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# Chapter One

## Introduction

Dividend payout is the amount of cash paid to shareholders expressed as a percentage of earnings per share. Lintner (1962) defined dividend payout ratio as the ratio of dividends to net income. The dividend payout ratio measures what percent of earnings is paid out as dividends. Holding everything else equal, the same firm that pays out more of its earnings today would pay out less in the future. If it had retained earnings, it would have earned more cash for payout later.

The issue of corporate dividends has long been observed, it is bound up with the development of the corporate firm itself. Corporate dividends date back at least to the early sixteenth century in Holland and Great Britain when the captains of sixteenth century sailing ships started selling financial claims to investors, which entitled them to share in the proceeds, if any, of the voyages. At the end of each voyage, the profits and the capital were distributed to investors, liquidating and ending the venture's life to reduce the possibilities of fraudulent practice by captains.

Dividend payout poses a very important aspect in the current business environment. Dividend policy is the regulations and guidelines that a company uses to decide to make dividend payments or not to shareholders. The dividend policy decisions of firms are the primary element of corporate policy. Dividend, which is basically the benefit of shareholders in return for their risk and investment, is determined by different factors in an organization. These factors include financing limitations, investment chances and choices, firm size, pressure from shareholders and regulatory regimes.

The structures of corporate dividend policies vary over time and across countries, especially between developed, developing and emerging capital markets. Glen et al. (1995) found that dividend policies in emerging markets differed from those in developed markets. They reported

that dividend payout ratios in developing countries were only about two thirds of that of developed countries.

### **1.1 Background of the Study**

A firm's payout decision is often intertwined with other financing or investment decisions. Some firms pay out little cash because management is optimistic about the firm's future and wishes to retain earnings for expansion. In this case the payout decision is a byproduct of the firm's capital budgeting decision. Another firm might finance capital expenditures largely by borrowing. This frees up cash that can be paid out to shareholders. In this case the payout decision is a byproduct of the borrowing decision. (Petit, 1972).

Enhancing shareholders' wealth and profit making are among the major objectives of a firm. (Jenson & Meckling, 1976) Shareholder's wealth is mainly influenced by growth in sales, improvement in profit margin, capital investment decisions and capital structure decisions. Firm performance in this case can be viewed as how well a firm enhances its shareholders' wealth and the capability of a firm to generate earnings from the capital invested by shareholders. Dividend policy can affect the value of the firm and in turn, the wealth of shareholders.

According to Fama (1991) to isolate payout policy from other problems of financial management one asks a question on the effect of a change in payout policy given the firm's capital budgeting and borrowing decisions. If a firm proposes to increase its dividend, the cash to finance that dividend has to come from somewhere. Fixing the firm's investment outlays and borrowing leaves only one possible source which is to issue stock. If a firm decides to reduce its dividend it will have extra cash. If investment outlays and borrowing are fixed repurchasing stock is the only one possible way that this cash can be used. The payout policy therefore involves a tradeoff between higher or lower cash dividends and the issue and repurchase of stock. There exist three opposing point views with payout policy. On one side there is a group that believes high dividends increase value. On the other side there is a group that believes high dividends bring high taxes and therefore reduce firm value and in the third party believes payout policy makes no difference.

There are dividend theories that have been put across by academicians (Baker, 2001). The theories view dividends as either relevant or irrelevant in making financial decisions. Miller and Modigliani theory proposes that in a capital market where there are no imperfections such as taxes, transaction costs, asymmetric information and agency costs, the dividend policy of a company is irrelevant for the market value of its shares. It therefore implies that financial managers cannot alter the value of their firms by changing dividend policy. They showed that firm value is enhanced by investing in productive assets and not by the way in which income is distributed to shareholders. According to their theory, dividend policy is therefore irrelevant and a rational investor does not have a preference between dividends and capital gains. Several researchers have come up to oppose the theory developed by

The agency cost theory suggests that, dividend policy is determined by agency costs arising from the divergence of ownership and control. Managers may not always adopt a dividend policy that is value-maximizing for shareholders but would choose a dividend policy that maximizes their own private benefits. Making dividend payouts which reduces the free cash flows available to the managers would thus ensure that managers maximize shareholders' wealth rather than using the funds for their private benefits (Ross, 2002).

The signaling theory proposes that dividend policy can be used as a device to communicate information about a firm's future prospects to investors. Cash dividend announcements convey valuable information, which shareholders do not have, about management's assessment of a firm's future profitability thus reducing information asymmetry. Investors may therefore use this information in assessing a firm's share price. Dividend policy under this model is therefore relevant

Bird in hand theory proposes that a relationship exists between firm value and dividend payout. It states that dividends are less risky than capital gains since they are more certain. Investors would therefore prefer dividends to capital gains (Mugenda & Mugenda 2003). Because dividends are supposedly less risky than capital gains, firms should set a high dividend payout ratio and offer a high dividend yield to maximize stock price. Researchers have different views about whether dividend payout materially affects the long term share prices. (Mugenda & Mugenda 2003) who

used a survey approach to capture managerial views and attitudes of corporate managers regarding dividend policy found that dividend policy serves to enhance corporate market value. However (Mugenda & Mugenda 2003) argue that empirical studies that conclude a causal relationship exists between earnings and dividends are based on short periods of time and are therefore misleading to potential investors. Therefore, dividends have no explanatory power to predict future earnings. This research therefore tries to establish whether a relationship exists between dividend payout and firm performance.

Profit is the surplus remaining after all costs including interests and taxes have been deducted from total revenue earned. Profit is said to be the most known measure of success of any given firm. It acts as a yardstick used in evaluating whether the owner's investment is worth or not. Dividend payout is basically returns to the shareholders for their capital employed in the firm. Dividend payout does not only entail cash outflow from the firm but it also has a substantial signaling effect. Profits are an important consideration to a finance manager when making financing, investing, and dividend decisions. Financing and investing decisions entail making choices on how much of the profits will be used to finance a firm's operations and undertake new investment opportunities. Dividends are the returns in form of cash or bonus shares issued to shareholders in regards to the shareholding held by the shareholder. It is the return on their investment in the firm. Dividend payout is the percentage of profits paid to shareholders in dividends. It is the ratio of annual dividend per share to profits per share of the firm (Brockington, 1993). The dividend policy guides the finance manager to decide how much will be paid out to shareholders in form of dividends for their share capital holding in the firm (Amidu & Abor, 2006). The main types of dividend policies are as follows. First, the constant payout ratio under which a firm agrees upon a constant percentage of the profits as dividends. It maintains this amount regardless of whether the firm makes more profits or not. Second, the residual dividend policy payout where a firm issues out dividends from the amount that remains after all investments have been undertaken. If all profits are used for investment then no dividends are to be issued out during that period. Third, stable dividend policy where a constant amount of money is distributed to every shareholder in the firm. Fourth, occasionally firms use the Stable plus extra policy where a constant amount of money is maintained as dividend to be issued to every shareholding but an extra amount can be paid when the firm makes huge profits in a

particular trading period. Dividends can be distributed to shareholders in form of cash or stock dividends. Cash dividends involve the dividends being distributed to shareholders in form of money. The profits are divided between the numbers of shares outstanding in the firm. (Amidu & Abor, 2006) account for the reason some investors would prefer cash dividends to other forms of dividends. Stock dividends are issued when the firm intends to retain the profits for reinvestment opportunities in the future. The profits are converted into stock which is given to shareholders free of charge. It guarantees the shareholder additional revenue in the future since dividends are issued in regards to the number of shares held by an individual. The more shares held the greater the amount one receives as dividends and vice versa.

Most companies however prefer payment of cash dividends rather than stock dividends. Stock dividends are often made to increase ownership of existing shareholders rather than diluting their interests through the introduction of new shareholders. This is normally the best option especially when the company is faced with serious cash flow problems. Dividend policy regulates and guides a firm's management when issuing dividends to shareholders. Mature companies with stable cash flows and limited growth opportunities tend to return large amounts of their profits to shareholders either by paying dividends or using the cash to repurchase common stock. Firms that are rapidly growing with good investment opportunities invest most of their available cash flows in new projects. They are likely to pay fewer dividends or repurchase their own stock. The dividend paid out has an effect on the liquidity and profitability position of a firm. Liquidity is the ability of a firm to meet its obligations as and when they fall due. (Mulwa, 2006). When a firm issues out dividends it reduces the amount of liquid cash that can be used to meet the demands of short time creditors and lenders. This can have a negative impact on the survival of a firm forcing it to an insolvency situation. Profitability of a firm can also be affected by the dividend decision. By issuing out dividends to the shareholders, the available cash that could have been used for reinvestment is drawn out of the firm. Profits are basically the surplus or profits retained by a firm from its normal business operations. It is what the firm remains with after deducting the firm's expenses from the revenue it earns from its operations.

A firm's profits as shown from its income statement are used to indicate the profitability and viability of a business venture (Brealy & Marcus 2007). A firm mainly exists for the sole reason of

maximizing wealth of the shareholders. Therefore a firm aims at maximizing profits at any given point in time. Profits on the income statement of a firm are important as they show the profitability and viability of the business venture. A firm that continually makes losses is deemed to be of no value to the owners as they do not receive any returns for their capital holding while at the same time reducing the capital base of the shareholders. The firm's profits are also used for valuation of a company. The value of equity of a firm is thereby determined by multiplying the current PAIT by a suitable multiple. The current PAIT may be adjusted onto a more representative basis to take into account such things as unusual events and owner manager policies. The suitable multiple is usually the price-earnings ratio of a listed company on the Nairobi securities exchange market. Various users of financial statements of a firm make their decisions by evaluating the performance of a firm. The firm's performance is well represented by examining the income statement which gives the balance of profits of a firm at the end of a financial period. The performance as depicted by the profitability of a firm can influence the decisions of financial statement users to invest in the firm or not.

Profits can be affected by both macro-economic and micro-economic factors prevailing. Macro factors are the factors outside the firms control while micro factors are the factors in which the firm has control over (Mizuno, 2007). Macro factors include political, environmental, socio-cultural, technological and legal factors. Micro factors on the other hand include the firm's customers, employees, competitors, media, owners and suppliers. Changing levels of profits indicate some level of changes in returns. This can be caused by risks involved in the industry as a whole or risks facing individual firms. For instance in Kenya in the year 2011, movements in interest rates, inflation and exchange rates presented real dangers to economic stability. Firms experienced high cost in borrowing funds and acquiring input resources. Faced by these challenges and a low consumer purchasing power meant that the earning ability of the firms will be reduced. Dividends are issued out from the retained profits of a firm. When a firm makes higher profits in a given trading period, it is expected to issue out more dividends to the shareholders. The proportion of profits distributed is measured by the payout ratio which is cash dividend divided by profits per share. From this point of view, it can be hypothesized that profits and dividend payout have positive linear relationship (Bitok, Cheruiyot, Maru & Kipsat (2010).

Among the requirements that companies that want to be listed in the Nairobi Securities Exchange must fulfill, is that they should have a clear future dividend policy. This makes dividend policy worthy of serious management attention.

In Kenya, sixty four companies are listed in the Nairobi Securities Exchange (NSE), which is the only stock exchange firm in the country (Nairobi Securities Exchange, 2018). The Nairobi Securities Exchange classified these companies into thirteen sectors namely; agricultural, automobiles and accessories, banking, commercial and services, construction and allied, energy and petroleum, insurance, investment, investment services, manufacturing and allied, telecommunication and technology, real estate investment trust, exchange traded fund.

## **1.2 Problem Statement**

A positively significant relationship is expected to exist between dividend payout and leverage, profitability, sales growth, cash flow, tax and earnings per share and a negative association between dividends pay out and risk and market-to-book value. The above relationship between dividend payout and its determinants has been studied empirically in Kenya.

Dividend policy is therefore, considered to be one of the most important financial decisions that corporate managers encounter (Ross & Westerfield 2002). It has potential implications for share prices and hence returns to investors, the financing of internal growth and the equity base through retentions together with its gearing and leverage. Dividend puzzle, both as a share value-enhancing feature and as a matter of policy is one of the most challenging topics of modern financial economics. They agree to the fact that a firm ought to pay dividends to shareholders if it cannot identify suitable investments which would bring higher returns than those expected by the shareholders.

According to (Mizuno, 2007) successful companies accorded key importance to four factors namely profitability, cash flow, financing requirements and availability of profitable investments. The nature of the industry, the size of the company and the number of years the company has been in operation are found not to significantly affect company dividend policy in relation to payout.

Aggregate dividend payout ratio for the Kenyan market will be 44.14%. Factors that determine dividend payout ratio among Savings and Credit Cooperative Societies (SACCO) in Kenya. The study established that SACCO's profitability, growth opportunity, cash flow and size variables positively influenced dividend payout ratio, while risk variable negatively influenced dividend payout ratio. There is a positive relationship between dividend payout and leverage, profitability, corporate tax, sales growth, industry and earnings per share. He also found a negative association between dividends pay out and cash flow.

They found a significant positive relationship between dividend policies of organizations and firm's profitability, a significant positive relationship between dividend policy and investments and a significant positive relationship between dividend policy and earnings per share. There is evidence that indicated that financial leverage has a positive interaction with dividend payout ratio but no significant interaction with investment. He also observed that irrecoverable advance tax has a positive, albeit weak influence on dividend payout ratio and overseas profit has a negative influence on the ratio.

Investigated the relationship between dividend changes and future profitability, measured in terms of either future earnings or future abnormal earnings. They found out that dividend changes provided information about the level of profitability in subsequent years, incremental to market and accounting data. They also found out that dividend changes are positively related to earnings changes in each of the two years after the dividend change. Historical evidence strongly suggested that expected future earnings growth will be fastest when current payout ratios are high and slowest when payout ratios are low. Welch (2009) examined the relation between dividends and earnings. Other studies however indicate there will be no significant relation between dividend policy and earnings in long run. He recommended that different possibilities of relationship between future earnings and dividend should be analyzed.

Some studies indicate there will be a positive relation between dividend payouts and future earnings growth. (Bitok, Tenai, Cheruiyot, Maru & Kipsat, 2010) conducted a study analyzing the impact of earning management on dividend payout policy. Results explored earning management and all control variables has negative relation with dividend payout policy. There is a positive relationship between dividends, earning and investment for firms listed on the Stock exchange.

However for non-actively traded shares, the accounting book value will be the most important determinant. Dividend increases are linked to higher pre-tax operating profit effects which outweighed post tax effects. For a wide portfolio of actively traded shares, gearing and firm size are seen to affect the dividend payout ratio. Dilawer (2012) examined the determinants of dividend payout ratios of listed firms and found statistically significant and positive relationship between dividend payout ratio and profitability, cash flow and tax. The results also showed a negative association between dividend payout and risk, institutional holding, growth and market-to-book value. The theoretically expected relationship between dividend payout and variables measuring firm performance are very clear but the empirical finds shows mixed results. The proposed study seeks to test the relationship between dividend payout and financial performance of listed on the Nairobi Securities Exchange. The proposed study will test the relationship between dividend payout and four variables measuring financial performance namely profitability, cash flow, sale growth and market-to-book value (Hanif, 2014).

### **1.3 Research Objectives**

The general objective of the research will be to establish the relationship between dividend payout and firm performance among listed companies in Kenya. The research will be also guided by the following specific research objectives;

1. To establish the effect of stable dividend policy on firms performance
2. To evaluate the effect of constant dividend policy on firms performance
3. To determine the effect of residual dividend policy on firms performance

### **1.4 Research hypothesis**

- I. There is no relationship between stable dividend policy and the performance of a firm.
- II. There is no relationship between constant dividend policy and the performance of a firm.

- III. There is no relationship between residual dividend policy and the performance of a firm.

### **1.5 Justification**

To corporate managers, the study findings will be used as a basis of planning as it will reveal the effect of dividend payout on financial performance. It will help manager to plan on the proportion of profits that should be retained versus the portion that will be distributed as dividends to stockholders. Managers are also rated on financial performance hence the findings of this study will be of great benefit to them.

For academicians, the findings of this study will make contributions to the existing empirical literature on dividend payout. It will be used to establish further research gaps as well as act as a reference for further research under the field of dividend. Thus this study is going to be of helping in trying to answer the question of whether dividends affect the performance of a firm.

Investors are the real owners of firms since they invest their money in the firm and in the end they expect good returns for their investment. Therefore this research study is going to prove helpful to the investors by determining the value of dividends payout to firm's performance.

### **1.6 Scope of the study**

The study will be composed of companies listed in the Nairobi Securities Exchange (NSE) that are currently trading with the exemption of the suspended stocks as they will not be very reliable.

## **Chapter Two:**

### **Literature Review**

#### **2.0 Introduction**

#### **2.1 Theoretical Framework**

This chapter analyses theories, past studies, literatures, researches and empirical studies done on the effects of dividend policy on the company's value.

##### **2.1.1 Dividend Irrelevance Theory**

The theory will be developed by Modigliani and Miller (1961). They argued that a firm's value is determined only by its basic earning power and its level of business risk and not the dividend policy adopted. In their view, dividend payout is irrelevant. Their conclusion will be that a firm value depended only on the income produced by its assets and not how this income is split. In review of this theory dividend issued out to shareholders does not determine the value of a firm hence irrelevant in regards to firm valuation. A shareholder can in theory construct his own dividend policy.

If a firm does not pay dividends a shareholder who wants a 2% dividend can create it by selling 2% of his shares. If a firm that pays higher dividend than desired by shareholder, he can use the unwanted dividend to buy additional shares of the firm's shares. If he can buy and sell shares hence create his own dividend policy without incurring costs, then the firm's dividend policy is irrelevant (Fama, 1991).

MM based their argument on unrealistic assumptions of a perfect capital market and rational investors such as: no differences between taxes on dividends and capital gains; no transaction and flotation costs incurred when securities are traded; all market participants have free and equal access to the same information (symmetrical and costless information); no conflicts of interests

between managers and security holders (no agency problem); and all participants in the market are price takers (Amidu & Abor 2006).

The proposition of dividend irrelevancy will be based on several binding assumptions about the nature of perfect capital markets. This is a 'p priori' model of how markets should work if they are perfect. Naturally, once we depart M&M's world of perfect capital market and relax one or more of the assumptions of perfect capital markets, the issue of dividend policy becomes more complicated. Introducing market imperfections might change the view that dividend decision is irrelevant. Importantly, if dividend policy is relevant it may interact with other decisions made by the firm about investment and financing. In words, there may conceivably be a range of reasons why dividend policy might matter (Dilawer, 2012).

### **2.1.2 Dividend Preference Theory or Bird in Hand Hypothesis**

The propagators of this school of thought were Lintner (1956) and Gordon (1959) as a response to Modigliani and Miller's dividend irrelevance theory. Their argument is based on the uncertainty of the future hence shareholders prefer receiving dividends to not receiving them. They also prefer current dividends to future capital gains because something paid today is more certain to be received than something expected in the future. One alternative and older view about the effect of dividend policy on a firm's value is that dividends increase firm value. In a world of uncertainty and imperfect information, dividends are valued differently to retained profits (or capital gains).

Investors prefer the "bird in the hand" of cash dividends rather than the "two in the bush" of future capital gains. Increasing dividend payments, *ceteris paribus*, may then be associated with increases in firm value. As a higher current dividend reduces uncertainty about future cash flows, a high payout ratio will reduce the cost of capital. A representative sample of that debate would include: Lintner (1962), Gordon (1963) Walter (1963), Baumol (1963), Brigham and Gordon (1968), and Van Horn and McDonald (1971). That is, according to the so-called "bird-in-the hand" hypothesis high dividend payout ratios maximize a firm's value. Gordon and Lintner's proposition will be made with an assumption that investors are risk averse and will therefore

prefer cash dividends now to future capital gains. With them dividend payment is assumed to be relevant to the investors.

(Mulwa, 2007) states that investors will prefer dividends now may not hold through especially considering the fact that not all investors pursue same interest in a given point in time. For example a well off investor may go for future capital gains given the circumstance while at the same time a non-well off investor may pursue a different strategy altogether by going for cash dividends now. Investors also do have different risk perceptions. They may be categorized into risk takers, risk neutral or risk averse. Risk takers have not been taken into account in this particular theoretical framework since they prefer capital gains in the future to current cash dividends (Hanif, 2014).

### **2.1.3 Tax Effect Theory**

The tax-effect Theory states that taxes are important considerations for investors. It states that capital gains are taxed at a lower rate than dividends. As such, investors may prefer capital gains to dividends. This is known as the "tax Preference theory". Additionally, capital gains are not paid until an investment is actually sold. Investors can control when capital gains are realized, but, they can't control dividend payments, over which the related company has control. Capital gains are also not realized in an estate situation. For example, suppose an investor purchased a stock in a company 50 years ago and the investor held the stock until his or her death, when it is passed on to an heir. That heir does not have to pay taxes on that stock's appreciation (Jenson & Meckling 1976).

This argument is based on the assumption that dividends are taxed at higher rates than capital gains. In addition, dividends are taxed immediately, while taxes on capital gains are deferred until the stock is actually sold. These tax advantages of capital gains over dividends tend to predispose investors, who have favorable tax treatment on capital gains, to prefer companies that retain most of their profits rather than pay them out as dividends, and are willing to pay a premium for low-payout companies. Therefore, a low dividend payout ratio will lower the cost of equity and increase the share price (Ross, Westerfield & Jaffe 2002).

In many countries a higher tax rate is applied to dividends as compared to capital gains taxes. Therefore, investors in high tax brackets might require higher pre-tax risk-adjusted returns to hold, Fama and French (2001) found that firms with higher growth and investments tended to have lower payouts. A shilling worth of tax today is more in value than the shilling in the future hence capital gains in future are preferred to dividends today (Brigham and Ehrhardt, 2011). However, in the real world taxes exist and may have significant influence on dividend policy and the value of the firm. In general, there is often a differential in tax treatment between dividends and capital gains, and, because most investors are interested in after-tax return, the influence of taxes might affect their demand for dividends. Taxes may also affect the supply of dividends, when managers respond to this tax preference in seeking to maximize shareholder wealth (firm value) by increasing the retention ratio of profits.

#### **2.1.4 Clientele Effect Theory**

The theory states that different shareholders of a firm prefer different dividend payout policies. Retired individuals or those with no regular source of income prefer firms that pay a high dividend payout. Such investors are usually in zero or low tax bracket hence taxes are of no concern to them. However, investors with regular source of income have no urgent need for dividend issued by the firm. They prefer the firm to pay less or no dividends at all but instead offer capital gains which attracts a low tax payment as compared to the dividends. Taxes and transaction cost influence a shareholders preference for either capital gains or dividends (Petit, 1977). In their seminal paper M&M (1961) noted that the pre-existing dividend clientele effect hypothesis might play a role in dividend policy under certain conditions. They pointed out that the portfolio choices of individual investors might be influenced by certain market imperfections such as transaction costs and differential tax rates to prefer different mixes of capital gains and dividends.

M&M argued that these imperfections might cause investors to choose securities that reduce these costs. M&M termed the tendency of investors to be attracted to a certain type of dividend-paying stocks a “dividend clientele effect”. Nonetheless, M&M maintained that even though the clientele effect might change a firm’s dividend policy to attract certain clienteles, in a perfect market each

clientele is “as good as another”; hence the firm valuation is not affected; that is, dividend policy remains irrelevant (Mugenda & Mugenda ,2003).

According to Welch (2009)In practice, investors often face different tax treatments for dividend income and capital gains, and incur costs when they trade securities in the form of transaction costs and inconvenience (changing portfolios). For these reasons and based on different investors’ situations, taxes and transaction costs may create investor clienteles, such as tax minimization induced clientele and transaction cost minimization induced clientele respectively. These clienteles will be attracted to firms that follow dividend policies that best suit their particular situations. Similarly, firms may tend to attract different clienteles by their dividend policies. For example, firms operating in high growth industries that usually pay low (or no) dividends attract a clientele that prefers price appreciation (in the form of capital gains) to dividends. On the other hand, firms that pay a large amount of their profits as dividends attract a clientele that prefers high dividends (Hanif, 2014)

#### **2.1.5 Information Content or Signaling Hypothesis**

Ross (1977) will be the propagator of this school of thought. According to this hypothesis, Ross postulated that investors can infer information about a firm’s future profits through the signal coming from dividend announcements, both in terms of the stability of, and changes in, dividends. However, for this hypothesis to hold, managers should firstly possess private information about a firm’s prospects, and have incentives to convey this information to the market. Secondly, a signal should be true; that is, a firm with poor future prospects should not be able to mimic and send false signals to the market by increasing dividend payments. Thus the market must be able to rely on the signal to differentiate among firms. If these conditions are fulfilled, the market should react favorably to the announcements of dividend increase and unfavorably otherwise. As managers are likely to have more information about the firm’s future prospects than outside investors, they may be able to use changes in dividends as a vehicle to communicate information to the financial market about a firm’s future profits and growth (Mugenda Mugenda &2003).

Outside investors may perceive dividend announcements as a reflection of the managers’ assessment of a firm’s performance and prospects. An increase in dividend payout may be

interpreted as the firm having good future profitability (good news), and therefore its share price will react positively. Similarly, dividend cuts may be considered as a signal that the firm has poor future prospects (bad news), and the share price may then react unfavorably. Accordingly, it would not be surprising to find that managers are reluctant to announce a reduction in dividends. Nkobe, et al. (2013), argue that firms tend to increase dividends when managers believe that profits have permanently increased. This suggests that dividend increases imply long-run sustainable profits. This theory may not however hold through due to the fact that information asymmetry may not exist in the market. Behavioral finance also do play a major role in criticizing this particular theory as most of its contents tends to suggest otherwise.

### **2.1.6 Agency Costs and Free Cash Flow Hypothesis of Dividend Policy**

One of the assumptions of M&M's perfect capital market is that there are no conflicts of interests between managers and shareholders. In practice, however, this assumption is questionable where the owners of the firm are distinct from its management. In these cases managers are always imperfect agents of shareholders (principals). This is because managers' interests are not necessarily the same as shareholders' interests, and they might conduct actions that are costly to shareholders, such as consuming excessive perquisites or over-investing in managerially rewarding but unprofitable activities.

Shareholders therefore incur (agency) costs associated with monitoring managers' behavior, and these agency costs are an implicit cost resulting from the potential conflict of interest among shareholders and corporate managers. The payment of dividends might serve to align the interests and mitigate the agency problems between managers and shareholders, by reducing the discretionary funds available to managers (Rozeff, 1982, Easterbrook, 1984, Jensen, 1986, and Alli, Khan and Ramirez, 1993). Jensen (1986) provided another explanation for paying dividends based on the agency costs hypothesis. Jensen contended that firms with excess (free) cash flow give managers more flexibility for using the funds in a way that benefit themselves but not shareholders' best interests. He argued that managers have incentives to enlarge the size of their firms beyond the optimal size to amplify the resources under their control and moreover to increase their compensation, which is often related to firm size.

Another source of the agency costs problem that may be influenced by dividend policy is the potential conflict between shareholders and bondholders. Shareholders are considered as the agents of bondholders' funds. In this case, excess dividend payments to shareholders may be taken as shareholders expropriating wealth from bondholders (Welch, 2009). Shareholders have limited liability and they can access the company's cash flow before bondholders; consequently, bondholders prefer to put constraints on dividend payments to secure their claims. Conversely, for the same reasons, shareholders prefer to have large dividend payments.

However, accepting the notion that increasing dividends will reduce the funds available to managers and force them to be in the market to acquire funds means that shareholders should be willing to tolerate the risk of the firm being more indebted and also accept paying higher personal tax rates on dividends. In other words, shareholders have to tradeoff between the costs and benefits of acquiring more dividends Dilawer (2012).

These six theories provide varied conclusions on dividend payout. Dividend Irrelevance theory propagated by Modigliani and Miller suggest that dividend payment is irrelevant in determining a firm's value which is best measured by the profits earned.

MM's argument therefore suggests that there exists no relationship between profits and dividend payout. The Dividend Preference theory by Gordon (1959) and Lintner (1956) tend to contradict with MM's hypothesis. For them, dividend payment is relevant and will impact on firm's value implying that a relationship exists between firm's profits and dividend payout. The Tax Effect theory, Clientele theory and the Agency costs and Free Cash Flow hypothesis do not in any case provide any conclusion on whether dividend payouts have any relationship both with the firm's value and profits or not. Information Content or Signaling hypothesis by Hanif (2014) suggested that investors can infer information about a firm's future profit position through the signal coming from dividend payment. The existence of agency costs problem in the market.

## **2.2 Empirical Review**

The Modigliani and Miller (1961) dividend irrelevance proposition has provided the foundation for much subsequent research on dividend policy both in the international and

local level. Modigliani and Miller (1961) built their conclusions on a certain set of assumptions of perfect capital markets which in reality some of them appear hard to meet. Relaxing one or more of these assumptions has formed the basis for most of international and local empirical studies. Petit (1972) used a long-term definition of dividend yield (previous year's dividends divided by the year-end share price). Their results showed that the dividend yield coefficients are not significantly different from zero either for a long period or for any of shorter sub periods. That is to say, the expected return either on high or low yield stocks is the same. Petit, therefore, concluded that, "we are unable to show that differences in yield lead to differences in stock prices". The conclusion lent important empirical support to M&M's dividend irrelevance argument and therefore gave no evidence on the relationship between profits and dividend payout. Baker, Farrelly and Edelman (1985) surveyed the chief financial officers (CFOs) of 562 firms listed on the New York Stock Exchange (NYSE) from three industry groups (150 utilities, 309 manufacturing and 103wholesale/retail). Based on 318 responses, they found that respondents strongly agreed that dividend policy affects common stock prices. Baskin (1989) studied firms in U.S during the period 1967 to 1986 found that the price volatility will be negatively related to dividend yield and payout ratio.

The findings depict that price volatility will give negative pattern of results in relation to both dividend yield and dividend payout. Simple linier regression is used to arrive at the findings. Baker and Powell (1999) surveyed 603 CFOs of US firms listed on the NYSE, and observed that 90 percent of respondents believed that dividend policy affects a firm's value as well as its cost of capital. Further studies by the same authors tend to confirm that dividend policy actually matters in the determination of firm value but do not show any relationship between profits and dividend payout. Baker, Veit & Powell (2001) researched on relationship between dividend policy and share price volatility and found a positive insignificant relationship between share price volatility and dividend yield for non-financial firms listed in the Dhaka Stock exchange during the period of 1999 – 2006.

The findings also depicted that debt and growth have positive insignificant relationship with share price volatility while payout ratio has a significant negative relationship with price volatility. Amidu Abor (2006) carried out a research on UK market with the objective of

determining the relationship between dividend policy and stock price volatility. After applying a multiple regression analysis on the data, the research showed that there exists a positive relationship between dividend yield and stock price volatility. The research also showed evidence that debt level; firm's size and earning explain price volatility as well. The research however did not prove whether a relationship exists between profits and dividend payout. Brealy Myers & Marcus (2007) studied the effect of dividend policy and share price volatility on Malaysian construction and material companies and found a negative insignificant relationship between dividend yield and share price volatility. This study give contradicting conclusion to the similar study done by Rashid and Rahman (2008) and both do not show whether there is any relationship between profits and dividend payout. The study applied cross sectional regression analysis in the study and concluded that dividend yield is positively related to stock price volatility in Pakistan market.

A study by Akbar and Baig (2010) on a sample of 79 companies listed at Karachi Stock Exchange for the period of 2004 to 2007 revealed that announcement of dividends either cash dividend or stock dividend or both had positive effect on stock prices. Share price is a key determinant of the value of the firm. If dividends are the key indicators of share price and the share price the key indicator of firm value, it is imperative that to maximize shareholders' wealth, shareholders should be afforded the highest combination of dividends and increase in the share price.

Agyei and Yiadom (2011) examined the relationship between dividend policy and performance of banks in Ghana. The study used panel data constructed from the financial statements of 16 commercial banks in Ghana for a period of 5 years, from 1999-2003. The financial statements were obtained from the Banking Supervision department of Bank of Ghana. STATA was used for the data analysis. The study found out that dividend policy had an effect on firm's value and that banks that paid dividends increased their performance.

Uwalomwa, Jimoh and Anijesushola (2012) investigated the relationship between the financial performance and dividend payout among a sample of 50 listed firms in Nigeria for the period 2006-2010. Variables used were ownership structure, size of firms and the dividend payouts. The study

found out that there was a significant positive association between the performance of firms and the dividend payout of the sampled firms in Nigeria. Additionally it revealed that ownership structure and firm's size has a significant impact of the dividend payout of firms as well.

Local studies consisted of the 48 companies listed at the NSE and covered a period of 5 years. Secondary data obtained from NSE, Stockbrokers, Kenya National Bureau of Statistics (KNBS) and Capital Market Authority (CMA). The study recommends that dividend changes have no effect on future profitability and also recommends further studies to be done. Mugenda & Mugenda 2003 ) in their study that sought to establish whether dividend policy affects firm's performance used a panel regression equation to meet his objectives. His method differs from a regular time series or cross section regression by the double subscript attached to each variable. The panel pooled crossed-section regression data will be used to gain the maximum possible observations. The dependent variables are return on assets and return on equity as the main accounting measures of performance. Dividend payout will be measured by the dividend payout ratio. This study recommends that dividend policy is still unresolved. The study concluded that dividend payout ratios positively correlate with future profits of companies though the relationship is low. The study suggest that further profits be conducted on the appropriation of profits and the future profits of companies so as to bring out clearly what role dividend play in signaling future profits. The study concluded the relationship between payment policies and stock price volatility and indicated that payment policies has a great impact on the stock price volatility. Stock price volatility being an indication of firm's profitability shows therefore that profits similarly have a relationship with dividend policies.

Bitok, Tenai, Cheruiyot, Maru & Kipsat (2010) revealed that there is a positive effect of liquidity on dividend payout. The findings also revealed that all other independent variables except cash flow has a positive association with dividend payout. This study harmonizes with other studies done in developing countries that portray a positive association between liquidity and dividend payout but does not state whether dividend payout is related to profits earned. For this reason, there is need to explore this matter more with various other models. These results have important implications to the shareholders. The relationship between dividend policy and stock

price volatility for the period 1999-2008 at NSE using correlation and multiple regression analysis and concluded that dividend yield has a positive relationship with price volatility while payout ratio has a negative relationship with price volatility. This conclusion therefore suggests that profits have a negative relationship with dividend policy. The negative relationship between payout ratio and price volatility give an indication that profits and dividend payout may also have a negative relationship and needs to be explored further.

Malombe (2011) in a study to establish the effects of dividend policy on profitability of SACCOs with FOSAs in Kenya used a descriptive research design focusing on 30 SACCOs. Secondary data was collected using the financial statements of the SACCOs sampled for the last five years. Regression model was used to establish the causal relationship between two variables, that is, a dependent (Dividend decisions) and independent variable (profitability). The study found out that the facets of dividend policy (dividend yield and dividend payout) affect the profitability of SACCOs. They either influenced it positively or negatively. The study also found out that the coefficient of SACCOs dividend yield varied from positive to negative. The study found out that the companies dividend payout varied in value although it was positive in most cases except for 2009. The study concluded that there is a positive relationship between dividend policy and the profitability of SACCOs with FOSAs in Kenya.

Mutie (2011) in a study to determine the relationship between prior dividends and financial performance of firms listed at the NSE sampled a total of 34 companies. The variables in the study were the firms' financial performance (earnings per share) and the prior period dividends (dividend per share). The study relied on secondary data collected from the companies' websites. The data was analyzed using the applications of Statistical Package for Social Scientists (SPSS) and then presented in the form of tables and graphs. The results of the study revealed that majority of firms enjoyed a better financial performance as indicated by their EPS after issuing dividends. As such, a relationship indeed existed between prior period dividend payments and financial performance of a firm.

Murekefu (2012) in a study to establish the relationship between dividend payout and firm's performance among listed firms at the NSE used multiple regression analysis to establish the relationship. The period of study was a 9 year between 2002 and 2010. The findings indicated a

strong and positive relationship in that dividend payout was a major factor affecting firm's performance.

Nkobe, Simiyu and Limo (2013) in a study to determine the impact of dividend policy on share price volatility in Kenya used data from actively trading companies listed in the NSE for a period of 10 years, 1999-2008. They estimation used multiple regression analysis between dividend measures (dividend payout ratio and dividend yield) and share price volatility. Regression analysis showed dividends as a major determinant of share price volatility, thus the higher the payout ratio the less the share price volatility, and the higher the dividend yield the lower the share price volatility

From the above empirical studies by both international and local researchers, there seems To be no general agreement on whether a relationship exists between profits and dividend payout. The study by Yasir et al. (2012) on dividend policy contradicts to a similar study by Baskin (1989) though the two were done in the same environment i.e. Pakistan market. Similarly, the study by Rashid and Rahman (2008) and a similar study on dividend policy by Zuriawati, Jorah and Abdul (2012) provide different suggestions. Whereas Rashid and Rahman (2008) suggest a positive insignificant relationship between dividend policy and share price, Zuriawati et al. suggests a negative insignificant relationship. On the other hand the local studies done by Ngobe et al. (2013) and a similar one by Ngunjiri (2010) on dividend payout policies provide contradicting findings.

For local empirical studies; the conclusion on the study by Abdi (2010) and Ngunjiri (2010) on dividend payout policies that dividend payout ratios have positive relationship with future profits tend to contradict with the study by Ngobe et al.(2013) whose conclusion showed a negative relationship. The study by Kimutai (2012) tends to agree with the findings of Abdi (2010) though in his study liquidity aspect will be used rather than profitability. There is therefore no general agreement in these local researches on the relationship between profits and dividend payout.

### **2.2.1 To establish the effect of stable dividend policy on firms performance**

Under the stable dividend policy, the company aims for a steady dividend payout every year. It does not change even if the earnings are volatile every year. The approximate level of the dividend payout is determined by looking at a forecast of the company's long-term earnings. This approach aligns the dividend growth rate of the company with its long-run earnings growth rate.

The stable dividend policy is the most popular dividend policy. Under this approach, short-term earnings' volatility is not reflected in the payouts. Hence, the shareholders can be least uncertain about the future dividends' level. This policy has the following very real possibilities:

Dividends may rise even in periods when earnings of the company decline. Dividends may not increase at the same higher rate of earnings in the booming years.

Because of these, the stable dividend policy may gradually move towards a target payout ratio. A target payout ratio is defined as a strategic goal which represents the share of earnings that the company aims to distribute as dividends to shareholders over a long-term. One such model on these lines of gradual adjustment is the target payout ratio adjustment model. Under this model, if the earnings of the company are expected to rise and the current dividend payout ratio is below the target dividend payout ratio, the investor can calculate the estimated future dividends as follows:

Expected Dividend = (Previous Dividend) + [(Expected Increase in EPS) \* (Target Payout Ratio) \* (Adjustment Factor)]

Where adjustment factor = 1/ number of years over which the dividends adjustments will happen.

### **2.2.2 To evaluate the effect of constant dividend policy on firms performance**

Under the constant dividend policy, a specific percentage of the company's earnings is paid out as dividends every year. The short-term earnings' volatility affects the dividends in this case and hence, the amount of dividends varies directly with the company's earnings. However, this policy is not used very frequently in companies.

The model works best for a mature company that pays a hefty portion of its earnings as dividends, such as a utility company. An increased uncertainty over quality of accounting information could

lead to a larger required return on investment  $K_e$ . Doubts regarding optimistic forecasts of a firm's earnings and dividend growth could lead to a lower expected dividend growth rate  $g$ . The dividend discount model makes an assumption that dividends are steady, or grow at a constant rate indefinitely. But even for steady, reliable, utility-type stocks, it may not be possible to forecast exactly what the dividend payment will be next year or several years later. It forces investors to evaluate different assumptions about growth and future prospects. The challenge is to make the model as applicable to reality as possible, which means using the most reliable assumptions possible

### **2.1.3 To determine the effect of residual dividend policy on firms performance**

Under the residual dividend policy, the company pays the dividends from the funds left after the finances for the capital expenditures of the current period are deducted from the internally generated funds of the company. This policy takes the company's investment opportunity schedule, target capital structure and the cost of capital raised externally into consideration.

The optimal capital budget is identified. The equity required to finance the identified capital budget under a given capital structure is determined. Retained earnings are used to the maximum extent possible to meet the requirements of equity. Dividends are paid from the residual earnings available after the requirements of the optimal capital budget are met.

This model is very simple to use. The company utilizes the funds for profitable projects and then distributes the remaining to the shareholders. The management is free to pursue profitable opportunities without worrying about the dividend constraints.

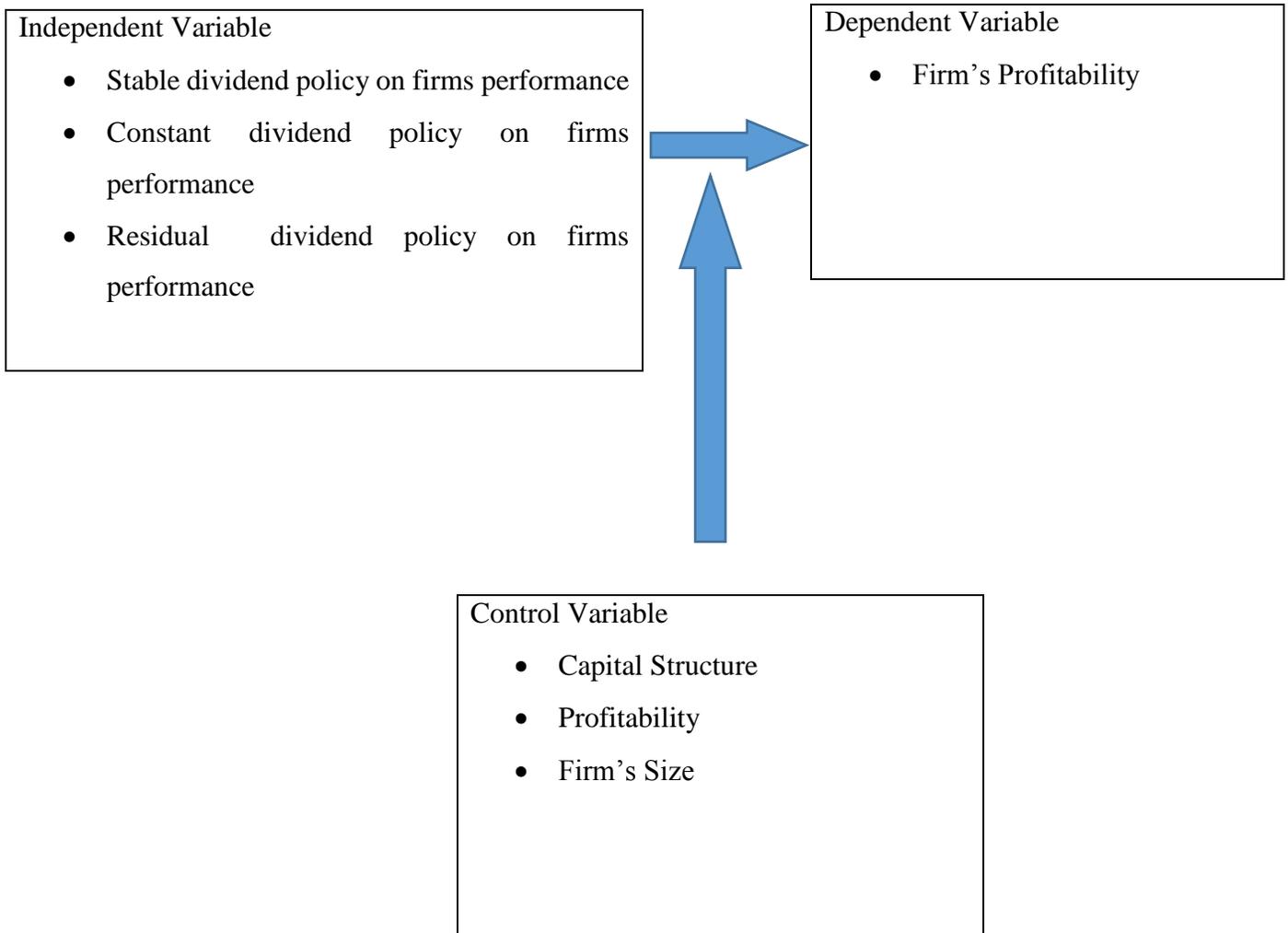
The dividend payments are however highly volatile as they fluctuate with the available investment opportunities. The investors may demand a higher rate of return on their equity because of the ambiguity about future dividends. It may also result in a lower valuation

### **2.3 Conceptual Framework**

A firm that pays high consistent, timely and reliable dividends will have a high value in the market compared to a firm that does not pay high dividends. A company with high optimal structure will have a high value in the market because its cost of capital will be low. Highly profitable companies

in the market have a high value compared to the unprofitable ones, the principle applies to marketable and established firms when compared to growing firms.

Table 2.1



### 2.3.1 Capital Structure

The goal of the capital structure decision is to determine the financial leverage that maximizes the value of the company. In the Modigliani and Miller theory developed without taxes, capital structure is irrelevant and has no effect on company value. Using more debt in a company's capital structure reduces the net agency costs of equity. The costs of asymmetric information increase as more equity is used versus debt, suggesting the pecking order theory of leverage, in which new

equity issuance is the least preferred method of raising capital. A company may identify its target capital structure, but its capital structure at any point in time may not be equal to its target for many reasons. Many companies have goals for maintaining a certain credit rating, and these goals are influenced by the relative costs of debt financing among the different rating classes. In evaluating a company's capital structure, the financial analyst must look at the capital structure of the company over time, the capital structure of competitors that have similar business risk, and company-specific factors that may affect agency costs.

### **2.3.2 Profitability**

Profitability is the company's ability to generate profits at the rate of sales, assets and certain capital. Thus, long-term investors will very concern with profitability analysis, for example for the shareholders, the shareholders will see profit actually be received in the form of dividends. In this study, the profitability measured by return on assets (Ismiyanti & Hanafi, 2003: 8). Companies with levels of profitability high dividends in low numbers, otherwise if the company received a lower profitability, the company will increase the payment of dividends, it is intended to maintain the reputation of the company in good standing in the eyes of investors (Jensen, Solberg & Zorn, 1992; cited in Nuringsih 2005: 1 5).

According to Gitman (2003: 145), profitability is the relationship between revenues and costs are generated using company assets both current and fixed in operating activities. Profitability demonstrates the ability of capital invested in total assets to generate profits. The higher level of profitability of the possibility of dividend distribution is also greater profitability is the company's ability to earn income or profit impact on dividend policy. If the company has a high level of profitability, the company will gain high profits and ultimately profit available for distribution as dividends to shareholders will be greater. The greater the profits from the company, the payment of dividends to shareholders or allocated to retained earnings will be greater (Sartono, 2001: 123). Profitability affect the dividend policy for the dividend is a portion of the net income of the company. Therefore, the dividend will be distributed if the company's profit. A decent profit and will be distributed to the shareholders is profit after the company meet its fixed obligations i.e.

interest and taxes. That the greater Companies the benefit would pay the larger share of revenue as a dividend (Sudarsi, 2002: 79).

### **2.3.3 Firms' size**

The size of the firm refers to the company's market capitalization (Al-Kuwari 2009), or the aggregate value of a company or stock. It is obtained by multiplying the number of shares outstanding by their current price per share. Companies could have Large-cap, small-cap and mid-cap stocks and all perform differently. Many studies have shown that small firms (capitalization or assets) tend to outperform large ones. Other studies have argued that it is not the size that matters, but it is the attention and number of analysts that follow the stock.x

Most often, companies with big size and good cash flows offer higher dividends than the companies of small size. As Najjar (2009) investigated in Jordan and concluded that in developing countries firm size affects the dividend payout decisions. Another research conducted by Perretti, Allen and Weeks (2013) and concluded that the firm size partially explains the dividend policies.

### **2.4 Critique**

It has already been stated in earlier paragraphs that M-M hypothesis is actually based on some assumptions. Under these assumptions, no doubt, the conclusion which is derived is logically sound and consistent although they are not well-based. For instance, the assumption of perfect capital market does not usually hold well in many countries. Since the assumptions are unrealistic in nature in real world situation, it lacks practical relevance which indicates that internal and external financing are not equivalent. The shareholders/investors cannot be indifferent between dividends and capital gains as dividend policy itself affects their perceptions, which, in other words, proves that dividend policy is relevant.

### **Dividend Irrelevance Theory**

The dividend irrelevance theory indicates that a company's declaration and payment of dividends should have little to no impact on stock price. If this theory holds true, it would mean that dividends do not add value to a company's stock price.

Yet studies show that stocks that do pay a dividend, like many blue chip stocks, often increase in price by the amount of the dividend as the book closure date approaches. Although the dividend may not actually be paid until a few days after this date, given the logistics of processing such a large number of payments, the price of the stock usually drops again the amount of the dividend. Buyers after this date are no longer entitled to the dividend. These practical examples can conflict with the dividend irrelevance theory (Mutie 2011).

Analysts conduct valuation exercises to determine a stock's intrinsic value. These often incorporate factors, such as dividend payments, along with financial performance, and qualitative measurements, including management quality, economic factors, and an understanding of the company's position in the industry.

Despite the dividend irrelevance theory many investors focus on dividends when managing their portfolios. For example, a current income strategy seeks to identify investments that pay above average distributions (i.e. dividends and interest payments). While relatively risk-averse overall, current income strategies can be included in a range of allocation decisions across a gradient of risk. Strategies focused on income are usually appropriate for investors in need of stable, established entities that will pay consistently (i.e. without risk of default or missing a dividend payment deadline). These investors might be older and/or willing to take on fewer risks. Dividends may feature in a range of other portfolio strategies, as well, such as preservation of capital (Hanif, 2014).

### **Dividend Preference Theory or Bird in Hand Hypothesis**

Bird in hand is a theory that postulates that investors prefer dividends from a stock to potential capital gains because of the inherent uncertainty associated with capital gains. Based on the adage a bird in the hand is worth two in the bush, the bird-in-hand theory states investors that prefer the certainty of dividend payments to the possibility of substantially higher future capital gains.

Investing for capital gains is predicated largely on conjecture. An investor may gain an advantage in capital gains by conducting extensive company, market and macroeconomic research. However,

ultimately, the performance of a stock hinges on a host of factors that are out of the investor's control.

For this reason, capital gains investing represents the "two in the bush" side of the adage. Investors chase capital gains because of there is a possibility that those gains may be large, but it is equally possible that capital gains may be nonexistent or, worse, negative.

From recent research, where investing is concerned, what is comfortable is rarely profitable. Dividend investing at 4 to 5% per year provides near-guaranteed returns and security. However, over the long term, the pure dividend investor earns far less money than the pure capital gains investor. Moreover, during some years, such as the late 1970s, dividend income, while secure and comfortable, has been insufficient even to keep pace with inflation.

### **Tax Effect Theory**

It states that capital gains are taxed at a lower rate than dividends. As such, investors may prefer capital gains to dividends. This is known as the "tax Preference theory". Additionally, capital gains are not paid until an investment is actually sold. Investors can control when capital gains are realized, but, they can't control dividend payments, over which the related company has control. Capital gains are also not realized in an estate situation. For example, suppose an investor purchased a stock in a company 50 years ago and the investor held the stock until his or her death, when it is passed on to an heir.

This is however not the case for some investors as they prefer dividends from a stock to potential capital gains because of the inherent uncertainty associated with capital gains.

### **Clientele Effect Theory**

The first side of the clientele effect describes the way in which certain investors – or clients – seek out stocks in a specific category. Some investors try to only invest in stocks with a high dividend, whereas other investors, such as technology investors, seek companies that are high-growth with the potential for high capital gains. Thus, the clientele effect first outlines the way in which the company's maturity and business operations initially attract a certain type of investor.

The second side of the clientele effect describes how current investors react when there are changes to a company's policies and procedures. If, for example, a public technology stock pays no dividends and reinvests all of its profits back into the company, it first attracts a growth investor. Then, if the company decides to stop reinvesting in its growth and instead pay a dividend, high-growth investors may exit their positions and instead seek other stocks with high-growth potential. Dividend-seeking income investors may now see the technology company as an attractive investment. This explains the second meaning of the clientele effect, which has an impact on the company's share price.

Consider a company that already pays a dividend and has attracted clientele whose investment goal is to obtain stock with a high dividend payout. If the company then decides to decrease its dividend, dividend investors may still sell their stock and invest in another company that pays a higher dividend. As a result, the company's share price will decline.

### **Information Content or Signaling Hypothesis**

Dividend signaling is a theory that suggests that when a company announcement of an increase in dividend payouts is an indication of positive future prospects. The theory is directly tied to game theory; managers with good investment potential are more likely to signal. While the concept of dividend signaling has been widely contested, the theory is still a concept used by proponents of inefficient markets.

Because the dividend signaling theory has been treated skeptically by analysts and investors, there has been regular testing of the theory. On the whole, studies indicate that dividend signaling does occur. Increases in a company's dividend payout generally forecast positive future performance of the company's stock while, conversely, decreases in dividend payouts tend to accurately portend negative future performance by the company.

A company with a lengthy history of dividend increases each year is signaling to the market that its management and board anticipate future profits. Dividends are typically not increased unless the board is certain the cost can be sustained.

## **Agency Costs and Free Cash Flow Hypothesis of Dividend Policy**

One assumption of M&M's perfect capital market is that there are no conflicts of interests between managers and shareholders. However in practice, this assumption is questionable where the owners of the firm are distinct from its management. In these cases managers are always imperfect agents of shareholders (principals). This is because managers' interests are not necessarily the same as shareholders' interests, and they might conduct actions that are costly to shareholders, such as consuming excessive perquisites or over-investing in managerially rewarding but unprofitable activities.

Shareholders therefore incur (agency) costs associated with monitoring managers' behavior, and these agency costs are an implicit cost resulting from the potential conflict of interest among shareholders and corporate managers. The payment of dividends might serve to align the interests and mitigate the agency problems between managers and shareholders, by reducing the discretionary funds available to managers (Rozeff, 1982, Easterbrook, 1984, Jensen, 1986, and Alli, Khan and Ramirez, 1993). Jensen (1986) provided another explanation for paying dividends based on the agency costs hypothesis. Jensen contended that firms with excess (free) cash flow give managers more flexibility for using the funds in a way that benefit themselves but not shareholders' best interests. He argued that managers have incentives to enlarge the size of their firms beyond the optimal size to amplify the resources under their control and moreover to increase their compensation, which is often related to firm size.

### **2.5 Research Gaps**

The profitability of companies has been observed to have an effect on the dividend policies adopted by the firms. High profitability has been assumed to boost the earnings of a firm hence inducing high dividend payouts to the shareholders. On the other hand, low profitability will reduce the liquidity of the firm thereby forcing the companies to pay low dividends or no dividend at all. Many studies have been done on the effect of a firm's profitability on the dividend policy. Other studies have been conducted to examine the determinants of dividend payout policies. Several variables have been used concurrently on different industries and firms. However, these studies have continued to create more gaps in the field of finance in relation to dividend policy. The dividend policy puzzle has never found a universally accepted solution. Contradictory findings

and results have been put forward in various literatures. This study therefore will be intended to pursue the endeavor to solve the puzzle in relation to profitability and its effect on dividend policy strategies adopted by firm

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter presents the methodology that will be used to carry out the study. The chapter considers in detail the methods that will be used to collect secondary data required in the study. In this chapter, the researcher discusses the research design and population size used. The researcher also discusses how collected data will be analyzed giving details of any models or programs that will be used in analysis with reasons as to why these particular models or programs will be applied.

#### **3.2 Research Design**

Research design refers to the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in the procedure (Babbie, 2002).

A descriptive survey design will be utilized in this study. Sekaran and Bougie (2011) asserts that a descriptive study is undertaken in order to ascertain and be able to describe the characteristics of the variables of interest in a situation while outlining their variability. This design refers to a set of methods and procedures that describe variables. It involved gathering data that describe events and then organizes, tabulates, depicts, and describes the data.

#### **3.3 Population**

Mugenda and Mugenda (2003) describe a population to an entire group of individuals, events or objects having a common observable characteristic. The study will be a census survey of the 64 firms listed at the Nairobi Securities Exchange based on the availability of information. Companies

suspended from the Nairobi Securities Exchange will also be studied since they have the relevant data.

### 3.4 Data Collection

Secondary source of data collection will be used in the study. The research will gather secondary data for a period of 6 years, 2011-2016 from the financial statements of listed firms available from the CMA website and respective companies annual reports most of which are publicly available.

### 3.5 Data Analysis

Multiple regression analysis will be used in this case to determine the relationship between dividend payout and firm's performance. The information gathered from secondary sources will be sorted, coded and input into the statistical package for social sciences (SPSSv20) for production of descriptive statistics and inferential statistics. The information generated by the SPSS will be used to make generalizations and conclusions of the study.

#### 3.5.1 Analytical Model

The multiple regression model is as laid below. Included in the study are control variables that affected the performance of the firm not captured by the dividend payout?

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where;

Y = Financial performance measured by ROA – ratio of pre-tax profits to total assets

X1 = Dividend Payout ratio – Dividend per share/ Earnings per share.

X2 = Firm's Size - The Log of total assets for a firm

X3 = Leverage – ratio of total debt to total capital of a firm

$\alpha$  = the constant term

$\beta_i$  = coefficient used to measure the sensitivity of the dependent variable to unit change in the predictor variables.

$\varepsilon$  = is the error term to capture unexplained variations in the model and which is assumed to be normally distributed with mean zero and constant variance.

### **3.5.2 Test of Significance**

Statistical indicators used will be the F-test and t-test level of significance. The significance of each independent variable will be tested. F-test will be used to test the significance of the overall model at a 5 percent confidence level. The p-value for the F-statistic will be applied in determining the robustness of the model. Independent variables with a p value of less than 5% were declared to have a significant effect on financial performance.

APPENDIX ONE: DATA COLLECTION FORM

YEAR	Dividend payout	Firms' performance	
2011			
2012			
2013			
2014			
2015			
2016			

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