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Drivers of Firm's Payout Policy

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Abstract:

Against the backdrop of changing financial landscape and growing investors' awareness, dividend decisions are gaining greater relevance in the today's corporate world. In this working paper the researchers aim at exploring different variables which influence the dividend policy of the firms. It focuses on various financial, behavioral, legal and strategic drivers of payouts based on the review of the secondary data available in the public domain. The study revealed that dividend policy of the firm is a combined output of the aforementioned variables.

Keywords: Dividend payout, corporate governance, life cycle, cash flow, signaling theory, clientele approach

1. Introduction

The study of BSE 100 companies by The Mint based on the database by Capitaline states that the dividend payout by BSE 100 companies has increased to 34.52% in 2014-15. It is the highest ratios since year 2004-05. Further, it states that 78 private sector companies out of this group of companies has climbed to 34.02% which is the highest in at least 11 years. At the same time 22 state PSUs have declared a payout of 35.40% which is marginally lower than 38.49% in the previous year. This data highlights the importance of the dividend payout decision by the firm and leads to the study which intends to look into the factors responsible in shaping up the dividend policy of the firm.

PAYOUT PATTERN

A Mint analysis of BSE-100 firms shows the share of their net profits given as dividends rose to 34.52% in 2014-15, the highest since at least 2004-05.

Fiscal year	Dividend (₹ crore)	Net profit (₹ crore)	Dividend payout ratio (in %)
2004-05	26,488	97,175	27.26
2005-06	31,388	1,15,257	27.23
2006-07	37,704	1,62,162	23.25
2007-08	43,297	2,15,725	20.07
2008-09	44,239	1,93,372	22.88
2009-10	59,648	2,51,332	23.73
2010-11	66,728	2,89,240	23.07
2011-12	75,285	3,11,344	24.18
2012-13	88,743	3,23,069	27.47
2013-14	1,04,568	3,55,634	29.40
2014-15	1,12,223	3,25,087	34.52

Source: Capitaline

Figure 1

1.1. Theoretical Framework

The operating profits (EBIT) are determined by the investment decisions of the firm. Various stakeholders namely debenture holders/providers of debt capital, Government, preference shareholders and equity shareholders have claim on these earnings in the form of interest, taxes, preference dividends and equity dividends in the order of preference. The earnings per share (EPS) is determined by the financing decision and the dividend per share (DPS) is determined by the Payout decision of the firm. Out of these three basic corporate finance decisions, dividend decisions are critical to the firm as well as owners of the firm as they involve a trade-off between the use of earnings for the business (Investment decisions) or distribution of the earnings to the shareholders. (Dividend decisions). In this working paper an attempt is made to study and understand the variables which influence the dividend decision of the firm.

1.2. Research Methodology

It involved study and review of various dividend theories in the area of corporate finance and behavioral finance, review of research papers, provisions of Companies Act 2013, Indian tax laws with reference to dividend distribution, articles in newspapers and journals, dividend announcements by corporates in recent past.

1.3. Objectives

- 1) To review the theories and models by different schools of thought in relation to dividend decision.
- 2) To study the legal framework for distribution of dividends in India.
- 3) To study the behavioral aspects affecting the dividend payout.
- 4) To explore the strategic drivers for payment of dividend.

2. Review of Different Theories of Dividend Policy

2.1. Lintner Model- Modern Approach

In 1956, John Lintner laid the foundation for the modern understanding of dividend policy. In his theory he concluded that dividends are sticky, tied to long-term sustainable earnings, paid by mature companies, and smoothed from year to year. Also the firms target long term payout ratio when determining dividend policy. His observation based on the empirical research was that most payout decisions were influenced by the historical payout ratio. As per Lintner model there are two parameters to a company's dividend policy – Target payout ratio and the speed with which the current dividends adjust to that target. Companies tend to set the long term target payout ratio according to the amount of positive net present value projects that are available. Earnings increase are not always maintainable, as a result dividend policy is not changed until managers can see that new earnings levels are sustainable. Lintner predicted a positive constant, reflecting firms' bias to increase dividends rather than cut them⁽¹⁾

2.2. Life Cycle Theory- Earned/Contributed Capital Mix

The dividend decision involves a trade-off between the advantages of savings in flotation costs and cost of retention (i.e. agency costs of free cash flows). As per Fama and French (2001), firms with current high profitability and low growth rates tend to pay dividends while firms with low profitability/high growth rates tend to retain the profits.

As per Harry De Angelo, Linda Deangelo, Rene´ M. Stulzb, c in their paper "Dividend policy and the earned/contributed capital mix: a test of the life-cycle theory", the probability of a firm paying dividends is positively related to its mix of earned and contributed capital, i.e., the firms with relatively high retained earnings as a proportion of total equity (RE/TE) and of total assets (RE/TA) are more likely to pay dividends. The theory of earned/contributed capital mix is in line with the theory of the life-cycle stage at which a firm currently finds itself. Firms which have a low RE/TE and RE/TA are usually in the capital infusion stage, whereas firms with high RE/TE and RE/TA would usually be in a more mature stage with high profits that make them largely self-financing, and hence are bound to pay dividends. The earned to contributed capital mix is a better indicator of firm's life cycle stage and thereby its ability to pay dividend than the cash balance of the firm because source of cash is also a relevant consideration in dividend decision.⁽²⁾

3. Legal Drivers for Dividend Decision

3.1. Dividend under the Companies Act, 2013

For the Indian companies the dividend decisions are governed by the provisions of Companies Act 2013 and the articles of association of the said company. Final Dividend is generally declared at an annual general meeting [Section 102(2)] at a rate not more than what is recommended by the directors in accordance with the articles of association of a company. An interim dividend is declared by the Board of directors at any time before the closure of financial year, whereas a final dividend is declared by the members of a company at its annual general meeting if and only if the same has been recommended by the Board of directors of the Company.

3.2. Dividends and Provisions of Income Tax Act 1961

As per the provisions of Income Tax Act 1961; Sec 115-O -A domestic company has to pay dividend distribution tax for any amount declared, distributed or paid by way of dividend be it interim or final. The dividend distribution tax is applicable for dividends declared, distributed or paid after March 31, 2003 or between June 1, 1997 to March 31, 2002.

Corporate taxation influences the dividend decision as it affects the net earnings after tax available for the company to distribute as dividend. Thus structure and rate of corporate tax plays an important role in determining the dividend policy. In Indian context, owing to dividend distribution tax, corporate profits which are retained are subject to lower rate of corporate tax as compared to the corporate profits that are distributed.

3.3. Changes in Taxation laws- Budget 2016

Budget 2016 has proposed tax @ 10% for investors receiving dividend in excess of Rs 10 lakhs per annum this is in addition to the dividend distribution tax that will be paid by the domestic companies declaring and distributing dividend. This proposed tax @ 10% shall be chargeable on the dividend income only to the extent it is in excess of Rs 10 lakh in aggregate. This amendment is effective from assessment year 2017-18. As per the published news, in the span of eight days since the Union Budget, as many as 253 companies have called board meetings to declare interim dividends to avoid tax outgo in April 2016. The proposed amendment is likely to impact the dividend payout policy of those domestic companies where the promoters' stake is high.

3.4. SEBI Act Provisions

A share re-purchase is another form of paying back to the shareholders, which could in a way affect dividend decisions. Indian companies were allowed to buy back shares from 1998. Once the Board of Directors approves the company's decision to buy back shares, companies inform SEBI about it. Share buyback in India is regulated by Sec 77A, 77AA, 77B of the Companies Act and SEBI (Buy-Back of Securities) Regulations, 1998.

While stock repurchases are like bumper dividends, they are not typically a substitute for dividends. Firms are likely to buy back shares when they have accumulated a large amount of unwanted cash or wish to change their capital structure by replacing equity with debt.

3.5. Dividend Policy for Public Sector and Government Companies

Government of India being a majority shareholder in Central Public Sector Enterprises (CPSEs), it has been decided vide office Memorandum dated January 5, 2016 by Ministry of Finance, that henceforth (i) A CPSE would pay an annual dividend of 30% of PAT or 30% of GOI's equity, whichever is higher. (ii) Due account should be taken of cash and free reserves with the CPSE, and accordingly special dividend would need to be paid to the Government, as a return for its equity investments. (iii) CPSE with large cash/ free reserves and sustainable profit may issue bonus shares. ⁽³⁾

3.6. Corporate Governance

When there is good corporate governance the managers' and shareholders' interests are closely aligned. This becomes evident in developed countries like US where there is strong corporate governance relative to emerging economies like India. Hence the mature companies are willing to make generous payouts. One of the factors which affect firm's payout is the quality of corporate governance. The past studies exhibit a strong positive correlation between governance quality and dividend payouts.

Corporate governance exists to provide checks and balances between shareholders and management and thus to mitigate agency problems. Hence, firms with better governance quality should incur less agency conflicts. In such firms, managers should be less likely to adopt a sub-optimal dividend policy. As a result, the quality of corporate governance should have an impact on dividend policy. This study provides empirical evidence on the association between aggregate governance quality and dividend payouts. ⁽⁴⁾

4. Behavioral Aspects Affecting the Payout Policy

4.1. Clientele Approach

The shareholders tend to invest in the firms whose dividend policy match with their preferences. While shareholders who belong to high tax brackets are skewed towards stocks which give capital appreciation than regular dividend income. The shareholders who are low tax payers are in favour of regular dividend paying companies. This grouping of shareholders in companies with dividend policies matching with their preferences is known as clientele effect. The companies will have the investor base which like their dividend policies. Hence it is difficult for the firms to change its dividend policy. At the same time, the firm's value won't be affected by their dividend payouts as each set of firms have their own set of investors whose dividend preference are aligned with the firms' policies.

4.2. Signaling Theory

Dividend announcement serve as a signal about the performance of the firm. The announcement of the firm is closely watched by the shareholders as an indicative of the prospects of good projects. A dividend increases larger than expectation is interpreted by the investors as higher earnings in the future and conversely a lower dividend payout than expectation would indicate some less favorable future earnings. It is one of the ways to convey the information about the firm though it is not the efficient and cost effective way of communication.

5. Strategic Motives

5.1. Promoters' Holdings and Payout Decision

In March 2016, an interim dividend of Rs 27.40 per share was declared by Coal India Ltd. Government of India being, the largest shareholder (79.64%) received dividend of Rs 17308 crore. Apart from disinvestment proceeds, dividend from public sector undertakings (PSUs) is an important source of non-tax revenue for the government. Most of the companies pay dividends every year. But sometimes the companies may pay special dividends. VSNL paid 750% special dividend to its shareholders before its disinvestment in Dec 2001. Govt. of India was the largest beneficiary of it owing to 53 % stake in it. In 2015 Tata Consultancy Services paid hefty dividends which provided a relief to debt strapped parent Tata Sons. Microsoft, the world's leading Software Company had a zero dividend policy and did not pay dividend for 17 years. It announced its first dividend in January 2003. Subsequently in July 2004, it decided to give back to its shareholders \$75 billion in various forms. It paid dividend to the tune of \$32 billion, in December 2004, followed by share buy-backs worth \$30 billion over four years and a doubling of Microsoft's ongoing dividend. Traditionally its policy was to plough back its earnings into research and innovation. Microsoft had one of the largest research budgets in the world. However, the efficiency of spending on innovation was not good. The huge built-up of cash reserve was to fund its legal lawsuits arising from its alleged monopolistic abuses. This decision was lauded as matured strategic decision by the owners of Microsoft.

5.2. Free Cash Flow Hypothesis- Agency Costs of Retained Earnings

Paying out dividend prevents managers from misusing the funds or using it for non-productive acquisitions or less profitable investment avenues. As per the free cash flow hypothesis put forth by Jensen in 1986 corporates use dividends as tool to mitigate agency costs. This hypothesis emerges from the conflict of interest between managers and shareholders.

Free cash flow hypothesis implies that cash-rich firms with scarce investment opportunities would have overinvestment problem and would go for increase in the dividend payout. Lang and Litzenberger (1989) tested the free cash flow hypothesis using Tobin's Q ratio to determine the dividend policy of overinvested firms. A Tobin's Q less than one implies overinvestment problem while the Tobin's Q more than one indicate that a firm is undertaking the value-maximizing level of investment. Examining a sample of 429 regular dividend changes between 1979 and 1984, Lang and Litzenberger inferred that the average announcement return of large dividend change was significantly higher for firms with low Tobin's Q than for firms with high Tobin's Q.⁽⁵⁾

6. Conclusion

To conclude, payout policy is a combined outcome of the above mentioned different variables. Each of these variables influence the dividend decision of the firm in varying degrees at different points of time. Going further, the impact of each variable on the payout decision needs to be assessed, wherein the current corporate practices would be reviewed vis-a-vis historical payout policies.

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