Motivators of Dividend Payout among Firms listed on the Stock Exchange of Mauritius

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Abstract

This paper aims at investigating the factors which motivate the dividend decision among the firms that are officially listed on the Stock Exchange of Mauritius. Factors such as the current ratio, price-to-book value, earnings per share, retention ratio, debt to equity ratio and market capitalisation rate per sector were considered. Using a sample of 38 listed companies on the SEM, the cross sectional analysis revealed that current earnings, retained earnings and liquidity are among the most significant motivators of dividend payout. Market capitalization rate per sector and price- to-book value turns out to be statistically insignificant while debt to equity ratio turns out to be positively related to dividend pay-out ratio which is in sharp contrast from the implication of the current legislation.

Keywords: Dividend policy, dividend pay out, factors affecting dividend payment

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1.0 INTRODUCTION

Dividend is the reward or return to the owners of a company stock for holding its share instead of other alternatives. A company may or may not choose to pay dividend irrespective of its prior dividend policy. Nevertheless, many investors view a regular dividend payment as

an important indicator of a good investment and as such, most companies are reluctant to reduce or not to make dividend payments.

Dividends may be considered as cash distributions of earnings made by a company to its owner's of capital. They are payments made by firms to their shareholders (McLaney, 1991)[1]. Corporate dividends fluctuate over time for various reasons, although most firms attempt to grow dividends more or less in line with the company's longer-term earnings growth rate. However, no single economic rationale can possibly explain the dividend phenomenon or capture the puzzling reality of corporate dividend behaviour.

In addition, the success of a financial manager is tied to the maximisation of shareholders' wealth and hence he needs to have a good understanding of the dynamics of dividend policy. Research on this topic and especially on factors affecting the dividend payout ratio is abundant in developed nations. However, research on this area in the Mauritian context is scant. To this end, the present study aims at investigating the factors (the current ratio, price-to-book value, earnings per share, retention ratio, debt to equity ratio and market capitalisation rate per sector) which motivate the dividend decision among the firms that are officially listed on the Stock Exchange of Mauritius.

2.0 LITERATURE REVIEW

2.1 Dividend Payment

Dividends have been in the limelight in financial research for quite a long time, more particularly since Lintner's (1956) seminal study on dividend distributions. Many investors view a steady dividend history as an important indicator of a good investment and as such, most companies are reluctant to reduce or stop their dividend payments. Brealey and Myers (2002) explained that dividend policy is a tradeoff between retaining cash for future investments (no dividends) and issuing equity to pay for dividends and still have money left for future investments.

Over time, different theories on dividend behaviour, such as the Dividend Irrelevance, (Miller & Modigliani, 1961), Bird in the Hand, Tax Differential, the Clientele Theory, the Dividend Information Signaling, Transaction Cost Theory and Agency theory, have highlighted the importance of dividend policies in companies. These factors show how firms and investors value different dividend payout policies and how they might have changed over time.

2.2 Motivators Of Dividend Payout

2.2.1 Earnings Per Share (Eps)

Ceteris paribus, a firm with relatively more stable earnings tends to pay out a higher fraction of its earnings as dividends as compared to one with variable earnings. Thus, a firm with higher EPS, but with a lower variance associated with it, will have a higher dividend payout ratio. If earnings are relatively stable, a firm is in a better position to predict its future earnings. In a firm, profitability will determine the relative attractiveness of paying out earnings in the form of dividends to shareholders unlike productivity.

[1] McLaney, E.J. (1991) *Business Finance for Decision Makers* (Pitman).

In this respect, Pandey (2001) in his study on the Kuala Lumpur Stock Exchange, argued that the dividend behaviour of Malaysian companies was sensitive to the changes in earnings. Fama and French (2001)[2] showed that the probability that a firm would pay dividends was positively related to profitability and size and negatively related to growth. In a similar vein, Kumar (2004)[3] stipulated that there was a positive association of dividends with earnings and dividend trends.

On the other hand, Fama and French (2001) postulated that lower profitability and strong growth opportunities produce much lower expected rates of dividend initiation by firms that had never paid. In addition, De Angelo and Skinner (2000) found that a loss is a necessary but not a sufficient condition for a dividend cut, and that dividend cuts improved the ability of current earnings to predict future earnings. Finally, Myers and Bacon (2001)[4] in their study on a sample of firms from the Compustat Database in the United States, provided evidence that an estimated five-year growth of earnings per share, as independent variable, was negatively related to the payout ratio and was statistically insignificant.

2.2.2 Retained Earnings

In addition, companies retain their earnings to finance investment in fixed and other assets, which should enable them to generate higher future earnings, and thus, enhancing their dividend paying capacity. Lintner (1956) posited that the determination of dividend policy would imply that the level of retained earnings and savings is a dividend decision by-product. Moreover, Darling (1957), Fama and Babiak (1968) found empirical support for Lintner's findings that dividends were indeed a function of current and past profit levels, and expected future earnings, and were negatively correlated with changes in the level of sales.

Nevertheless, it could also be argued that dividend policy is "sticky" – managers decrease dividends only when absolutely necessary – in the event of poor earnings with reserves insufficient to fund the dividend.[5] Similarly, Graham et al (1962)[6] claimed that $1 of dividend is worth four times as much to shareholders as $1 of retained earnings.

2.2.3 Debt To Equity Ratio

A debt obligation implies that a firm is planning either retention of earnings to pay off the debt or new external financing in the future. Firms with substantial debts usually have several constraints on their dividend policy and will therefore follow more conservative dividend policies. Thus, a highly geared firm ratio would seldom be able to make major changes in its dividend policy because of constraints on payouts.

Myers and Bacon (2001) argued that the debt to equity ratio was positively correlated to the dividend yield, and was significant at the 95% level. Therefore, firms with relatively few investment opportunities and low growth would tend to be more geared and vice versa (Ross, 2000).

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[2] Fama E. and K. French, 2001: "Disappearing dividends: Changing firm characteristics or lower propensity to pay?", Journal of Financial Economics 60, (June 2001) pp 3-43.

[3] Refer to Kumar, J. 'Corporate Governance and Dividends Payout in India.' *Finance/Economics Working Paper Archives* at WUSTL 0409007, Sep 2004.

[4] Myers and Bacon (2001): 'The Determinants of Corporate Dividend Policy.' *Proceedings of the Academy of Accounting and Financial Studies*, Vol. 7, no. 1.

[5] See Myers, 1984; and De Angelo, and Skinner, 2003

[6] Graham, Dodd, and Cottle, 'Security Analysis: Principles and Techniques,' in ed. 4, "McGraw-Hill Book Co, New York," 1962, p. 480.

2.2.4 Cash As A Percentage Of Total Assets

Profitability does not mean liquidity, that is, although, firms may have large retained earnings to declare dividend, it may not have sufficient funds to make such payment. Furthermore, if a firm chooses a high dividend payout without the cash flow to back it up, that firm will ultimately have to reduce its investment plans or turn to investors for additional debt or equity financing. All of these consequences are costly. Therefore, most managers do not increase dividends until they are confident that sufficient cash will flow in to pay them (Brealey-Myers – 2002)[7].

Jensen (1986) defined free cash flows as those cash flows, which are in excess of funds required for all projects that have positive net present values after those projects, are discounted at the cost of capital. He further stipulated that if a firm has free cash flows, it is better off sharing them with shareholders as dividend payout in order to reduce the possibility of the funds being wasted on unprofitable (negative net present value) projects. Firms with numerous growth opportunities have a lower level of free cash flows than firms with few growth opportunities. Having a relatively lower level of free cash flow, means that agency costs will be lower and the need for dividends to reduce agency costs will be lessened. Study findings of Myers and Bacon (2001) show a negative and insignificant relationship between the liquid ratio and the dividend payout. Thus. to increase liquidity, firms might lower dividend payouts requiring less external financing.

2.2.5 Price To Book Value

The theory of corporate finance recognizes that from the point of view of investors, dividend payments would represent tangible evidence of a company's worth and on going viability. Thus, a company that will increase dividend payout is signaling that it has expected future cash flows that are sufficiently large to meet debt payments and dividend payments without increasing the probability of bankruptcy.

Howe (1998) believed that since managers are more informed than the market about the future prospects of their firms, their actions might convey new information to investors. While the evidence on whether the level of dividend payouts affects firm value is mixed, studies had consistently documented that stock returns around the announcement of a dividend change was positively correlated with the change in dividend.[8] Reddy (2002)[9] examined the dividend behaviour and attempted to explain the observed behaviour with the help of a trade-off theory and signaling hypothesis. Therefore, dividend omissions provided information about future earnings.

Firms, which are undervalued, as assessed by the price to book value ratio, might use dividend increases as signals to the market. Hence, as the ratio of price to book value decreases, dividend increases may become more frequent.

[7] Brealey-Myers(2002), 'Principles of corporate Finance,' in ed. 6, *Mc Graw-Hill Book Company, New-york,* pp. 445

[8] .See Aharony and Swary 1980; Asquith and Mullins, 1983; Brickley, 1983; Petit, 1972

[9] Reddy, Y. Subba, (2002) 'Dividend Policy of Indian Corporate Firms; an Analysis of Trends and Determinants.' *NSE Working Paper*.

2.4 Other Factors Affecting Dividend Payout

2.4.1 Agency Costs and Transaction Costs

Jensen and Meckling (1976)[10] argued that agency costs would be lower in firms with high managerial ownership stakes because of the better alignment of shareholder and manager goals and in firms with large block shareholders that are better able to monitor managerial activities. As such, the payment of dividend reduced the agency problem between manager and shareholder by reducing the discretionary funds available to managers[11]. In addition, a similar type of conflict exists between shareholder and bondholder because shareholders can expropriate wealth from bondholders by paying themselves dividends. In this respect, bondholders may try to contain this problem through restrictions on dividend payments in the bond indenture (Kalay, 1982).

Fenn and Liang (2001)[12] found that managerial stock incentives mitigate the agency costs for firms with negative relationship between dividends and management stock options. Furthermore, Alli *et al.* (1993)[13] explained that as the number of stockholders increased, the agency problem would become more severe and thus, the need for monitoring managerial actions would also increase. If dividends could alleviate this problem, a positive relation is expected between number of common stockholders and dividend payout ratio. However, they also explained that higher insider ownership would lead to lower agency problem; hence, lower dividend payout, so, a negative relationship is expected between stock held by insiders and dividend payout ratio.

2.4.2 Behaviour And Specificities of Firms

Large and well-established firm with a record of profitability and some stability of earnings will have easy access to capital markets and other forms of external financing. On the other hand, the small, new, or venturesome firm has a greater amount of risk for potential investors. Its ability to raise equity funds or debt from capital markets is restricted, and it must therefore retain earnings to finance its operations. Smith and Watts (1992) found that industry growth rates, profitability, asset mixes, earnings variability and capital investment needs seemed most important in determining the firm's capital structure.

Sometimes, when designing dividend policies, some firms consider the behaviour of their competitors. This is a factor that depends on the extent to which these firms believe that dividend payments can signal information to its stakeholders and the degree of competitive attitude they have. However, Howe and Shen (1998) argued that the dividend payments of one firm cannot affect the share prices of its competitors.[14]

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[10] Jensen, M.C. and William H. Meckling, (1976) 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.' *Journal of Financial Economics*, Vol. 3, No. 4.

[11] Jensen and Meckling, 1976; Rozeff, 1982; Easterbrook, 1984; Crutchley and Hansen, 1989; Jensen *et al.*, 1992; Alli *et al.*, 1993; and Saxena, 1999

[12] Fenn G. and Liang N (2001), 'Corporate Payout Policy and Managerial Incentives' *The Journal of Financial Economics*, 60, 45-72.

[13] Alli *et al.* (1993), 'Determinants of Corporate Dividend Policy: A Factorial Analysis', *The Financial Review* (November), pp. 523-547.

[14] John S. Howe and Yang-Pin Shen (1998) 'Information Associated with Dividend Initiations: Firm-Specific or Industry-Wide?' *Financial Management*, Vol. 27, No 3, Autumn 1998, Special Issue: Dividends.

Besides, Holder et al (1998)[15] concluded in their study about dividend policy determinants, that corporate focus is negatively related to dividend payout ratios. They define a corporation as being focused when the firm's sales are attributable to a distinct business line. Therefore, larger firms tend to have higher payout ratios than smaller firms.

Finally, Da Silva, Goorgen and Renneboog (2002) showed that firms with banks as their major shareholder would be more willing to omit their dividend than firms controlled by other types of shareholder. Conversely, Hofler et al (2004)[16], which investigated the relationship between institutional ownership and dividend payout behaviour of the firm in Germany, purported that neither institutional holdings nor bank control was statistically significant in determining dividend payouts.

3.0 RESEARCH METHODOLOGY

An econometric analysis using secondary data to capture the significance level of main selected factors, which affect dividend payout, was used. A cross-sectional analysis of data for a three-year average (2000, 2001, and 2002) was conducted to test the most important determinants of firms officially listed on the SEM. A sample of 39 firms, all listed on the SEM's official market, was initially considered. However, due to limited data for one firm, a final sample of 38 firms was examined. Thereafter, a sub- regression was carried out to test the signaling effect by undervalued firms, as measured by Price to Book value. It was observed that access to data was very difficult and companies were unfortunately most reluctant to provide information for confidential reasons. To this effect, the study concentrates on a cross sectional regression on a short term.

For the purpose of our model, a multiple regression analysis would be used as follows:

$$DP = f\,(EPS, RE, CR, PB, DE, MPS)$$

- $$DP_i = k + ß_1EPS_i + ß_2RE_i + ß_3CR_i + ß_4PB_i + ß_5DE_i + ß_6MPS_i + u_i$$

[15] Holder, Langrehr and Hexter (1998)

The selected variables that used in the regression analysis are defined below:

DEFINITIONS OF SELECTED VARIABLES

	Variables		Definition
Dependent Variable (Y)	**DP**	Dividend Payout	Dividend per share/Earnings per share averaged for the past 3 years.
Independent Variables (Xs)	**EPS**	Earnings Per Share	Earnings after tax before dividends/no. of shares averaged for past 3 years.
	RE	Retained Earnings	Retained Earnings averaged for the past 3 years.
	CR	Current Ratio	Current Assets/Current Liabilities for past 3 years averaged.
	PB	Price to Book Value	Market Price per share/Net Asset Value of the share averaged for past 3 years.
	DE	Debt to Equity Ratio	Total External long term debts/shareholders' capital + Reserves averaged for the past 3 years
	MPS	Market Capitalisation Rate Per Sector	Market Capitalisation of firm for year 2003 as a percentage of total market capitalisation of all firms in their respective sector.

4.0 ANALYSIS AND DISCUSSION

A descriptive analysis is initially conducted before considering results from the cross-sectional regression.

4.1 Descriptive Statistics

Table 1: Summary Statistics of the Variables

	DP	EPS	RE	CR	PB	DE	MPS
Mean	0.920260	3.920746	0.418507	2.572806	0.799088	2.484572	0.182368
Median	0.498000	2.910000	0.494500	1.271500	0.655000	0.217000	0.095000
Std. Dev.	3.719752	6.932994	0.321953	4.280586	0.645929	18.92788	0.323231
T-statistics	2.685298	6.038100	13.87913	6.417359	13.20877	1.401529	6.024062
P-value	0.0083	0.0000	0.0000	0.0000	0.0000	0.1638	0.0000
Correlation Coefficient with DP	1	-0.05338	-0.21021	-0.03849	-0.04474	-0.00604	-0.03241

From the above table, the means for all the series are significant at 1% level except for debt to equity ratio. Also, the firms on average tend to have a high DP, EPS, CR and DE ratios. However, debt to equity ratio is insignificant and should be interpreted with cautious. Essentially, the high standard deviation of the debt to equity ratio may suggest that some firms may be less leveraged than others. With regards to the variable of interest, dividend payout, firms on average, seem less concerned on retaining earnings for future growth and more keen to give shareholders their fair share of returns. It is also interesting to consider the correlation coefficient of the independent variables with the dependent variables. It seems

that all the variables are negatively correlated with the dividend pay out ratio. However, this negative relationship will be further explored under the cross-sectional regression.

4.2 Cross sectional analysis

Using a sample of 38 firms listed on the SEM, the following regression results (table 1) were obtained.

Table 2 : Results of the regression[17]

$DP_i = k + ß1EPS_i + ß2RE_i + ß3CR_i + ß4PB_i + ß5DE_i + ß6MPS_i + u_i$		
Independent variables	**coefficient**	**P-value**
Constant	1.8741*	0.000
EPS_i	– 0.23678*	0.010
RE_i	– 0.99099*	0.000
CR_i	– 0.059669**	0.054
PB_i	– 0.043435	0.797
DE_i	+ 0.089277***	0.120
MPS_i	+ 1.0711	0.360
No. of observations	38	
Adjusted R^2	0.76245	
F-stats	20.7926*	

Source: computed: (***), (**), (*) indicate significance at the 15 , 10, 1 % levels respectively

From the above table, the coefficient of determination is 80.1% implying that 80.1% of the variation in dividend payout can be explained by variation in the selected dividend determinants. The adjusted R^2 is 76.25%, which suggests that the model is a good fit. Finally, the F-test, which measures the overall significance of the regression and it is the formal test statistic to assess goodness of fit, was computed.

H_o: Overall regression model is not significant.
H_1: Overall regression model is significant.

Based on the computed F-value, we reject H_0 at 1% significance level and conclude that the overall regression is significant.

Also, from table 2, only earnings per share and retained earnings are found to significant at 1% level. The coefficient of the intercept term is 1.85, implying that when all the other explanatory variables are equal to zero; the dividend payout will be equal to 1.85. Thus, this indicates that there might be other factors, qualitative or quantitative, influencing the dividend payout of the firms under consideration.

The results of the regression have been analysed below:

Earning Per Share

The coefficient of EPS is -0.24. This implies that a 100% rise in EPS will lead to a 24% fall in dividend payout. The reason behind this is mainly because Dividend Payout is measured

[17] No severe multicollinearity was detected. (For more information, see results (table 3) in appendix). Also, since the data consisted of a cross-section and not a time-series, no further test such as autocorrelation or ADF tests were required.

by expressing Dividend Per Share as a fraction of Earnings Per Share. Hence, as EPS, (which is in the denominator), rises, DP should naturally fall if the rise in DPS does not exceed that of EPS.

However, the OLS results do not point out right away that, there exists a negative relationship between DPS and EPS. In-fact, it shows that a 100% rise in EPS might not result in a 100% rise in DPS. Thus, the rise in earnings might not be fully paid out as dividends. Nevertheless, the earnings rise still contributes to a rise in dividends, but to a lesser percentage. Possible reasons for this might be that firms retain part of these earnings to replenish their reserves finance future growth or expansion projects as pointed out both by Fama and French (2001) and Myers and Bacon (2001).

Another possible reason might be that firms might have a higher EPS but the latter might be associated with a higher variance. Hence, firms would be reluctant to use their rise in EPS to its full capacity to increase dividends. Thus, as stipulated by Lintner (1956), the probability of an increase in the dividend rate should be greatest when only the current earnings have decreased and it should somewhat be less when only the earnings from the previous year have increased.

Retention ratio

The coefficient of RE is -0.99, implying that a 100% rise in RR will lead to a 99% fall in dividend, implying that retained earnings is negatively related to dividend payout. The above findings support those previously found, that shareholders of growth firms, which retain their earnings for expansion purposes, experience a decline in their dividends. This might suggest that for the periods (2000-2002) under study, the listed firms exploited retained earnings mainly for restructuring and growth prospects rather than dividends, most probably because of better investment opportunities as pointed out by Glen et al. (1995).

Other probable reasons, as to why earnings were not distributed as dividends, might be that firms wanted to retain their ability to maintain their unit volume of sales, long term competitive position or financial strength as pointed out by Buffett (2002). The study findings also support those of Dhondee (2003), about dividend policy in Mauritius. Essentially, Dhondee (2003) claimed that managers prefer to retain earnings in Mauritius for two main reasons, namely, the increase future opportunity cost of investment and the possibility of more financial resources to allow for fringe benefits.

Current ratio

The coefficient of CR is -0.06, which indicates that a 100% rise in CR will lead to approximately a 6% decline in dividend payout. Again, it can be deduced that growth firms despite being profitable, might require cash to finance their expanding activities and might thus follow a conservative dividend policy.

Firms under observation do not seem to fully comply with Jensen (1986) free cash flow theories of sharing their free cash flows to its maximum with shareholders as dividend payout in order to reduce the possibility of wasting these funds on unprofitable projects. However, the findings support that of Baker et al (1999), Myers and Bacon (2001), which show a negative relationship between the liquid ratio and the dividend payout. To increase liquidity, firms might lower dividend payouts requiring less external financing.

Price to Book Value
A 100% rise in Price to Book value, leads to a 4.34% fall in dividend payout. Thus, a fall in PB will lead to a rise in dividend payout. It could be argued that firms with low price to book values have fewer growth prospects and few investment opportunities such that they have higher payout ratios.

It could also be that firms which are undervalued might have recourse to a rise in dividend payout to act as signals on the market to increase their share value, and hence the value of their firm. Nevertheless, the results being insignificant (Table2), indicates a weak or almost absence of a signaling effect for the firms chosen.

The following regression was run, along with a dummy variable (D), so as to get a more precise understanding as to whether undervalued firms as opposed to overvalued ones, have recourse to dividend signals to boost up their market value :

D = 0 for undervalued firms[18] (PB>1);
D = 1 for undervalued firms (PB<1)

DP = **K** + ß$_1$**(PB)** + ß$_2$**D**
DP = 0.81313 **–** 0.079550 **(PB) +** 2.8663**D**

Once again, the probability value was found to be insignificant, stating that undervalued firms might not be initiated in general to use dividend signals to increase the value of their firm. The above findings evidence that a corporate dividend policy used as a means of putting the message of quality as signals is a weak hypothesis, implying that possible alternative methods of signaling might be perfect substitutes. The study findings seems to support that of Easterbrook (1984), whereby there might be the possibility that firms are unwilling to use dividend signals to raise firm value since they already issue disclosures of their prospects and profits.

Debt to Equity ratio
The result revealed that a 100% rise in Debt to Equity ratio results in an 8.93% rise in dividends. The study findings support that of Myers and Bacon (2001), revealing that debt to equity ratio is positively correlated with dividend yield. Basically, when debt to equity is high, it usually correlates with a slow growth company, and that company is forced to pay a higher dividend.

However, this is in sharp contrast with the view that firms with high debt ratio are not be able to make regular changes in its dividend policy because of constraints on payments. Essentially, this view is supported by the legal framework and restrictions, according to Section (61) of the Mauritian Companies Act 2001. For instance, immediately after distribution, by the company at any time, it must be able to satisfy the solvency test. Debt covenants undertaken to minimise dividend payments are necessary to prevent bondholder wealth transfers to shareholders (Kalay -1982).

[18] We are assuming that the firm is not viable and is close to bankcruptcy.

Market Capitalisation rate per sector
A 100% change in MPS results in a 107% change in DP ratio. Thus, there exists a positive relationship between MPS and DP, which nevertheless is insignificant, even at the 15% significance level. This might suggest that large firms, their size being measured by capitalisation rate, might have easy access to capital markets and other forms of external financing. On the other hand, small firms have a greater amount of risk for potential investors and might most probably have a lower dividend payout rate than a well-established firm.

5.0 CONCLUSION

Dividend payments are in reality an unwritten contract between shareholders and corporate management. The cross sectional analysis revealed that current earnings, retained earnings and liquidity are the most significant motivators of dividend payout. However, dividend signals used by undervalued firms boost up their firm's value seem to be weak, as there might be other alternative methods of signaling the firm's performance and acting as better substitute or more possibly the market might not be very responsive to such dividend signals. It has also been observed that the gearing level is positively related to dividend payout ratios which are inconsistent with the current legislation on solvency test.

Appendix
Table 3 : Estimated correlation matrix of variables

	EPS	**RR**	**CR**	**PB**	**DE**	**MPS**
EPS	**1.0000**	-0.38669	-0.25099	0.018902	0.20453	0.14526
RR	-0.38669	**1.0000**	0.64035	0.72535	0.10807	0.14986
CR	-0.25099	0.064035	**1.0000**	0.0035903	-0.089017	-0.10591
PB	0.018902	0.072535	0.0035903	**1.0000**	0.031454	0.29123
DE	0.20453	0.10807	-0.089017	0.031454	**1.0000**	0.20736
MPS	0.14526	0.14986	-0.10591	0.29123	0.20736	**1.0000**

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