Impact of Dividend Policy on the Value of Indian Banks

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A b s t r a c t

Dividend policy has always remained one of the most debated issues in the area of corporate finance. Dividend policy relevance has been researched extensively, but researchers have failed to build any consensus on it. Dividend policy is influenced by a number of factors such as firms risk, cash flow situation, leverage, agency cost etc. Dividend decision of a firm can be seen as a source of signal which shows that profitable firms with good project investment opportunities will pay higher dividends to present themselves distinct from other firms which are having projects with lesser profits. However relationship between dividend policy and value of firm is an issue which has attracted attention of both the researchers and academicians. There are divergent views about the impact of dividend policy on the value of the firm. The aim of the paper is to investigate the impact of dividend policy on value of Indian Banks. The sample consists of 16 banks listed on the National Stock Exchange over a period of 2007 - 17. Firm value is taken as dependent variable whereas dividend payout is taken as independent variable. The study uses profitability, firm size, financial leverage and liquidity as control variables. Regression analysis is used for the purpose of data analysis in this research.

Key words: Dividend policy Indian Banks value of firm.

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Dividend refers to the corporate net profits distributed among shareholders. The dividend policy of a firm determines what proportion of earnings is to be paid to the shareholders and what proportions is to be retained back by the firm for reinvestment purposes. Retained Earnings are an easily accessible important source of long term funds for any organization. However there is an inverse relationship between retained earnings and cash dividends. If a firm's capital investment decision is independent of its dividend policy a higher dividend payment will result into greater dependence of the firm on external source of financing. Thus dividend policy has a bearing on the choice of financing. Returns associated with the shareholders comprise cash dividends and capital gains.

According to Miller and Modigliani (1961) if a company retaining earnings rather than giving to shareholders, then shareholders enjoy capital appreciation equal to the amount

of earnings retained. But if it distributes earnings by way of dividends instead of retaining it, then shareholders enjoy dividends equal in value to the amount by which his capital would have appreciated had the company chosen to retain its earnings. The dividend payout decision of a company has got a direct influence on both cash dividend and capital gains. So, for management it is very important to decide upon whether to pay the dividends or to invest the money back into the company to exploit on other opportunities which result in capital gains.

The exact proportion of earnings that the company should pay as cash dividends to shareholders is a very crucial decision. Firms always try to make an optimal dividend decision which leads them to the maximization of the shareholders' wealth through the increased share prices in the market. The relationship between payout ratio and retention ratio become more complex in case of banking sector which is a high debt sector. The capital structure of banks primarily contains equity shares and long term debt. Equity accounts for payment of dividends to the shareholder which is not mandatory. But in the absence of payment of dividends to the shareholders the bank will have to face a decrease in the reputation, fall in the share price and market capitalization. On the other hand long term debt obligations account for periodic payments of fixed charges in terms of interest and principal. In this study an attempt is made but with focus on Indian banking sector. The paper examines the impact of Dividend Policy on the value of Indian Banks.

Literature Review

According to the dividend irrelevance theory in perfect capital markets (no taxes, no transactions costs, and no other market imperfections), dividend policy does not affect firm value Miller and Modigliani (1961). The role of dividend policy has been reconsidered in imperfect capital markets.

According to the residual theory, dividends are paid by a firm only after all acceptable investment opportunities have been undertaken Gordon (1963) and Lintner (1962) In the dividend relevance theory, they suggest a direct relationship between a firm's dividend policy and its market value. Their "bird-in-the-hand" argument states that existing and potential investors consider current dividends less risky than future dividends or capital gains.

Black and Scholes (1974) carried out their research on firms listed on the New York Stock Exchange for the period between 1931 and 1966, and results suggested that there is no correlation between dividend and market value.

Bhattacharya (1979) and Miller (1985) suggested that dividend announcements convey information about the future prospects of the firms. Due to the information content in dividends, dividend announcements are taken as a signal of the companies' good position that will raise the stock prices and vice versa. Investors with imperfect information about company conditions would use dividends as a clue to the prospects of the companies.

Hakansson (1982) suggested that dividends, whether informative or not, give no value role when investors have homogeneous beliefs and time-additive utility as well as a market which is entirely efficient.

Ohlson (1995) assumed that dividend payouts only decrease current book value and future earnings, but it do not affect current earnings which is, to some extent, consistent with the assumptions of Miller and Modigliani.

Baker & Wurgler (2004) argue for a "catering theory of dividends" in which firms cater to the preferences of investors, initiating or increasing dividend payment in periods when the exogenous demand for dividends is high.

Dragotă et al. (2009) focused on the effect of corporate taxation on dividend policy for the Romanian listed firms over the period 1998-2005. Using a sample of 65 firms, the authors found that corporate tax burden does not play a major role in the dividend decision making process. However, the authors highlighted that Romanian listed firms changed the dividend policy in 2005, after Romania introduced a flat tax system.

Hussainey et al. (2011) examined the relationship between dividends policy and share price changes in the British Stock Market, and the evidence showed that the dividend payout ratio and security price changes have a negative correlation.

Barbuta-Misu (2013) analyzed the dividend policy of five Romanian Financial Invest Companies (FICs) over the period 2006-2012 and found that the financial crisis affected the dividend distribution rate in 2008 and 2009. Similar results have been obtained by Berceanu et al. (2012) on the same sample of FICs. To the best of our knowledge, there is no paper on the effect of dividend policy on firm value.

Profilet and Bacon (2013) investigated the impact of selected financial factors on overall securities, price volatility, using the ordinary least squares regression model. They determined that among other factors, dividend payment has a positive impact on share price volatility.

Objectives of the Study

➢ The paper focuses on analyzing the impact of Dividend Policy on the value of Indian Banks.

Research Methodology

Study Period and Sample Selection

For the purpose of this study financial data of Indian Banks [public and private] from 2007—17 was taken. This period included recession and post recession period.

8 Public and 8 Private sector Banks listed on NSE were taken for the study on the basis of following criteria's:

➢ Availability of data for continuous period of 10 years

➢ Continuous dividend payments for 10 years

The banks finally considered for the study are State Bank of India (SBI), Bank of Baroda (BoB), Union Bank of India (UBI), Punjab National Bank (PNB), Allahabad Bank (AL), ICICI Bank (ICICI), HDFC Bank (HDFC), Axis Bank (AB), Indusend Bank (IB), Federal Bank (FB).

CMIE Prowess online database has been also used for the purpose of collecting data

Defining Variables

Variables and model used by earlier researchers Rehman [2016], Kalay and Lemmon [2008] and Lewellen and Badrinath [1997] have been considered in this paper too.

Dependent Variable:

• Firm Value (FV): Tobin's q, is the most commonly used proxy for Firm Value. The book value of assets is a proxy for assets in place, whereas the market value of assets is a proxy for both assets in place and investment opportunities. Thus, a high MBA ratio indicates that a firm has many investment opportunities relative to its assets in place. Tobin's q is defined by the ratio of the market value of assets over the replacement value of assets. Perfect and Wiles (1994) showed that Tobin's q and the MBA ratio are highly correlated (the correlation coefficient is about 0.96). For this study Natural Logarithm of market value of firm over replacement value of its asset is considered as proxy of Firm Value.

Independent Variable:

• Dividend Payout (DP): Standard measure for dividend payout i.e. DPS / EPS is used in this study.

Studies conducted earlier have shown that Leverage, Firm Size, Profitability and Liquidity are some other variables that have an impact on the value of the firm. In this study these variables have been considered as control variables and are kept constant for the study period in order to test the relative relationship between the dependent and independent variables.

Control Variables:

• Profitability (PR): Titman and Wessels (1988) used EBIT/ASSETS as a measure of profitability. Other measures include return on assets and return on sales (profit margin). For this study ROA i.e Return of Assets is used as proxy for profitability.

• Firm Size (FS): Size is measured by the natural logarithm of sales or the natural logarithm of total assets. For the purpose of this study natural logarithm of assets is used as proxy of firm size.

• Financial Leverage (FL): For this study EBIT / (EBIT—Interest) is used as a proxy of Financial Leverage

• Liquidity (LQ): In this study Current Ratio [Current Assets / Current Liabilities] is used as a proxy for Liquidity.

Hypothesis Formation:

Ho: There is a significant effect of Dividend Policy on the Firm Value.

Model Selection

Taking into consideration the objective of the study, regression analysis is best suited for the analysis and the same is used for data analysis. Normalization of the data was done before using the regression model. Ordinary Least Square Method is better suited for this purpose (Shah and Hijari, 2004) hence the same has been used for this research. The regression equation used is as follows.

$$Fv_{it} = \beta_0 + \beta_1 DP_{it} + \beta_2 FL_{it} + \beta_3 FS_{it} + \beta_4 PR_{it} + \beta_5 Lq_{it} + \epsilon_I$$

With the help of White test and Breusch–Pagan test Autocorrelation and Het roscedasticity from the data was removed respectively. Variance Inflation Factor test was carried out which showed that there is no Multicollinearity. Having ensured the normality of data, regression analysis was carried out. Data Analysis and Interpretation.

Table I : Descriptive Statistics

Variable Name	Mean	Standard Deviation	Min.	Max.
Firm Value -- FV	0.199	0.581	1.013	2.386
Dividend Payout –DP	0.293	0.394	1.00	3.401
Financial Leverage – FL	0.193	0.241	0.873	1.641
Firm Size -- FS	10.81	1.46	6.098	17.035
Profitability -- PR	0.193	0.121	0.874	1.173
Liquidity -- LQ	2.164	1.318	1.013	6.417

Table number I above depicts descriptive statistics of all the variables used in the study. Mean value of Dividend Payout is 0.293 which means that the average dividend payout of the banks under consideration is 29.3%. Moreover looking at the minimum and maximum values of dividend payout it can be further inferred that there is significant difference across banks. The table also depicts that the average of financial leverage is 0.193 which indicates that the average debt component in the capital structure of banks during the study period was 19.3%. Moreover the debt proportion in the capital structure of banks during the study period also varied a lot. This is inferred from the maximum and minimum values of financial leverage.

Table II: Correlation between Variables

	FV	DP	FL	FS	PR	LQ
FV	1					
DP	0.074	1				
FL	0.291	-0.198	1			
FS	0.210	0.193	0.199	1		
PR	-0.011	0.195	-0.371	0.173	1	
LQ	-0.057	0.016	-0.374	-0.154	0.147	1

Table number II above depicts the Correlation between variables used in the study. Looking at the values above it, can be stated that there exists a positive correlation between dividend payout and firm value which is in line with many earlier studies. Further it is observed that the firm size and degree of financial leverage also has a positive correlation with the firm value. However there is a negative relationship between financial leverage and dividend payout which means that firms with high amount of debt tend to pay less dividends and vice versa.

Further Ordinary Least Square Regression model was used to identify the influence that independent variables have on dependant variables (refer table III)

Table III
Impact of Dividend Payout on Firm Value

Variables	Coefficient
Constant	-1.9729
DP	0.10963*
FL	1.3056*
FS	0.1539*
PR	0.2164*
LQ	--0.0049

* Significant at 0.01 and 0.05 level

$R^2 = 0.797$

Adjusted $R^2 = 0.627$

F Value = 11.153

From the above table following inferences can be drawn

- Since the value of R^2 =0.797 it can be inferred that the independent variables have an impact on the capital structure of manufacturing firms to the extent of 79%.

- The F Value of 11.153 and P Value of 0.000 lead us to the inference that the model is statistically significant.

- Dividend policy has a positive impact on the value of the bank. This is in line with the study conducted by Rehman [2016] and Traditional Approach of dividend payment. Banks which pay more dividends are valued more by investors as compared to banks which pay less dividends.

- The study also reveals that leverage, profitability and firm size also have a positive impact on the value of the firms. This is similar to the results of study conducted by [Masulis, 1983; Martinez Sola et al. 2013]

- Liquidity statistically does not have any significant influence on the value of the firm.

Conclusion

This paper focused on analyzing the impact of Dividend Policy on the value of Indian Banks. For this purpose 8 Public and 8 Private sector Banks listed on NSE were taken for the study. Financial data of Indian Banks [public and private] from 2007-17 was taken. This period included recession and post recession period. Dividend Payout (DP) was taken as independent variable and firm value was taken as dependent variable. Profitability, Firm Size, Leverage, Liquidity were taken as controlled variables. Regression model was used for the purpose of data analysis. The results indicated that Dividend policy has a positive impact on the value of the banks. Leverage, profitability and firm size also have a positive impact on the value of the firms however liquidity did not have any significant influence on the value of the firm. The results of this study were in line with earlier studies conducted by Rehman [2016]; Masulis, [1983]; Martinez Sola et. al. [2013].

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