

Dividend Policies On Capital Structure And Shareholders' Value In Commercial Banks Listed In The Nairobi Securities Exchange, Kenya

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Abstract: *Firm managers often experience difficulties coming up with dividend decisions that satisfy the various needs of shareholders and the firm. Thus, it is evident that the dividends policies present a never-ending challenge for managers who on one hand seek to maximize on investment opportunities and profitability by using inexpensive capital in form of retained earnings but on the other hand need to assure the investors that the bank is indeed committed to creating wealth for them. The firm's dividend policies on capital structure and the resulting effect on shareholders value have, however, not received sufficient attention from an empirical research perspective, hence, motivating the need for the present study. The study adopted the descriptive cross sectional research design targeting 32 management and investment department staff members from 11 banks listed in the NSE using purposive sampling. Structured questionnaires and data sheets were used to collect both primary and secondary data respectively. The data was analysed using both descriptive and inferential statistics with the aid of SPSS version 21.0. The findings revealed that dividend policies on capital structure decisions significantly affected the shareholders' value in banks listed by the NSE. Therefore, it was recommended that the banks need to be more flexible on their financing decisions so as not to discourage their diverse investors.*

I. Introduction

The area of corporate dividend policy has attracted attention of management, scholars and economists culminating into theoretical modeling and empirical examination. Dividends are commonly defined as the distribution of earnings (past or present) in real assets among the shareholders of the firm in proportion to their ownership. Retained dividends can, however, be a cheap source of capital as no agency costs are incurred. Theoretically, the dividend policy has the 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 (Omran & Pointon, 2004). According to Frankfurtet and McGoun (2000), the dividend puzzle, both as a share value-enhancing feature and as a matter of policy is one of the most challenging topics of modern financial economics. Dividend policy is concerned with financial policies regarding paying cash dividend in the present or paying an increased dividend at a later stage. Whether to issue dividends, and what amount, is determined mainly on the basis of the company's unappropriated profit (excess cash) and influenced by the company's long-term earning power.

When cash surplus exists and is not needed by the firm, then management is expected to pay out some or all of those surplus earnings in the form of cash dividends or to repurchase the company's stock through a share buyback program (Fama & French, 2001). If there are no NPV positive opportunities, i.e. projects where returns exceed the hurdle rate, and excess cash surplus is not needed, then – finance theory suggests – management should return some or all of the excess cash to shareholders as dividends (Chay & Jungwan, 2008). Mizuno (2007) agrees 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. This is the general case, however there are exceptions. For example, shareholders of a "growth stock", expect that the company will, almost by definition, retain most of the excess earnings so as to fund future growth internally (Ben-David, 2010). By withholding current dividend payments to shareholders, managers of growth companies are hoping that dividend payments will be increased proportionality higher in the future, to offset the retainment of current earnings and the internal financing of present investment projects. The effect of the listed firm's dividend policies on its capital structure however, have not received sufficient attention from an empirical research perspective. This is the main thrust of the present study.

Capital structure refers to the way a corporation finances its assets through some combination of equity, debt, or hybrid securities. A firm's capital structure is then the composition or 'structure' of its liabilities. The firm's ratio of debt to total financing is referred to as the firm's leverage. In reality, capital structure may be highly complex and include dozens of sources. Arnold (2002) stated that firms normally change their capital structure to convey information about the current profitability and risk of the firm. Presumably firms with good news about their future profitability will want to tell investors, rather than make a simple announcement; dividends payout may be increased to add conviction to the statement. When a firm increases this ratio, investors may believe that management is announcing a positive change in the expected future profitability of the firm. The signal to investors is that management and the board of directors truly believes that things are better than the stock price reflects.

In a symmetrically informed market, all interested participants have the same information about a firm, including managers, bankers, shareholders, and others. However, if one group has superior information about the firm's current situation and future prospects, an informational asymmetry exists. Most academics and financial practitioners believe that managers possess superior information about their firms relative to other interested parties. Dividend changes (increases and decreases), dividend initiations (first time dividends or resumption of dividends after lengthy hiatus), and elimination of dividend payments are announced regularly in the financial media. In response to such announcements, share prices usually increase following dividend increases and dividend initiations, and share prices usually decline following dividend cuts and dividend eliminations. The idea that dividend payouts can signal a firm's prospects seems to be well accepted among the chief financial officers (CFOs) of large US corporations. In a survey of these executives conducted by Abrutyn and Turner (2000), 63% of the respondents ranked signaling explanation as the first reason for dividend payouts.

Information about the prospects of a firm may include the firm's current projects and its future investment opportunities. The firm's dividend policy, either exclusively or in combination with other signals, such as capital expenditure announcements or trading by insiders, may communicate this information to a less informed market. Empirical studies in this area include Akerlof's (2000) and Bhattacharya (2009) model. Pettit (2002) documented that announcements of dividend increases are followed by significant price increases and that announcements of dividend decreases are followed by significant price drops. Three studies of large changes in dividend policy Asquith and Mullins (2003) (dividend initiations), Thaler and Womack (2005) (dividend omissions) showed that the market reacts dramatically to such announcements. Other research studies which tested the dividend announcement effects include Aharony and Swary (1980) Ofer and Siegel (2007). Other empirical studies however showed mixed evidence, using the data from US, Japan and Singapore markets. A number of studies found that stock price has a significant positive relationship with dividend payments, Ariff and Finn (2006), while others found a negative relationship like Loughlin (2009). Dividends are meant convey private information to the market, predictions about the future earnings of a firm based on dividend information should be superior to forecasts made without dividend information. A number of studies have tested these implications of the information content of dividends which includes studies by Michaely and Swaminathan (2002), Brook and Ziv (2001).

The capital market is a bit more developed in Kenya having been institutionalized in the colonial times six decades ago. Since then it has undergone successive transformations in the course of which the erstwhile Nairobi Stock Exchange has been reconstituted into the Nairobi Securities Exchange which effectively expands its mandate. In addition the formation of the Capital Market Authority was a significant watershed in the administration and regulation of the market together with the other markets. The CMA in a bid to nurture and reform the market to be more efficient and reliable source of long term encourages capital investment in the economy for example through establishment of a Central Depository System and introduction of various rules and regulations (CMA, 2013). Fifty four companies are listed in the Nairobi Securities Exchange (NSE), which is the only security exchange market in the country (Nairobi Securities Exchange, 2013). It has two segments, that is, the main market segment and the alternative investment market segment.

The banking system in the country has been cited as playing a major role in facilitating development and is, therefore, extremely important engine of economic growth (Kuria, 2013). Commercial banks operations in Kenya are controlled by CBK which defines the environment in which these banks should operate. It also sets the various capital requirements that any commercial bank should operate by setting up minimum capital requirements. However, globalization of the financial markets though instrumental in developing the financial system and improving transparency, market discipline and financial infrastructure (Chipeta, Wolmarans, & Vermaak, 2012), brings about additional risks into the system. Therefore, the study sought to establish how a bank dividend decisions affect their shareholders' wealth.

Management are in a dilemma about whether to pay a large, small or zero percentage of their earnings as dividends or to retain them for future investments. This has come about as a result of the need for management to satisfy the various needs of shareholders and the company. In Kenya shareholders cannot increase the amount of dividend as declared by directors but have power to reduce. The tax on dividend suffers a

withholding tax of 5% while capital gains tax was abolished thus making for investors to prefer capital gains to dividend. Thus, it is evident that the dividends policies present a never-ending challenge for managers who on one hand seek to maximize on investment opportunities and profitability by using inexpensive capital in form of retained earnings but on the other hand need to assure the investors that the firm is indeed committed to creating wealth for them. The aspect of dividend policies and resulting shareholder value, though, has received more theoretical attention than empirical attention in research. Therefore, the present study sought to bridge this gap by providing more empirical information on how dividend policies on capital structure affect the shareholder's value in commercial banks listed in the NSE. This was tested under the hypothesis:

H0₁: Dividend policies on capital structure do not significantly affect the shareholders' value in firms listed by the NSE.

II. Research Methodology

The study adopted the descriptive cross sectional research design which was meant to ensure that the research is carried out in a manner that only attempts to describe the existence of the variables without manipulating them in any way and also to give a more in-depth view to the study problem by examining the variable at different levels using different firms with unique dividend policies. The study focused on 11 commercial banks listed in the Nairobi Securities Exchange over a 7 year period between January 2008 and December 2014. This time period was considered because it will be sufficiently reasonable to accommodate all changes that occurred in the payout dividend pattern. Listed banks were chosen because their data was more readily available than that for unlisted banks. Purposive sampling was ideal for the present study because specific persons at the management of the firms were concerned with policy decisions and implementation. These were key informants and were expected to give more accurate and reliable information on the dividend policies and shareholders value. Thus, the study sample size was 32 respondents purposively selected from 11NSE listed commercial banks.

Questionnaires and data sheets were used as data collection instruments. Primary data was collected using structured questionnaires while secondary data was collected using the data sheets that allowed the researcher to abstract data from the firms published statements and compute the shareholders value. The study ensured that the research instruments produced the expected results by pre-testing the instrument to ensure that the questions are well framed and that they were understood, that is, that they were not ambiguous in any sense. The method used was the content validity. To establish instrument reliability, the study used the internal consistency method to ascertain the consistency of the questionnaire items. Reliability of the research instrument was then calculated using Cronbach's coefficient alpha for either even or uneven items based on the order of number arrangement of the questionnaire items. According to Fraenkel & Wallen (2000), as a rule of thumb, a proposed instrument should only be used if an α value of 0.70 or higher is obtained on a substantial sample. The pre-test yielded a Cronbach Alpha value of 0.7913 prior to administration of the questionnaires which was above the recommended value of 0.70 implying that the accuracy level of the questionnaires was up to 79%. Some questionnaire items were then deleted and others added to improve the reliability.

Data was analyzed using descriptive and inferential statistics with the aid of Statistical Package for Social Sciences (SPSS). Descriptive analysis involved the use of means and standard deviations while inferential statistics involved the use of both correlation and linear regression analyses to determine the relationship between variables. The regression model was model was expected to hold under the equation:

$$y = a + b_1x_1 + e$$

Where, y = Shareholder's Value
 X_1 = Capital Structure
 b_1 = Coefficient of the variable x_1
 e = error term.

III. Results And Discussions Of Findings

The presentation of results and collected through questionnaires and reports is done in this section followed by the discussion of the results.

Dividend Policies and Capital Structure and Shareholders' Value in Listed Banks

The study sought to determine how dividend policies on capital structure affect the shareholders' value in commercial banks listed in the NSE. The results are presented in Table 1.

Table 1 : Dividend Policies on Capital Structure and Shareholders' Value in Banks

Statement	Minimum	Maximum	Mean	Std. Deviation
Our dividend decisions are informed considerably by the capital costs	1	5	3.79	1.084
Our banks pays dividends after carefully considering the market trend so as not to affect its leverage	1	4	2.58	0.838
The projected yields from the project are critical in determining the financing decisions in our bank	1	5	3.37	0.496
Our bank will pay dividends only if it does not have profitable investment opportunities	2	5	2.68	0.671
Our bank prefers paying dividends from stock rather than in cash	2	5	3.58	0.769
The bank encourages minimum dividend pay out to reduce liquidity risks	3	5	4.42	0.607
The financing options are usually combined in optimal ratios in order to derive the maximum benefits associated with them	1	5	4.21	1.316

N=32

The results summarized in Table 1 suggest that;

- That dividend decisions in the banks were informed considerably by the capital costs as reported by majority of the respondents (mean = 3.79). Some banks paid dividends only after carefully considering the market trend so as not to affect their leverage (mean = 2.58).
- Concerning investment, it emerged that the projected yields from the project was critical in determining the financing decisions in the banks and consequently the dividend decisions as indicated by a mean of 3.37. Hence, some of the banks paid dividends only when they did not have profitable investment opportunities (mean = 2.68).
- Most (mean = 3.58) of the banks preferred paying dividends in form of stock rather than in cash, however, this depended on the type of investors the bank was attracting. It also appears that the banks were very cautious to avoid the liquidity risk and thus most (mean = 4.42) encouraged minimum dividend pay out to reduce liquidity risks.
- Their financing options were also usually combined in optimal ratios in order to derive the maximum benefits associated with them as indicated by majority (mean = 4.21) of the respondents.

Correlation Analysis

Table 2: Summary of Correlations

		Capital Structure
	N	32
Shareholder's Value	Pearson Correlation	0.4314
	Sig. (2-tailed)	0.01
	N	32

A correlation analysis was carried out to determine whether dividend policies on capital structure had a significant effect on the shareholders' value in banks listed by the NSE. The results in Table 4.7 shows that there was indeed a significant relationship ($r = 0.4314$, $p < 0.05$). The high Pearson's product moment coefficient of correlation suggests a strong relationship exists between the variables, hence, providing grounds for the rejection of the null hypothesis.

Regression Analysis

Regression analysis was used to determine the amount of variation dividend policies on capital structure had on the shareholders' value in banks listed by the NSE and also to establish whether a linear relationship existed between both variables. This is as shown in Table 4.8

Table 4.8: Multiple linear regression analysis model summary

R	R Square	Adjusted R Square	Std. Error of the Estimate		
0.4314	0.1861	0.159	1.248		
	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	5.212	2.147		2.014	0.001
Capital Structure	0.4001	0.551	0.4313	4.079	0

a. Predictors: (Constant), Shareholders' value in listed banks

b. Predictors: (Constant), Capital Structure

As indicated by the results in Table 4.8, the adjusted r square value, $r = 0.159$ suggest that the linear regression model could explain for approximately 16% of the variations in the shareholders' value in banks listed by the NSE. The linearity of the model is also established, hence;

$$y = 2.212 + 0.4313x$$

This means that the shareholders value was positively associated with the dividend policies. This leads to the rejection of the null hypothesis, **H01: The dividend policies on capital structure do not significantly affect the shareholders' value in banks listed by the NSE.** These findings agree with Ariff and Finn (2006) that there was a positive relationship between dividend policies and shareholders value but disagree with Loughlin (2009) who found a negative relationship between the variables. These results also disagree with Miller and Modigliani (1961) theory that postulated that the dividend policy of a company is irrelevant for the market value of its shares. Moreover, they contrast with the views of Stulz (2000) who held that a bank's value is enhanced by investing in productive assets and not by the way in which income is distributed to shareholders, therefore, making the dividend policy irrelevant. Therefore, the results suggest that dividend policies were indeed significant to capital structure decisions and they affected the shareholders' value in the banks listed by the NSE. They must, therefore, be taken into account in banks and other banks when considering their project financing options.

IV. Conclusions And Recommendations

The findings have revealed that indeed capital structure had a significant effect on the shareholders' value in banks listed by the NSE. This was so since dividend decisions are informed considerably by the capital costs and availability. It was also revealed that most of the banks paid dividends only after carefully considering the market trend so as not to affect their leverage. The NPV of proposed projects were also critical in determining the financing decisions in the banks and consequently the dividend decisions, hence, most of the banks paid dividends only when they did not have profitable investment opportunities. It was also evident that most of the banks were very cautious when it came to their liquidity position and thus most encouraged minimum dividend pay out to reduce liquidity risks. Their financing options were also usually combined in optimal ratios in order to derive the maximum benefits associated with them. The effects of dividend decisions on capital structure must, therefore, be taken into account by the commercial banks when considering their project financing options as they were relevant to the shareholders wealth. It is recommended that the commercial banks be more flexible on their financing decisions so as not to discourage their diverse investors some of who are investing solely to obtain dividends and do not seek control of the banks. High yield projects also have correspondingly high risks attached and some investors have lower risk tolerances.

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