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EFFECTS OF PROFITABILITY ON DIVIDEND PAYOUT BY COMMERCIAL AND SERVICES FIRMS LISTED IN THE NAIROBI SECURITIES EXCHANGE

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ABSTRACT

Many reasons exist why companies pay or fail to pay dividends. Yet figuring out why companies pay dividends and investors pay attention to dividend is the "dividend puzzle". The general objective of this study was to assess effects of profitability on dividend payout by commercial and services firms listed in the Nairobi Securities Exchange (NSE) in Kenya. This study was based on four theories which are dividend relevance theory, dividend irrelevance theory, free cash flows hypothesis and signaling theory. Descriptive research design was applied in this research study. The target population for this study was all the 10 commercial and services firms listed in the NSE as at 31st December 2015. Data for these companies for 10 years (2005 – 2014) was used in the study. Both primary and secondary data was applied in this study. Data was collected from the audited financial statements of the commercial and services firms, NSE and the using a questionnaire survey to the firms and also using secondary information from Capital Markets Authority. The study applied descriptive statistics and panel data analysis model. The study used panel data analysis and applied the fixed effects model. To do the analysis, the researcher applied Stata analysis software. The statistics that were derived from the descriptive, correlation and panel data analysis were presented using tables and figures. Profitability was an insignificant factor in determining dividend payout. The study recommended that though profitability may not hurt the ability of the firm to pay dividends in the short term, continued poor performance will definitely affect payout negatively.

Keywords: *Profitability, Dividends, Commercial and service firms.*

1. INTRODUCTION

One of the central issues of corporate finance has been the dividend decision of a firm, which has always been studied in relation to a firm's financing and investment decisions. The dividend policy of a company relates to the decisions regarding the distribution of profits in the form of dividends and the retention of profits for further use in the business. The distribution of dividends and retention of earnings for growth are in conflict. Dividend policy of a company affects the long term financing decisions and shareholder's wealth. High dividend payout may be harmful in the long term because in this case, profits cannot be used for the further expansion of the company. But this policy will be beneficial to raise the share prices in the short run (Bar-Yosef & Huffman, 1986). On the other hand, low dividends and higher retained earnings can increase long term earnings and dividends. A company's dividend policy may also be restricted by the availability of liquid funds. If only a limited amount of cash can be made available, a high dividend policy is not possible (Pandey, 2011). Profits have long been regarded as the primary indicator of a firm's capacity to pay dividends. Abor and Bokpin (2010) noted that current and past years' profits are important factors in influencing dividend payments. Firms which continually post good profits are in a better position to pay dividends to their shareholders. On the contrary, companies that perform poorly over many years are unable to sustain dividend payments to their shareholders. Baker and Weigand (2015) also found that a major determinant of dividend payment was the anticipated level of future earnings. Apart from past and anticipated future earnings, Al-Malkawi, Rafferty and Pillai (2010) noted that risk (year-to-year variability of earnings) also determines firms' dividend payout. A firm that has relatively stable earnings is often able to predict approximately what its future earnings will be. Such a firm is therefore more likely to pay out a higher percentage of its earnings than a firm with fluctuating earnings. Moreover, Bohren, Josefsen and Steen (2012) used beta value of a firm as an indicator of its market risk. They found statistically significant and negative relationship between risk and the dividend payout. Their findings suggest that firms having a higher level of market risk will pay out dividends at lower rate.

2. Statement of the Problem

Many reasons exist why companies pay or fail to pay dividends. Yet figuring out why companies pay dividends and investors pay attention to dividend is the "dividend puzzle" which is problematic (Abor & Bokpin, 2010). Dividend payout policy is an important corporate issue and may be closely related to, and interacts with, most of the financial and investment decisions firms make. A proper understanding of dividend payout policy and the factors influencing dividend payout is critical for many other areas such as asset pricing, capital structure, mergers and acquisitions, and capital budgeting. Firms' dividend decisions have been observed to be affected by their profit level, risk, size, agency costs, taxation and corporate governance among other factors and other such factors (Baker et al., 2013). Though dividend policy has been identified as a major corporate decision faced by management, it remains one of the puzzles in corporate finance (Abor & Bokpin, 2010). Further, it is important for shareholders to know factors that influence dividend payment so that they can make informed decisions when they are investing. There has been emerging consensus that there is no single explanation of dividends. Bohren et al. (2012) agree that, there is no reason to believe that corporate dividend policy is driven by a single goal.

Various empirical works by Olantundun (2000), Anand (2004), Al-Malkawi (2007), Gill et al. (2010), Arko et al. (2014) and Yarram (2015) have established different factors influencing dividend payout in different organizations. Locally, Maniagi et al. (2013) noted that current earnings, profitability growth opportunities and firm size are the main determinants of dividend payout for non- financial firms on NSE. Recently, King'wara (2015) established that that dividend payout ratio of non-financial firms in Kenya is impacted negatively by the growth rate, debt ratios and firm size and positively by earnings, market-to-book ratio and retained earnings to total assets ratio. The current study sought to assess the effects of profitability on dividend payout by commercial and services firms listed in the Nairobi Securities Exchange (NSE) in Kenya.

3. Literature Review

Eriotis (2015) found out that Greek firms had a long-run constant dividend payout policy. His study adjusted the firms' distributed earnings and size in the Lintner model and reported that an increase in the earnings did not change the dividend distribution pattern of firms. The study by Eriotis also determined that variables such as sales growth and other performance measurements in the firms had a negative impact on dividend decision.

Perretti, Allen and Weeks (2013) conducted a study aimed at establishing the determinants of dividend policies for American depository receipts (ADR) firms. The study had been informed by the notion that cross-listed firms may face unique incentives for establishing dividend policies in comparison to US firms. This study aimed to test the implications of the lifecycle and signaling theories of dividend policy in the context of non-US firms cross-listed on US stock exchanges via ADRs. The study hence classified ADRs according to the firms' dividend paying histories as regular payers, non-payers, former payers, new payers and switchers.

In the study by Perreti et al. (2013), multinomial logit regressions measured the likelihood of dividend payers to pay dividends, as well as the possibility of a dividend amount increase, decrease, or no change, based upon previously identified determinants of dividend payments and a measure of economic conditions in the home country. The results indicated profitability among other factors was a major determinant of dividend payout. Firms that were highly profitable were observed to pay dividends often that those firms that did not enjoy high profitability. This study however focused on macro-economic conditions together with firm specific factors while the current study only isolates firm specific factors. Locally, Musiega et al. (2013) conducted a study aimed at establishing the determinants of dividend payout policy among non-financial firms on Nairobi Securities Exchange (NSE). A sample of 30 non-financial companies for duration of five years from 2007 to 2011 was selected. Secondary data was collected from audited financial statements of companies from NSE website and the websites of non-financial firms. Dividend payout ratio was dependent variable while independent variables were profitability among other variables. The study established that profitability and firms' growth activities were positively correlated to dividend payout.

A study by Fatemi and Bildik (2012) presents evidence of worldwide dividend disappearance in their study of more than 17,000 companies from 33 countries. They found that the greatest decline in the propensity to pay among smaller and less profitable firms with more investment opportunities compared to larger, more profitable, low-growth companies, but concluded that all firms are less likely to pay, even after controlling for firms' characteristics. Gill, Biger and Tibrewala (2010) analyzed the American service and manufacturing firms and found that the dividend payout ratio is a function of profit margin and sales growth among other factors. For the services industry, the dividend payout ratio was found to be a function of profit margin, sales growth, and debt-to-equity ratio. For manufacturing firms, the dividend payout ratio was found to be a function of profit margin, tax and market-to-book ratio.

Bhayani (2008) examined the influence of earnings on dividend policy of listed companies in India. He found that the current year's earnings are the foremost factor affecting the dividend behaviour of a firm and concluded that Indian companies follow a stable cash dividend policy. Kanwal and Kapoor (2008) further examined the dividend policies of companies in the information technology sector in India. They explored various factors such as profitability among others. The study, however, established profitability did not significantly affect dividend payout. Al-Malkawi (2007) studied the determinants of corporate dividend policy in Jordan for a period between 1989 and 2000. Size, age and profitability of the firms were found to be the determinant factors of corporate dividend policy in Jordan. The findings provided strong support for the signaling hypothesis. Twaijry (2007) on the other hand studied the emerging market of Malaysia. The study confirmed that current dividends are affected by the past and future. Also, dividends were associated with net earnings but less strongly.

4. Research Methodology

The target population for this study was all the 10 commercial and services firms listed in the NSE as at 31st December 2015. Data for these companies for 10 years (2005 – 2014) was used in the study. The study made use of questionnaires. Closed ended questions are accompanied by a list of all possible alternatives from the respondents who selected the answer that best describes their situation. The study used both qualitative and quantitative data. The study applied descriptive statistics and panel data analysis model. Descriptive statistics that were used to analyze the data include means, range, minima, maxima and standard deviation. Data obtained from the questionnaires was processed through editing and coding and then entering the data into a computer for analysis using descriptive statistics with the help of Statistical Package for Social Sciences (SPSS) version 21.0,which offers extensive data handling capabilities and numerous statistical analysis procedures that analyses small to very large data statistics (Bell, 2007).

5. Findings

The study had a purpose of establishing the effect of profitability in dividend payout. The questionnaire had items which required respondents to indicate the level of agreement to the provided statements on profitability and how it influenced dividends in the company. Likert scale rating from 1-5 was used (1- Strongly disagree, 2 – Disagree, 3 – Neutral, 4 – Agree and 5 - Strongly agree). Results presented in Table 1 indicate that respondent were of the view that when the profitability of the company reduces, the company reduces its dividend payout (4.61). The results also indicated that respondents agreed that dividend decisions convey information about the company profitability to investors (4.23). Moreover, study results revealed that when the profitability of the surveyed firms suffers, the dividends payable are reduced (4.13). Similarly, study results show that when the surveyed companies project high profitability growth, they show that to their investors through paying high dividends (4.11).

Table 1: Effect of Profitability on Dividend Payout

Statement	Mean
Dividend decisions convey information about our company profitability to investors	4.23
When the profitability of the company reduces, the company reduces its dividend payout	4.61
When we project high profitability growth, we show that to our investors through paying high dividends	4.11
When the profitability of a firm suffers, the dividends payable are reduced	4.13

Moreover, study results revealed that when the profitability of the surveyed firms suffers, the dividends payable are reduced (4.13). Similarly, study results show that when the surveyed companies project high profitability growth, they show that to their investors through paying high dividends (4.11). However, the results established no significant effect of profitability on dividend payout ($\beta = 0.0028$; $p > 0.05$). This is despite the fact that profitability had a positive effect on dividend payout. These findings are contrary to findings by Abor and Bokpin (2010) who noted that current and past years' profits are important factors in influencing dividend payments. Similarly, the findings contrast findings by Baker and Weigand (2015) who established that a major determinant of dividend payment was the current and the anticipated level of earnings. The study findings however agreed with results by Bulan and Hull (2013) that noted that current earnings do not really reflect the firm's ability to pay dividends.

6. Conclusion and Recommendation

The study had a purpose of establishing the effect of profitability in dividend payout. Results indicate that respondent were of the view that when the profitability of the company reduces, the company reduces its dividend payout (4.61). The results also indicated that respondents agreed that dividend decisions convey information about the company profitability to investors (4.23). Moreover, study results revealed that when the profitability of the surveyed firms suffers, the dividends payable are reduced (4.13). Similarly, study results show that when the surveyed companies project high profitability growth, they show that to their investors through paying high dividends (4.11). However, the results established no significant effect of profitability on dividend payout ($\beta = 0.0028$; $p > 0.05$). This is despite the fact that profitability had a positive effect on dividend payout. Profitability has a positive but insignificant effect on dividend payout by commercial and services firms. This implies that changes in profitability are not expected to have significant effect on dividend payout. This is the case when the companies decide to have a certain dividend payout. However, when the profitability of the company reduces, the company reduces its dividend payout though not significantly. Dividend decisions however, convey information about the company profitability to investors.

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