big, average or small based on their relative market share in their respective industries. Companies with a market share equal to or exceeding 40% were considered as big; those with below 40% but above 20% were considered as average, while those with below 20% were considered as small.

Factor analysis was used to rank the factors considered in order of importance. This method was also used by Karanja (1987) and in part by Farida (1993). Responses to the questionnaires were coded and presented by way of tables and graphs for analytical purposes. Managers were required to rank each factor on a range from very important (score of 5) to not important (score of 0). On collection of all the data, percentage scores were awarded to each factor. Factors with a score of 70% or above were categorized as of high importance, factors with a score of between 50% and 69% were categorized as of medium importance while factors with a score of between 1% and 49% were ranked to be of low importance. Zero score factors were categorized as non important.

#### 4. Empirical findings

A total of fourteen factors were identified from the cross section of companies as relevant in the dividend decision. These factors are as follows in order of overall ranking:

**Table 1. Overall factor rankings (in order of importance)**

High importance (Score at least 70%)	Medium importance (Score between 50% and 69%)	Low importance (Score between 1% and 49%)
Profitability Cash flow Financial needs	Available investments Economic growth rate Availability of alternative finance Investor interpretation Inflation rate Payouts by other companies	Shareholders control Target payout Loan terms restricting dividend payouts Tax rate on dividend Personal preferences of management

Companies seem to accord the greatest importance to the current and expected future profits in assessing the amount of dividends to distribute. This factor is rated as very important by management. This is closely followed by the cash flow position of a company and the financial needs, in that order. Other factors considered to significantly affect dividend payout are the availability of profitable investments, general economic growth rate and the company's ability to access finance.

Further, companies did not attach significant importance to the need to maintain shareholders control, set target ratios, restrictions on loan contracts and the withholding tax rate on dividend income, possibly because occurrence of such situations is not common in most companies. The personal inclinations and preferences of management are ranked as least important in the dividend payout decision.

Companies were also categorized into four industries. Analysis of factor rankings was then made to determine whether the nature of industry affected the rankings of the factors. The factors ranked as most important in each of the four broad categories of industries are summarized below:

**Table 2: Factors ranked as highly important across the four main industries**

Nature of industry			
Agriculture	Commercial and Services	Finance and Investment	Industrial and allied
Profitability	Profitability	Profitability	Profitability
Cash flow	Cash flow	Availability of alternative investments	Cash flow
Financial needs	Financial needs	Inflation rate	Availability of alternative investments
Investor interpretation	Availability of alternative investments	Investor interpretation	Financial needs

From the table, the nature of the industry does not significantly change the ranking of the most important factors, except in the Finance and Investments industry where financial market parameters in terms of

availability of investments and inflation are considered as very important right after the profitability levels. However, profitability is still considered the most important factor in determining dividend payouts across the industries.

In terms of size, companies were categorized as either big, average or small based on their relative market share in their respective industries. Companies with a market share equal to or exceeding 40% were considered as big; those with below 40% but above 20% were considered as average, while those with below 20% were considered as small.

The factor rankings on the basis of size are summarized below:

**Table 3: Factors ranked as highly important across the company sizes**

Size of companies		
Big	Average	Small
Profitability	Profitability	Profitability
Cash flow	Cash flow	Cash flow
Financial needs	Financial needs	Ease of access to alternative finance
Availability of alternative investments	Availability of alternative investments	Financial needs

Again, size appears not to significantly affect the ranking of the factors, except for small companies where access to finance features high among the factors ranked as important. This could be because small companies have limited access to external finance, hence would prefer to retain profits to finance growth rather than pay dividends when the sources of alternative finance are constrained.

The study further considered the effect of the age of a company on the importance attached to the various factors. For this purpose, companies were grouped into three age categories; below 10 years, between 10 and 20 years and above 20 years. However, none of the respondent companies in the study was below 10 years old.

The summarized results of the analysis are as follows:

**Table 4: Factors ranked as highly important across the company ages**

Age of companies	
Above 20 years	Between 10 and 20 years
Profitability	Profitability
Cash flow	Cash flow
Availability of alternative investments	Financial needs
Economic growth rate	Ease of access to alternative finance

Although profitability and cash flow positions were ranked highly regardless of the age of a company, other factors ranked highly appeared to reflect the maturity stage of companies above 20 years of age. Such companies appear to have hit their income plateaus hence would not worry so much on their financial needs or the availability of alternative finance in arriving at their business decisions on dividends. For smaller companies which are yet to establish themselves in the market, consideration of their financial needs and access to alternative finance ranked high in determining their annual dividend policy.

## 5. Summary and conclusions

The study examines the determinants of dividend payout ratios for quoted companies in Kenya. The research findings identify the company's current and future profitability as the prime consideration in the dividend payout decision. Other factors also considered as important are the cash flow position, the immediate financial needs and the availability of profitable investments.

Further, the study indicates that the industry in which a company operates, size of the company and age do not significantly influence a company's dividend payout decision as these variables do not affect the factor rankings. However, smaller companies and young companies (less than 10 years old) tend to rate certain factors tied to their limited capital base highly, such as financial needs and availability of alternative finance.

Given that the dividend payout decision has an impact on other decisions and strategies of a company, such as the investment and financing decisions, it is important that a proper balance be achieved between the short term and long term interests of the company, shareholders and other investors. Although paying dividends may satisfy the short term interests of shareholders, it might work against their long term interests as the company might be unable to invest in profitable ventures as the cash is utilized to pay the dividends.

Thus, profitability, cash flow position, financial needs of the company and the availability of profitable investments are the key factors whose specific attention can assist a company attain its desired balance in

stakeholders' interests.

Another significant conclusion of the study is that, considering that size, industry type and age of a company do not affect the dividend policy of a company, it could be possible to generate a standard optimal dividend policy applicable to companies regardless of their peculiarities. This could be an area for further research.

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