Chapter 64

A Diagnosis of the Determinants of Dividend Payout Policy in India: A Factor Analytical Approach

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ABSTRACT

Dividend decision involves the portion of a firm’s net earnings that are paid out to the shareholders, and the remaining is ploughed back in the company for its growth purpose. Despite comprehensive theoretical and empirical explanations, dividend policy and its determinants are a puzzle to be fixed in corporate finance. This chapter is an attempt to assess the dynamics and determinants of dividend-payout policy using a factor analytical tool and a multiple regression analysis as a supportive tool. The authors take into account the sample of ten automobile companies based on Market Capitalization listed on the Bombay Stock Exchange (BSE) for a period of 10 years from 2002-2003 to 2012-2013. The results of the factor analysis show that six factors, current ratio, cash flow, retained earnings per share, earnings per share, equity dividend, and corporate dividend tax, are identified as the most critical factors determining dividend payout in Indian automobile companies. However, regression results depict only three factors (i.e. cash flow, equity dividend, and corporate dividend tax) have been found statistically significant in determining dividend payout policy.

1. INTRODUCTION

Dividend policy decision is an integral part of a company’s financial decision making as it is explicitly related to the other two major decisions—investment and financing decision. Management should develop such a dividend policy, which divides the net earnings into dividends and retained earnings in an optimum way to achieve the objective of maximizing the wealth of shareholders. It
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refers to the practice that corporate management follows in taking dividend payout-decisions (Lease et al., 2000).

The development of such policy will be greatly influenced by investment opportunities available to the firm and the value of dividends as against capital gains to the shareholders. Since the dividend policy determines whether distribute the earnings to shareholders or self-finance through retained earnings, so it is an important issue that receives more attention these days from financial analysts, academics and practitioners. The corporate dividend policy contributes not only at the micro level but also to the analysis of several macroeconomic issues, as cash dividends constitute a part of national income and any variation in corporate dividend payouts may affect the corporate propensity to save and reinvest. Therefore, it is of great importance not only for the corporation itself but also for the economy as whole.

The study of dividend policy has captured the attention of finance scholars since the middle of the last century. The roots of the literature of determinants of dividend policy and dynamics relates to Lintner’s classic study (1956), Darling (1957), Brittain (1966), and Fama and Babiak (1968). They have attempted to solve several issues pertaining to dividends and formulate theories and models to explain corporate dividend behavior. However, empirical evidences many times provide inconclusive results as to what determines the optimal dividend policy. Almost three decades ago Black (1976) epitomizes the lack of consensus by stating “The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don’t fit together.” Corporate dividend policy is not an easy, straightforward and simple aspect of finance as many people conceive it (Hackett, 1981). It has long been regarded as an unresolved economic puzzle, which require rational resolution if the prevailing economic paradigm of corporate finance is to continue (Miller, 1986). Despite many studies conducted by financial economists, the issue of dividend policy determinants still remains debatable.

2. REVIEW OF LITERATURE

Lintner (1956) conducted a classic study on how U.S. managers make dividend decisions, which is focused in the behavioral aspect of dividend policy and concluded that managers only increase dividends when they believe that the level of the firm’s earning has permanently increased.

Miller and Modigliani (1961) argued that in a perfect market dividend policy has no effect on either the price of a firm’s stock or its cost of capital, shareholders wealth is not affected by the dividend decision and therefore, they would be indifferent between dividends and capital gains.

Friend and Puckett (1964) concluded that in growth industries retained earnings are more important than the dividends in determining share price. While, in case of non-growth industries, dividends seem to be more important than retained earnings.

Brittain (1966) indicated that the capacity of a firm to pay dividends has been better explained in terms of cash flows as a variable, i.e., profits after taxes plus depreciation as against the Lintner’s profits net of taxes, as it reflected true earnings.

Farrar and Selwyn (1967) viewed that investors would normally prefer low dividends as the dividends are subject to higher tax rate than that of capital gains resulting out of earnings capitalization.

Fama and Babiak (1968) concluded that net income seems to provide a better measure of dividend than either cash flows or net income and depreciation included as separate variables in the model.

Van Horne and McDonald (1971) found that the payment of dividends through excessive equity financing reduced share prices. While new