EFFECTS OF DIVIDEND POLICY ON SHARE PRICES

Case of companies in
Nairobi securities exchange

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Full Length Research

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Dividend policy refers to management's long-term decision on how to deploy cash flows from business activities-that is, how much to invest in the business, and how much to return to shareholders. The determination of the amount of dividends payable is an important decision that companies undertake since the objective of the firm is to maximize the shareholders' wealth as measured by the price of the company's common stock. The study concluded that higher pre-tax risk adjusted returns associated with higher dividend yield stocks to compensate investors for the tax disadvantages of returns affected tax incentives and that investors whose portfolios had low systematic risk preferred high-pay-out stocks. This was consistent with Brennan's model (Brennan, 1970).The study also found out that an increase in firms' stocks trading volume affected the share price and investors who wanted current investment income owned shares in high dividend payout firms and this was consistent with the findings of Botha (1985). The study further concludes that free cash flow caused conflict between management and shareholders which in turn affected the share price and that the executive option plan persuaded management to reduce corporate dividends by an amount that was equal to the option plan. This was consistence with the findings of Lambert, Lanen and Larker (1989). The study recommends that companies consider all pertinent issues before issuing dividends. Since the share market is positively responsive to the dividend announcement, companies should always strive to pay divided consistently for their shares to perform well at the stock exchange. Dividend policy have an effect on the share prices of the firms quoted at NSE thus, companies (firms) should pay dividends to maintain high share prices.

Key words: Capital asset pricing model, dividend per share, net present value, weighted average cost of capital.

INTRODUCTION

The dividend policy of a company determines what proportion of earnings is distributed to the shareholders by way of dividends, and what proportion is ploughed back for reinvestment purposes. Since the main objective of financial management is to maximize the market value of equity shares, one key area of study is the relationship between the dividend policy and market price of equity shares. Dividend policy connotes to the payout policy, which managers pursue in deciding the size and pattern of cash distribution to shareholders over time (Davis 2006). Since managements' primary goal is shareholders' wealth maximization, which translates into maximizing the value of the company as measured by the price of the company's common stock. This goal can be achieved by giving the shareholders a "fair" payment on their investments. However, the impact of firm's dividend policy on shareholders wealth is still unresolved. Capstaff, Klaeboe, and Marshall, (2004) defines dividend policy under the relevance theory as, "The dividend policy is a practical approach, which treats dividends as an active decision variable and retained earnings as the residue. Dividends are more than just a means of distributing net profit, and that any variation in dividend payout ratio could affect share prices; a firm should therefore endeavor to establish an optimal policy that will maximize shareholder's wealth. Dividend policy has been an issue of interest in financial literature since Joint Stock Companies came into existence. Dividend policy suggests a positive attitude for, it is a deliberate policy to maintain or increase dividend at a certain level with the ultimate aim of sustaining the price of the ordinary shares on the stock exchange. This is because capital markets

are not perfect, although shareholders are indifferent between dividend and retained earnings due to market imperfections and uncertainty, but they give a higher value to the current year dividend than the future dividend and capital gains. Dividend policy can be of two types: managed and residual. In residual dividend policy the amount of dividend is simply the cash left after the firm makes desirable investments using NPV rule. If the manager believes dividend policy is important to their investors and it positively influences share price valuation, they will adopt managed dividend policy. Firms generally adopt dividend policies that suit the stage of life cycle they are in. Dividend policy is one of the most complex aspects in finance. Three decades ago, Black (1976) in his study on dividend wrote, *"The harder we look at the dividend picture the more it seems like a puzzle, with pieces that just don't fit together"*. Why shareholders like dividends and why they reward managers who pay regular increasing dividends is still unanswered. Dividend policy remains a source of controversy despite years of theoretical and empirical research, including one aspect of dividend policy: the linkage between dividend policy and stock price risk (Allen and Michaely, 2003). Paying large dividends reduces risk, thus influence stock price (Gordon, 1963), and is a proxy for the future earnings (Baskin, 1989). If dividend policy is stable, high dividend stocks will have a shorter duration.

Background of the study
Dividend policy has been an issue of interest in financial literature since Joint Stock Companies came into existence. Dividend policy suggests a positive attitude for, it is a deliberate policy to maintain or increase dividend at a certain level with the ultimate aim of sustaining the price of the ordinary shares on the stock exchange. This is because capital markets are not perfect, although shareholders are indifferent between dividend and retained earnings due to market imperfections and uncertainty, but they give a higher value to the current year dividend than the future dividend and capital gains. Dividend policy can be of two types: managed and residual. In residual dividend policy the amount of dividend is simply the cash left after the firm makes desirable investments using NPV rule. If the manager believes dividend policy is important to their investors and it positively influences share price valuation, they will adopt managed dividend policy. Firms generally adopt dividend policies that suit the stage of life cycle they are in. Dividend policy is one of the most complex aspects in finance. Three decades ago, Black (1976) in his study on dividend wrote, *"The harder we look at the dividend picture the more it seems like a puzzle, with pieces that just don't fit together"*. Why shareholders like dividends and why they reward managers who pay regular increasing dividends is still unanswered. Dividend policy remains a source of

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The Nairobi securities exchange
In the 1920s when Kenya was a British colony, an informal way of dealing in shares and stocks was commenced in Kenya. In 1951, an Estate Agent Francis Drummond established the earliest professional Stock broking firm, and impressed upon the then finance minister of Kenya Sir Ernest Vasey the idea of creating a stock exchange in East Africa. Considering the proposal, which was given by the then finance minister of Kenya Sir Ernest Vasey and Francis Drummond, the London Stock Exchange officials approved to recognize the creation of the Nairobi Securities Exchange as an overseas stock exchange in July, 1953. In 1954, the Nairobi Securities Exchange was comprised as a voluntary organization of stockbrokers enrolled under the Societies Act. The business of shares trading was restricted only to the resident European community though Africans and Asians were not permitted to deal in securities until in 1963 when Kenya became independent. In the first three years of independence the economic development was stable, market confidence was regenerated and the exchange operated several highly oversubscribed public issues. In 1972, development was discontinued and share prices were depressed, when the oil crisis brought in inflationary pressures in the economy. A 35% capital gains tax was launched in 1975, imposing foster losses to the exchange and simultaneously the exchange lost its regional character following the nationalizations, exchange controls and other inter-territorial restrictions initiated in adjacent Tanzania and Uganda. In 1980, The Kenyan Government understood the requirement of design and implement policy transformation to promote the sustainability of economic growth with an efficient and steady financial system. In1984, A Central Bank of Kenya study, "Development of Money and Capital Markets in Kenya" was known as a blueprint for structural reforms in the financial markets which helped the creation of a regulatory body 'The Capital Markets Authority' (CMA) in 1989. Notably, in 1994 the NSE 20-Share Index recorded an all-record high of 5030 points on Feb. 18, 1994. The NSE was rated by the International Finance Corporation (IFC) as the best performing market in the world with a return of 179% in dollar terms In December 1995, the entire Exchange Control Act was revoked. With the privatization of Kenya Airways in 1996, the largest share issue in the history of NSE, and the Kenya Airways Privatization team is rewarded the World Bank Award for Excellence for 1996. In February 2001, basic reformation

of the capital market of Kenya took place and divided the market into four independent market segments: the Main Investments Market Segment (MIMS), the Alternative Investments Market Segment (AIMS), the Fixed Income Securities Market Segment (FISMS) and later Futures and Options Market Segment (FOMS). In the2001/2002 budget, the Government offered the extra incentives to capital markets investments. On17th April 2002, the CMA declared the sanction of the new NSE trading and settlement rules with amendments. On 26th July 2002, with the introducing of a New Foreign Investor Regulations, there are three categories of investor on the capital markets; local, East African and foreign. On 5th August 2002, the Nairobi Securities Exchange, the Capital Markets Authority of Kenya, the Association of Kenya Stockbrokers, the CMA Investor Compensation Fund, and 9 institutional investors through the Capital Markets Challenge Fund have signed a Shareholder Agreement for establishment of the Central Depository and Settlement Corporation (CDSC). On Monday, 11 September 2006 live trading on the automated trading systems of the NSE was implemented.

Statement of the problem
The empirical studies which have mainly focused on developed economies show that there is a relationship between the dividend payments and stock prices (Zhou and Ruland, 2006; Pandey, 2004). Current dividend payments reduce investor's uncertainty, causing investors to discount the firm's earnings at lower rate of return while dividend reduction increases investors' uncertainty raising the required rate of return. According to Nairobi Securities Exchange publication (2010), shows that CMC Holdings limited increased their payout ratio from 27.49% in 2009 to 28.28% in 2010 thus impacting positively on the stock prices from Kshs 15.35 in 2008 to Kshs 18.85 in 2009. It also shows that CFC Stanbic Bank limited changed their payout ratio from 32.05% in 2009 to 16.16% in 2010 thus impacting negatively on the stock prices from Kshs 129.00 in 2007 to Kshs 60.00 in 2008. Therefore, dividend policy has impact on the share prices of NSE thus triggering the research to be undertaken. Theories and discussions on dividend suggests relevance of dividend policy as far as market price per share (MPS) is concerned, however no model or theory has been developed to show how a particular dividend payout policy affects share's value. Locally studies that have been done on dividend policies include: Maina (2000) carried out a study to establish whether there exists a relationship between dividend and investment decisions since both compete for internally sourced funds and given that funds obtained by debt are very expensive and not available to all firms. The purpose of this study was to unfold the relationship between dividend policy and share prices with the aim of helping management to re-sketch their dividend policies and to either validate or disprove the academic explanation of the practice of

paying dividends.

Specific objective
- To identify how clientele effect influence share prices of NSE
- To determine how tax incentives influence share prices of NSE
- To identify how free cash flows influence share prices of NSE

Rationale of the study
During the past ten years, business trends have been moving toward globalization and the number of multinational corporations continues to grow. Newly developed information technology allows investors around the world to trade stocks in other countries without physically crossing borders. Cross-national investors become cross-national shareholders via internet. Their decisions to trade depend merely upon information announced to the public. Dividends are one of the key factors that influence the prices of shares. The relevance of dividend policy on stock price is a matter of considerable importance to the management who sets the policy to the investors who invest in shares, and to the financial economists who endeavor to understand and appraise the functions of the capital markets. Over the half last century, the clash of ideas whether dividend policy is relevant or irrelevant has been the focus of a great deal of attention and continues to be a controversial topic among financial scholars around the world. Therefore, it is important to have an understanding of whether dividend policy is important or not in Kenya. The topic of this study is to discern the effect of dividend policy on share prices of Nairobi Securities Exchange.

Theoretical review
Clientele effect theory
According to Botha (1985), the tax induced clientele argument is based on shareholders' different tax status, which causes shareholders to have preference in respect to returns from investments. This argument implies that there are three major groups of shareholders, namely, those seeking immediate dividend income, those seeking capital appreciation and those who are indifference to both dividends and capital appreciation. A firm is thus not only faced with one clientele but with different clienteles, with preference from one dividend policy to another. Investors who want current investment income such as retirees will own shares in high dividend paying firms while investors who do not require dividends distributions owns shares in low dividend paying firms. Thus different dividend clienteles would probably be found in the following life cycles of companies, namely, maturity phase for high dividend payout companies, the growth phase for low dividend payout companies and the expansion phase for indifference between dividend income and capital growth. Allen, Bernardo and Welch

(2000) suggest that clienteles such as institutional investors tend to be attracted to invest in dividend-paying stocks because they have relative tax advantages over individual investors. The purpose of this theory is to predict the decisions of investors. This will then affect the financial decisions of the firm.

Empirical studies
Several studies have been done on the information content of dividend announcements on the price of common shares. For example, a number of studies have analyzed the share price reaction to the announcement of changes in regular paid dividends (Ghosh and Woolridge, 2008 and Capstaff et al., 2004). Black and Scholes (1974) attempted to answer this question in a study that covered a period of 35 years (from 1931 to 1966). They created 25 investment portfolios from companies listed in the New York Index and classified them into five groups according to the cash dividend policy they followed. Then they divided each group into five categories according to risk (beta coefficient). Examining the investment portfolios returns compared with the cash dividends (cash dividends distribution policy in place), they did not find any statistically significant relationship between the cash dividends and the total portfolio return. Scholes's study (1982) accused Litzenberger and Ramaswamy's (1979) study of being distorted in that it is affected by cash dividend increases or a lack of information. In Scholes's study, they excluded all companies that announced their profits and distributed them in the same month in order to mitigate the impact of the dividend declaration. They came to the conclusion that portfolio total revenue is in direct proportion to the cash dividends, but that the impact of the difference between the tax percentage on cash dividends and capital gains is not 23%, but only 4%. This influence in terms of statistical significance does not differ from the impact of zero, which means there is no effect regarding the difference of tax rate on cash dividends and capital gains. A local study by Bitok (2004) on the effect of dividend policy on the value of the firms quoted at the NSE found that paying dividends reduces risk to the companies and thus influence stock price. The study also found that dividend yields and payout ratio serves as proxies for the amount of projected growth opportunities. On another research by Karanja (1987) on dividend practices of publicly quoted companies, it was found that there are many reasons why firms pay dividends and the dividend payment directly affected the share price of the company in question. One reason is lack of investment opportunities, which promises adequate returns. Firm's cash position was the most important consideration of timing of dividends.

METHODOLOGY
The researcher considered the case method to be a suitable research methodology for this research. Previous research had revealed that the case method was

appropriate when investigating the of dividend policy on share prices of companies in NSE which was the circumstance surrounding this study. The study targeted the forty six listed and trading companies in the NSE with the target respondents being staff members working for the companies. The study used a random sample of thirty five members. This represented a four percent representation the thirty five members were chosen to represent three levels of the firm's structure namely Top level management, middle level management and low-level management. Primary data was collected for the purpose of this study. The research instrument for the study was a questionnaire. Secondary data was collected from the websites of the various companies, journals and relevant texts. To establish the validity of the data, the research sought opinions of experts in the field of study especially the researcher's supervisor. This facilitated the necessary revision and modification of the research instrument thereby enhancing validity. Reliability of the data was enhanced through a pilot study that was conducted on the listed companies in Nairobi Securities Exchange. The pilot study was to enable the researcher to be familiar with research and its administration procedure as well as identifying items that require modification. The result helped the researcher to correct inconsistencies arising from the instruments, which ensured that they measured what was intended.

A multiple regression analysis was conducted so as to determine the relationship among variables (independent) on the effect of dividend policy on share prices. The regression equation took the form;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \alpha$$

Where Y is the dependent variable (Share prices), β_0 is the regression coefficient, β_1, β_2, β_3, β_4 and β_5 are the slopes of the regression equation, X_1 = Clientele effect independent variable, X_2 = the Tax incentives variable, and X_3 = cash flows independent variable while α is an error term normally distributed about a mean of 0 and for purposes of computation, the α is assumed to be 0.

Reliability analysis
Cronbach's alpha was calculated by application of SPSS for reliability analysis. The value of the alpha coefficient ranges from 0-1 and may be used to describe the reliability of factors extracted from dichotomous (that is questions with two possible answers) and or multi-point formatted questionnaires or scales (i.e., rating scale: 1=poor, 5=excellent). A higher value shows a more reliable generated scale. Cooper and Schindler (2008) has indicated 0.7 to be an acceptable reliability coefficient. The table 1 illustrates the results of the reliability analysis. It involved questionnaires from seven respondents. As the alpha coefficients were all greater than 0.7, a conclusion was drawn that the instruments had an acceptable reliability coefficient and were appropriate for the study.

Validity is the accuracy or meaningfulness of

Table 1: Reliability Analysis

Variable	Cronbach's Alpha	No of Items
To identify how clientele effect influence share prices of NSE	.8257	4
To determine how tax incentives influence share prices of NSE	.7452	5
To identify how free cash flows influence share prices of NSE	.7701	4

inferences, which are based on the research results (kothari 2008). The validity was determined through the use of content validity test index which was obtained by summing items rated 4 or 5 by experts and dividing by the total number of items in the questionnaire. Content validity index of 0.802 was obtained. This value indicated that the instrument was acceptable as recommended by Davis 2002. Davis (2002) recommended content validity index of 0.80 for new measures.

FINDINGS AND DISCUSSIONS
Tax incentives
According to the findings, the respondents indicated that higher pre-tax risk adjusted returns associated with higher dividend yield stocks affected share prices to a very large extent as shown by a mean of 2.6, the respondents indicated that investors whose portfolios had low systematic risk preferred high-payout stocks to a very large extent as indicated by a mean of 2.4, the respondents indicated that Stock's pre-tax returns positively and linearly related to its dividend yield and its systematic risk , Positive relationship between investors' ages and their portfolios' dividend yield and a stock with higher dividend yield sold at a lower price affected share prices to a great extent as indicated by a mean of 2.3 respectively. The respondents demonstrated that they higher pre-tax risk adjusted returns were associated with higher dividend yield stocks to compensate investors for the tax disadvantages of returns affected share prices. This was in agreement with the Brennan's model which maintains that a stock's pre-tax returns should be positively and linearly related to its dividend yield and to its systematic risk.

Clientele effect
From the findings, the respondents indicated that increase in firms' stocks trading volume affected the share prices to a very large extent as indicated by a mean of 2.8, the respondents indicated that investors who wanted current investment income owned shares in high dividend payout firms and size of the trading volume of stocks affected the share prices to a great extent as indicated by a mean of 2.6 respectively, the respondents indicated that investors who did not require dividend distributions owned shares in low dividend payout firms which in turn affected the share prices to a moderate extent as indicated by a mean of 2.4. The respondents clearly explained that increase in firms' stocks trading volume greatly affected the share prices. These findings

supported findings by Richardson, Sefcik and Thompson (1986) where they tested a sample of 192 US firms that initiated dividends for the first time during the period of 1969 through 1982.Where they found that increase in firms' stocks trading volume is due to the signaling effect or was a product of investors in various tax clienteles adjusting their portfolios.

Free cash flow
According to the findings, the respondents indicated that Free cash flow caused conflict between management and shareholders which in turn affected the share price to a very large extent as indicated by amean of 2.7, the respondents indicated that executive option plan persuaded management to reduce corporate dividends by an amount that was equal to the option plan and dividends reduced free cash flows available to managers which in turn affected the share price to a great extent as indicated by a mean of 2.6 respectively, the respondents further indicated that dividends were a way of removing free cash flows from managerial control in firms that faced limited investment opportunities and this affected the share price to a moderate extent as indicated by a mean of 2.1.The respondents affirmed that free cash flow was the major cause of conflict between management and shareholders. This was in agreement with the Easterbrook's (1984) analysis; the monitoring role of dividends mitigates agency conflicts between managers and shareholders. The agency problem in Jensen's (1986) analysis arises from managers' incentives to consume private benefits, for example, building their empires by investing free cash flows in negative net present value projects or spending cash on perquisites. Thus, dividends alleviate this problem by reducing free cash flows available to managers.

Regression analysis
The researcher conducted a multiple regression analysis. This was done to test relationship among variables (independent) on the effect of dividend policy on share prices. The statistical package for social sciences (SPSS) was applied to code, enter and compute the measurements of the multiple regressions for the study. Table 2.

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (share price) that is explained by all the three independent

Table 2: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.796(a)	.893	.591	.42945

Table 3: ANOVA (b)

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	36.739	3	12.913	13.948	.000(a)
Residual	20.461	32	.864		
Total	57.200	23			

a. Predictors: (Constant), Clientele effect, tax incentives and free cash flows
b. Dependent Variable: share price

Table 4: Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	.423	.369		.290	.004
Clientele effect	.453	.148	.757	5.869	.001
Tax incentives	.205	.123	.115	.935	.003
Free cash flow	.295	.138	.092	.688	.002

b) Dependent Variable: Share price

variables (Clientele effect, tax incentives and free cash flows).

The three independent variables that were studied, explain only 89.3% of the factors affecting dividend policy on share prices as represented by the R^2. This therefore means that other factors not studied in this research contribute 10.7% of the factors affecting dividend policy on share prices. Therefore, further research should be conducted to investigate the other factors (10.7%) factors affecting dividend policy on share prices. Table 2.

The significance value is 0.000which is less that 0.05 thus the model is statistically significance in predicting how Clientele effect, tax incentives and free cash flows affect the share prices. The F critical at 5% level of significance was 2.32. Since F calculated is greater than the F critical (value = 13.948), this shows that the overall model was significant.

The researcher conducted a multiple regression analysis so as to explaining the effect of dividend policy on share prices. And the three variables as per the SPSS generated table 3, the equation ($Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \varepsilon$) becomes:
$Y = 0.453X_1 + 0.205X_2 + 0.295 X_3 + 0.423$
Where Y is the dependent variable (share price), X_1 is the Clientele effect variable, X_2 is Tax incentives variable and X_3 is free cash flows variable. Table 4.

According to the regression equation established, taking all factors into account (Clientele effect, Tax incentives and free cash flows) constant at zero, share price will be 0.423. The data findings analyzed also showed that taking all other independent variables at zero, a unit increase in clientele effect will lead to a 0.453 increase in share price; a unit increase in tax incentives will lead to a 0. 205 increase in share price; a unit increase in free cash flow will lead to a 0.295 increase in share price. This infers that clientele effect contribute more to share price followed by the by free cash flow. At 5% level of significance and 95% level of confidence, clientele effect had a 0.001 level of significance; tax incentives showed a 0.003 level of significant, free cash flow showed a 0.002 level of significant hence the most significant factor is clientele effect.

CONCLUSION
The study concludes that higher pre-tax risk adjusted returns associated with higher dividend yield stocks affected share price and that investors whose portfolios had low systematic risk preferred high-pay-out stocks.
The study further concludes that an increase in firms' stocks trading volume affected the share price and those investors who wanted current investment income owned shares in high dividend payout firms.
Finally the study concludes that free cash flow caused conflict between management and shareholders and that the executive option plan persuaded management to reduce corporate dividends by an amount that was equal to the option plan.

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