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A STUDY OF PAYER AND NON-PAYER FIRMS IN INDIA

IMPACT OF INVESTMENT OPPORTUNITIES, GROWTH, COST OF EQUITY AND OWNERSHIP STRUCTURE

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THE present article tends to study the dividend behavior of NSE and BSE firms over the last five years. Dividend decision being one of the most important financial management decisions should be studied to find out whether the firm is moving towards its goal of maximizing shareholders' wealth or not. The article studies the dividend trend of the selected firms for the period 2001-2005 and divides them into payer and non-payer groups. Further, the study uses regression analysis to establish the relationship between dividend paid and Investment Opportunities, Growth, Cost of Equity and Ownership Structure. It finds out payer firms to have large size, less investment opportunities and high cost of retained earnings and the opposite in case of non-payers. Both of these however show an increase in dividend paid with increase in equity ownership by promoters as this helps in reducing agency costs.

Introduction

Issue of dividend payment is one of the most commonly observed phenomenon in corporations worldwide. A number of researchers have provided insights, theoretical as well as empirical, into the dividend policy puzzle. However, the issue as to why firms pay dividends is as yet unresolved. Several rationales for a corporate dividend policy have been proposed in the literature, but there is no unanimity among researchers.

The issue of dividend policy is important for several reasons:

- First, researchers have found that a firm uses dividends as a mechanism for financial signaling to the outsiders regarding the stability and growth prospects of the firm.
- Secondly, dividends play an important role in a firm's capital structure. Yet another set of studies have established the relationship between firm dividend and investment decisions.

Further, a firm's stock price is affected, among other things, by the dividend pattern.

Firms usually do not like to reduce or eliminate dividend payments; hence, they make announcements of dividend initiation or increases only when they are confident of keeping up with their good performance. Moreover, because the success of financial managers is tied to the maximization of shareholders' wealth (and firm value), so they must understand the dynamics of dividend policy.

Despite the rich literature on dividend policy of Indian firms on the overall issue of dividend policy, most studies exclude finding out the difference between characteristics of payer and non payer firms from their analyses.

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This paper, on the other hand, uses several financial variables to explain the possible differences in the dividend policy of both payer and non payer firms and the reasons for non payment.

The remainder of the paper is organized as follows: Section II provides a brief review of the relevant literature. Section III presents the description of the data and the empirical methods used. Section IV contains the results, and Section V concludes the paper with a summary.

Literature Review

Miller and Modigliani (1961) view dividend payment as irrelevant. According to them, the investor is indifferent between dividend payment and capital gains.

Black (1976) poses the question again, "Why do corporations pay dividends?" In addition, he poses a second question, "Why do investors pay attention to dividends?" Although, the answers to these questions may appear obvious, he concluded that they are not. The harder we try to explain the phenomenon, the more it seems like a puzzle, with pieces that just do not fit together. After over two decades since Black's paper, the dividend puzzle persists.

Miller and Rock (1985), for instance, developed a model in which dividend announcement effects emerge from the asymmetry of information between owners and managers. The dividend announcement provides shareholders and the market place the missing piece of information about current earnings upon which their estimation of the firm's future (expected) earnings is based. The latter, of course, determines the current market value of the firm. In this respect, we can clearly see the role played by dividends. The dividend announcement provides the missing piece of information and allows the market to establish the firm's current earnings. These earnings are then used in predicting future earnings.

John and Williams (1985) constructed an alternative signaling model in which the source of the dividend information is liquidity driven.

Crutchley and Hansen (1989) examined the relationship between ownership, dividend policy, and leverage and concluded that managers make financial policy trade-offs to control agency costs in an efficient manner. More recently, researchers have attempted to establish the link between firm's dividend policy and investment decisions.

Jensen, Solberg, and Zorn (1992) linked the interaction between financial policies (dividend payout and leverage) and insider ownership to informational asymmetries between insiders and external investors. They employed a simultaneous system of equations and found that corporate financial decisions and insider ownership are interdependent.

In summary, the literature suggests that there are different factors that determine dividend policy of firms. However, not much work seems to have been done in comparing dividend policies of the payer and non-payer groups. In this paper some of the factors that could affect a payer and non-payer firm's dividend policy and how they might differ are studied.

Data and Empirical Methods Used

Sample Size: The study consists of a sample size of 52 companies of which 26 are payers and 26 non-payers.

Sample Composition: The sample comprises of companies which are listed on NSE or BSE and those listed both on NSE and BSE and for whom data was available for the last 5 years i.e. they were listed throughout the last 5 years. The companies listed for less than 5 years have been excluded for the purpose of study.

Sampling Method: Stratified Random sampling has been done for the present study.

Data: Secondary sources have been used for gathering data. This secondary data was gathered from annual reports of companies listed on BSE and NSE as well as various websites.

Time Period of Study: Study has been done for the last 5 years i.e. 31st march 2001-31st march 2005. For the companies whose accounting year is January to December data was analyzed for the period 31st December 2000 to 31st December 2004.

Test Statistic: The study used regression analysis to achieve the objectives set. Factor Analysis was not used as it is used to reduce a large number of factors into a few ones and it does not indicate the relationship between the dependent and the independent variable. The study involves factors already grouped into four and tends to find out the relationship of these with the independent variable i.e. dividend which can be done by using regression analysis.

Analysis and Results Regression Analysis Results of Payer and Non Payer Frims

Regression Equation

Payout Ratio = a + b1 IOS + b2 Growth in Revenues + b3 Percentage Shares held by Promoters + b4 Cost of Retained Earnings.

- Value of all the variables has been taken as an average of the last five years.
- IOS stands for Investment Opportunity Set and is the ratio of market value to book value per share of the firm.

	Payer Firms		Non-payer Firms	
Variable	**Coefficient**	**T-value**	**Coefficient**	**T- Value**
Constant	0	0	0.01	0.05
Investment Opportunity Set	-0.048	-0.817	-0.317	-1.307
Growth in Revenues	0.091	1.571	-0.17	-0.07
Percentage Shares Held by Promoters	0.016	0.285	0.449	1.779
Cost of Retained Earnings	-0.933	-15.604	0.035	0.075
R Square	0.944		0.163	

- Cost of retained earnings is measured by the formula:

  Ke = (Dividend/price per share) + growth

Analysis of the Results

- Both payer and non-payer firms show a negative relationship between dividend payment and Investment Opportunity Set which means that in both cases dividend payout decreases with an increase in investment opportunities and vice-versa.

  As payer firms have increased dividend payment over the last five years this is indicative of the fact that these firms possess less investment opportunities. On the other hand, non-payer firms have not paid dividend over the last five years which shows presence of investment opportunities leading to retention of profits and hence non payment.

- For payer firms, dividend payout is positively related with growth in revenues i.e. higher the growth in revenues higher will be the payout rate. This is in continuation with the fact that due to higher revenue growth but lack of investment opportunities, these firms have paid dividend continuously over last 5 years.
- In case of non-payer firms payout is negatively related with growth in revenues i.e. higher the growth in revenues, lower will be the payout rates. The same is supported by the first finding. As non payer firms have more investment opportunities increase in revenues leads to increase in investment and lower payout.
- Both payer and non-payer firms have a positive relationship between percentage share holding by promoters (which acts as a surrogate of agency cost) and payout ratio. Agency cost are the cost incurred by shareholders to obtain full information about company's investment plans, future earnings, expected dividend payments etc. these can be reduced by paying more dividend i.e. a higher payout as it is considered that, higher payout may require raising capital frequently from primary markets which leads to automatic monitoring of firm by external agencies and reduces agency costs. Therefore, higher agency cost should ideally result in higher payout ratio and this corollary is true for both regular payers and irregular or non payer firms. Although both payer and non payer firms have a percentage of shareholding by promoters which is quite significant in some of the firms, payout ratio is zero in case of non payer firms over the last five years primarily due to the reason of low revenue growth and large investment opportunities; while it has been higher in case of payers due to high revenue growth accompanied with lack of investment opportunities.
- Cost of retained earnings has a positive relationship with payout ratio in case of non payers and negative relationship in case of payers. This shows that non payers have investment opportunities due to which retention of earnings is required. These firms are able to re-invest their earnings at a rate higher than the rate expected by the shareholders. They will maximize the value per share if they follow a policy of retaining all the earnings for internal investment and hence the optimum payout ratio for these firms is zero. Therefore for nonpayer, decrease in cost of retained earnings occurs with low or zero payout.
- In case of payers investment opportunities are less profitable and in case they retain their earnings they would earn a return less than minimum rate required by shareholders. So, for payers, a decrease in cost of retained earnings with high payout and hence optimal payout for these firms is 100%.

Conclusion

From the above four findings, it can be concluded that basically the firms found out to be payer firms on BSE are those which have reached a maturity stage and hence there investment opportunities are low growth in revenues is high but the cost of retaining these revenues is higher. So these firms have been regularly paying dividend at an increasing rate over the last 5 years. On the other hand, the non payers firms are growth firms due to which they have investment opportunities and growth in revenues in these firms is not accompanied by payment of dividend as cost of retained earnings is low. So the payout policy of these firms has been a payout ratio of zero percent. Both payer and non- payer firms show a positive relationship with equity ownership by insiders.

Overall the article has developed a model of dividend payout policy of payer and non-payer firms in India. Further research can be done on the effect of dividend initiation and omissions on value of such firms.

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