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The Determinants of Corporate Dividend Policy: Evidence from Palestine

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Abstract

This paper aims at finding if there is any difference between the dividend policy implemented by listed companies in the Palestine market and those that are popularly documented in the literature. The data used for this study is collected from the Palestinian Stock Exchange for a period from 2008 to 2012 and from the interviews with Chief Financial Officers (CFOs) of the listed companies. The paper finds that profitability and firm size are positively significant to the dividend payout, while financial leverage and asset structure are negative to it. The views from CFOs mostly support this finding. We however do not find the impact of liquidity, free cash flows, growth opportunities and ownership on dividend payout as indicated in the literature. The CFOs also agree with most common dividend policy theories documented in the literature. We conclude that there is not much difference between the Palestinian market and other developed markets in terms of the approach to dividend policy and its determinants. Our research therefore adds to the literature with new evidence from the Palestine market.

JEL classification numbers: G35, G11
Keywords: dividend policy, payout ratio, Palestine

1 Introduction

Dividend policy refers to the amount of annual profits that can be paid to shareholders and how much a firm should reinvest in the business to finance its

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growth and meet its obligations. The decision to pay dividends or not is a highly controversial and debated topic in the field of corporate finance. Black (1976) summarized the dividend issue as that "The harder we look at the dividend picture, the more it seems like a puzzle". The dividend decision is influenced by many factors that vary from market to market. While the literature on dividend policy has been well documented for developed markets, a small amount of research has been given to developing ones. With respect to the Palestine market, no research in this area so far has been conducted, and this inspired the authors to pursue this research.

This study is expected to fill the gap by providing an empirical evidence from the Palestinian market, which is unique in terms of its political and economic situation, its short-term experience and its limited number of listed firms. Palestine is still under occupation with a high country risk. The stock exchange is very small with only 49 listed firms, most of them are relatively small in size, and the ownership structure of Palestinian firms is highly concentrated on family ownership which implies greater supervision and control over management activities and reduced agency conflicts between owners and managers. There is a suspicion that dividend behaviour in this context may differ from the models accepted in developed countries, as well as in other emerging markets.

This paper aims at finding if there is any significant difference between the dividend policy in Palestine and that in developed markets documented in the literature. The paper looks at the factors that influence the dividend policy of the companies listed on the Palestine Stock Exchange (PEX) and examines the perception of the financial managers towards the dividend policy. The paper is organized as follows. The literature will follow the introduction before the methodology is presented. The data analysis will discuss our findings before some concluding remarks are offered at the end.

2 Literature review

The first strand in dividend policy literature centers around the discussion of its impact on the valuation of the firm. The famous dividend irrelevance theory by Miller and Modigliani (1961) suggests that the firm's valuation is independent of its dividend policy. Black and Scholes (1974) supported the theory, arguing that an increase in dividends has no permanent impact on a firm's stock price. Fama (1974) similarly argues that investors can create homemade dividends by themselves and thus the dividend policy is not relevant.

Other researchers however argue that there is a link between dividend policy and the value of the firm. For example, Gordon (1959) argue that investors prefer

certain dividends to future price appreciation which is risky and uncertain, and hence the value of the firm should increase with increased pay-out ratio. Other researchers such as Brennan (1970), Miller and Scholes (1978), Litzenberger and Ramaswamy (1979) or John and Williams (1985) see the tax preference effect and suggests that low pay-out ratio would increase the value to shareholders.

The second strand in the literature explains the rationale behind the choice of dividend policy. Some researchers considering the asymmetric information world and see the dividend policy as a signal about the future of the firm and thus it should influence the firm's value (e.g. Ross, 1977). Jensen and Meckling (1976), Rozeff (1982) and Easterbrook (1984) support the view that dividends could be used as a tool to mitigate agency costs and information asymmetry between shareholders and managers.

Mueller (1972) considers the life cycle of the firm with an assumption of S-shaped growth and suggests that matured, large and profitable firms tend to pay higher dividends as the growth opportunity declines. Mayers and Majluf (1984) argue that high-growth firms should not pay dividends if they have to recoup the cash through issuing new risky securities. Fama and French (2002) supported this argument when they found that profitable firms that have few investments pay higher dividends. Grullon, Roni and Bhaskaran (2002) also report that dividends send signals to investors and outsiders about changes in a firm's life cycle. They point out that large dividend payouts signal a long maturation process in which a firm witnesses a decline in growth rate, systematic risk and reinvestment rate.

Another research by Baker and Wurgler (2004) proposes that managers rationally cater to investor demand and give investors what they want. They pay dividends when the market puts a premium on stock prices, and they do not pay dividends when the market prefers not to pay. Their argument is that the propensity of firms to pay dividends increases when dividend premiums are positive, but declines when negative. Empirical studies, such as Tsuji (2010), however finds no evidence to support this hypothesis in the electrical appliances industry in Japan.

The other but popular strand focuses on the firm characteristics that determine the dividend policy. For example, Lloyd, Jahera and Page (1985) find that dividends are affected by the firm size where larger firms tend to pay higher ratio and more regular dividends. Holder, Langrehr and Hexter (1998) find that the insider ownership was inversely related to the debt level and dividend payouts, and that dividends are positively influenced by the number of shareholders due to higher agency costs (see also Rozeff (1982); Short, Zhang and Keasey, 2002). Khan (2006) showed a significant inverse relationship between dividend payments and ownership concentration when he investigated the impact of ownership structure on the dividend policy of 330 UK firms. The asset structure is also found important to the dividend policy but empirical findings suggest mixed

conclusions. Myers (1984) argues that firms with higher tangible assets pay higher dividends. However, Aivazian, Booth and Cleary (2003), Trang (2012), or Al-Ajmi and Abo Hussain (2007) find either reverse conclusion or no significant relationship in emerging markets.

Gill, Biger and Tibrewal (2010) suggest that the firm's profitability plays an important role. Jensen, Solberg and Zorn (1992) see negative relationship between dividend payout and level of leverage. The findings of Alzomaia and Al-Khadhiri (2013) showed that large, profitable firms with low debt levels have higher dividend payouts. The role of risk, the other side of profitability, is also well documented in the literature. Chang and Rhee (1990) argue that firms with greater stability in operating profits could follow a stable dividend policy. Patra, Poshakwale and Ow-Yong (2012) suggests the role of liquidity showing that the availability of cash is one of the key factors that influenced the dividend decision.
This paper focuses on the firm characteristics that determine the dividend policy using from secondary data and regression analysis. The questionnaire interviews with Chief Financial Officers (CFOs) of the listed firms however will offer opinions on the other strands of literature mentioned above on dividend policy.

3 Data and Methodology

3.1 The determinants of dividend policy

To estimate the determinants of dividend policy, we use data collected from the audited financial reports of the Palestinian listed firms over a five-year period from 2008 to 2012. Of the 49 listed firms in the PEX, we select a total of 21 firms for this study. Firms that are listed after the year 2009 and that do not pay dividends at all during the study period are excluded. The reason for the exclusion is because we want to focus on the firms which do in fact consider paying dividends over the five-year period. The 21 firms represent the manufacturing, financial, real estate sector and services industries. Table 1 represents the definition and the descriptive statistics of variables.

Table 1: Definition of variables and their descriptive statistics

Variable	Definition	N	Mean	SD
Dependent variable	Dividend per share			
Profitability	The after-tax profit (EPS)	105	0.09	0.10
Financial leverage	Total debt to total assets	105	0.17	0.18
Asset structure	The ratio of non-current assets to total assets	105	0.15	0.22
Business risk	Beta coefficient	105	0.53	0.24
Liquidity	The current ratio	105	0.37	0.38
Free cash flow	The ratio of (Net profit - Change in net WC – Change in fixed assets) to total assets	105	2.92	3.92
Growth opportunities	The firm's total market value to its book value	105	0.01	0.16
Firm size	The natural logarithm of total assets	105	1.02	0.48
Ownership dispersion	The natural logarithm of number of shareholders	105	10.80	1.57

The generic OLS regression model below is used to estimate the determinants of dividend policy:

$$y = f(x)$$

In this equation, the left hand side is the dividend per share and the right hand side is a function of explanatory variables including profitability, financial leverage, asset structure, business risk, free cash flow, growth opportunities, firm size, and ownership dispersion as explained in Table 1. The econometric regression procedure follows the approach similar to Pal and Goyal (2007) that initially starts with all dependent variables and then excludes those that are not well fitted to the precedent model. This process eventually gives us 5 models with Model 1 comprising all explanatory variables and Model 5 including the best fitted explanatory variables.

3.2 The views of CFOs

To understand further the behavior of the firms that pay dividends, we also use the structured questionnaire interview to collect opinions from the CFOs on their dividend policy. Of the 21 above selected firms, we focus on the firms that pay dividends regularly so we pick 11 firms that pay dividends at least three years during the study period. The questionnaire follows the findings from the dividend literature and asks the CFOs to rank their agreement on four-level scale basis. We conduct the face-to-face interviews so are convinced that the interviewees fully understand the questions. The results of the interviews not only help justifying our findings from the regression analysis but also suggesting the common philosophy of CFOs towards the dividend policy.

4 Findings

4.1 The determinants of dividend policy

Table 2: The determinants of dividend policy

Variables		Model 1	Model 2	Model 3	Model 4	Model 5
Constant	Coefficient	-0.071	-0.072	-0.069	-0.084	-0.072
	t-statistic	-1.111	-1.211	-1.195	-1.808	-1.643
Profitability	Coefficient	0.471	0.470	0.469	0.472	0.481
	t-statistic	12.79	13.469	13.554	13.86	15.024
Financial leverage	Coefficient	-0.141	-0.141	-0.142	-0.145	-0.144
	t-statistic	-3.591	-3.639	-3.719	-3.909	-3.873
Asset structure	Coefficient	-0.062	-0.063	-0.063	-0.060	-0.060
	t-statistic	-2.183	-2.232	-2.284	-2.269	-2.262
Free cash flow	Coefficient	-0.060	-0.060	-0.059	-0.060	-0.062
	t-statistic	-1.710	-1.736	-1.729	-1.768	-1.813
Firm size	Coefficient	0.011	0.011	0.011	0.012	0.012
	t-statistic	1.797	1.808	1.803	2.561	2.497
Growth opportunities	Coefficient	0.010	0.010	0.009	0.009	
	t-statistic	0.833	0.840	0.822	0.802	
Beta coefficient.	Coefficient	0.008	0.008	0.008		
	t-statistic	0.380	0.386	0.422		
Liquidity	Coefficient	0.000	0.000			
	t-statistic	0.238	0.231			
Ownership dispersion	Coefficient	0.000				
	t-statistic	-0.071				
R^2		0.756	0.755	0.755	0.755	0.753
Adjusted R^2		0.732	0.735	0.738	0.740	0.741

Table 2 represents the results from our econometric procedure. The R-squared of more than 0.75 in all five models imply that the models are good to explain the dividend policy. We find that profitability, financial leverage, asset structure, free cash flows, and the firm size are significant determinants of the dividend policy in Palestine, while other factors including growth opportunities, business risk – beta coefficient, liquidity and ownership dispersion are not.

Specifically, the profitability and the firm size are found to positively and significantly affect the dividend per share. The finding is relevant to findings from the literature such as those by Jahera and Page (1985) on the firm size and by Gill et al (2010) on the profitability or those by Alzomaia and Al-Khadhiri (2013) on the link between large and profitable levels on high dividend payouts. The

negative influence of free cash flows, asset structure and financial leverage also see some supports from the existing literature. For example, Myers (1984) argues that firms with higher tangible assets pay higher dividends. Or finding from by Alzomaia and Al-Khadhiri (2013) also indicates the negative relationship between debt level and payout ratio. Our finding confirms the role of the availability of cash flows, as in Patra, Poshakwale and Ow-Yong (2012. Interestingly, we do not find support for the role of ownership as many other studies have revealed (Holder, Langrehr and Hexter, 1998; Rozeff, 1982; Short, Zhang and Keasey, 2002; and Khan, 2006).

4.2 The views of CFOs

The views of CFOs of Palestinian firms on dividend policy are drawn based on structured questionnaire interviews. Given the limited number of responses (11 responses), the results from the interviews should be best considered as supplementary evidences to the findings from regressions. Three major areas have been asked for opinions, including (i) the factors that influence the dividend policy, (ii) the views on dividend policy theories, and (iii) the dividend policy implementation. Results are reported in Tables 3, 4, 5:

Table 3: Descriptive statistics- factors influencing dividend policy

	Factors	Level of importance			
		None	Low	Med	High
1	Pattern/ trend of past dividends	0.0%	27.3%	45.5%	27.3%
2	Level of current and future profitability	0.0%	0.0%	27.3%	72.7%
3	Concern about impact on the share price	9.1%	27.3%	54.5%	9.1%
4	Stability of cash flows	0.0%	0.0%	27.3%	72.7%
5	Liquidity concerns, such as the amount of cash available	0.0%	0.0%	27.3%	72.7%
6	Desire to maintain a target payout ratio	9.1%	27.3%	27.3%	36.4%
7	Desire to conform to the industry's payout ratio	18.2%	18.2%	45.5%	18.2%
8	Projections about the future state of the economy	9.1%	27.3%	63.6%	0.0%
9	Desire to avoid giving a false signal to investors by changing the dividend	18.2%	18.2%	45.5%	18.2%
10	Signaling incentives/ using dividend changes to convey information to financial markets	9.1%	36.4%	54.5%	0.0%
11	Desire to maintain a target capital structure	9.1%	45.5%	27.3%	18.2%
12	Current degree of financial leverage	9.1%	45.5%	18.2%	27.3%
13	Investment considerations (e.g. the availability of profitable investments)	0.0%	18.2%	45.5%	36.4%
14	Legal constraints (e.g. capital impairment)	18.2%	27.3%	36.4%	18.2%
15	Contractual constraints (e.g. restrictions on dividends in loan agreements)	9.1%	36.4%	36.4%	18.2%
16	Comply with the policy of the mother company or a major shareholder/s.	45.5%	9.1%	36.4%	9.1%
17	Availability of alternative sources of capital	9.1%	45.5%	36.4%	9.1%
18	Financing considerations (e.g. the cost of raising external financing)	0.0%	27.3%	54.5%	18.2%
19	Control issues such as the firm's ownership structure	9.1%	27.3%	36.4%	27.3%
20	Meet current shareholders' needs for income	9.1%	9.1%	45.5%	36.4%
21	Shareholders' characteristics (such as tax position, consumption)	18.2%	45.5%	36.4%	0.0%

Table 4: Descriptive statistics - dividend theories and explanations

	Statement	Level of Agreement (1 = strongly disagree; 5 = strongly agree)				
		1	2	3	4	5
	Panel A:Bird-in-the-hand theory					
1	Investors prefer current cash dividends to retained earnings and uncertain future capital gains.	0.0%	36.4%	0.0%	54.5%	9.1%
	Panel B: Signaling theory					
2	The stock price falls when a firm unexpectedly announces a dividend cut.	9.1%	9.1%	.0%	72.7%	9.1%
3	The stock price rises when a firm unexpectedly announces a dividend increase.	0.0%	0.0%	0.0%	81.8%	18.2%
4	Investors view changes in dividend payments as signals of the stability of the firm's future profitability.	0.0%	9.1%	0.0%	72.7%	18.2%
5	Dividend announcements can convey information about a firm and help investors to value the stock price.	0.0%	0.0%	18.2%	54.5%	27.3%
6	Dividend increases may signal either the future prospects of a firm or a lack of profitable investment opportunities, so they are ambiguous.	.0%	54.5%	9.1%	27.3%	9.1%
	Panel C: Tax preference theory					
7	Investors generally prefer to invest in firms whose dividend policies fit their tax preferences.	0.0%	36.4%	0.0%	36.4%	27.3%
8	Firms that pay high (low) dividends attract investors in low (high) tax brackets.	0.0%	36.4%	18.2%	36.4%	9.1%
	Panel D: Agency theory					
9	Dividends encourage managers to look after shareholders' best interests.	0.0%	9.1%	9.1%	54.5%	27.3%
10	The payment of dividends forces managers to seek external financing, thus subjecting them to additional scrutiny.	0.0%	27.3%	9.1%	36.4%	27.3%
	Panel E: Life cycle theory					
11	The dividend policy tends to follow a firm's life cycle.	0.0%	18.2%	0.0%	54.5%	27.3%
	Panel F: Catering theory					
12	Managers should respond to the dividend preferences of investors.	0.0%	72.7%	0.0%	18.2%	9.1%

Table 5: The implementation of dividend policy

Statement	Option	Frequency	Percent %
Who is the most influential player in developing the dividend policy ultimately approved by the board of directors of your company?	CFO	1	9.1%
	CEO	9	81.8%
	Others	1	9.1%
	Total	**11**	**100.0%**
How often does your firm re-examine its dividend policy?	Yearly	9	81.8%
	Other	2	18.2%
	Total	**11**	**100.0%**
Does your firm have an explicit target payout ratio (a long-term desired dividend to earnings ratio)?	Yes	8	72.7%
	No	3	27.3%
	Total	**11**	**100.0%**

As shown in Table 3, CFOs seem to be more concerned with issues of cash flows, profitability, financing costs and the perspective of the economy in determining the dividend policy, while they do not see the importance of other factors such as the desire to pursue a target payout ratio or target capital structure, the level of financial leverage, the influence from big shareholders, or the availability of sources of capital. Other factors see diverse opinions, meaning also that they are not important determinants of dividend policy.

In terms of philosophy towards dividend policy theory, Table 4 presents the CFOs' opinions on popular theories of dividends. The findings suggest that CFOs do agree with most of the common theories, such as the bird in the hand (Gordon, 1959), the signaling and agency (Jensen and Meckling, 1976; Rozeff, 1982), the tax preferences (Brennan, 1970), and the life cycle theory (Mueller, 1972; Fama and French, 2002). They however do not agree with catering theory (Baker and Wurler, 2004) and with that high dividend payout should attract low-tac brackets investors in the tax preference theory and that high payout rate implies the lack of profitable opportunities in the future in the signaling theory.

Table 5 reveals some interesting facts about the implementation of the dividend policy in Palestine. The results suggest that the CEO in the firms is the most influential player in the dividend policy and that the dividend policy is mostly reviewed on yearly basis and companies in most cases have an explicit long-term target payout ratio.

4.3 Discussions

The findings from econometric regressions suggest that profitability and firm size positively influence, while free cash flows, asset structure and financial leverage negatively affect the dividend policy in the Palestine market. These findings are

mostly supported by the findings from interviews with CFOs of the listed companies, except for the financial leverage that the CFOs do not see its importance on the dividend policy. Of the factors that are not found significant in the regression models, we find the importance of growth opportunities from the CFOs' opinions.

The analysis of results from CFOs' questionnaire survey suggests that their views on the dividend theories are mostly relevant to the existing literature, which means that there is not much difference in terms of philosophy between companies in a developing market like Palestine and those in the developed markets. The implementation of dividend policy also shows no difference between markets, such as the role of the CEO in determining the dividend policy (Baker and Powell, 2000).

5 Conclusions

This paper aims at providing an empirical evidence on the factors that influence the dividend policy in the Palestinian market. The paper basically comprises two parts with the first part focusing on the secondary data analysis and the second part reporting results from a questionnaire survey of CFOs of the listed companies. The findings from the survey are used as supplementary supports for the regression results. The opinions from CFOs also show their philosophy towards and the implementation of the dividend policy.

Using the data from the 21 listed companies on the Palestine Stock Exchange, we find that profitability and firm size positively influence, while free cash flows, asset structure and financial leverage negatively affect the dividend policy. These findings are mostly supported by the findings from interviews with CFOs of the listed companies, implying that there is a consistency between their views and their actions. The interviews also confirm their agreement with most of the dividend theories documented in the literature.

Our research suggests that there is not much different in approach to dividend policy and the implementation of it between Palestine market and the developed markets as well documented in the literature. Given the risks caused by political and economic disturbance in Palestine, this research adds to the literature with a message that the dividend policy as described in the literature is independent of economic conditions.

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