

## Determinants of Dividend Payout Ratio: Evidence from Malaysian Public Listed Firms

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### ABSTRACT

Dividend policy is a decision made by an organization to determine the amount of dividend to be paid and the level of the profit to be retained. Prior studies claimed that dividend policy can help to reduce the agency problems in the organization. Thus, this decision is very important. However, to date, there is no general consensus on the factors which influence dividend policy. Therefore, this study aims to examine the determinants of dividend policy among public-listed firms in Malaysia. Secondary data was hand-collected from the annual reports of the listed firms for a period of five years. This study employs multiple regression to estimate the relationship between the determinants and dividend payout decisions. The results indicate that investment opportunity, liquidity and firm size significantly influence the dividend payout of Malaysian listed firms. This study contributes to the literature related to dividend payout in developing countries, specifically in the Malaysian business environment. It also provides information to the managers about how their decisions would affect the agency costs of the organization.

**KEYWORDS:** Dividend Payout, Agency Cost, Investment Opportunity, Liquidity, Malaysia.

### INTRODUCTION

Dividend payout has always been a debatable subject in corporate finance. Dividend policy is one of the corporation financial decisions that has been of concern among researchers and practitioners [1]. Dividend decision is important for both the investors and corporations. It is the decision of organization management about what proportion of the earnings should be invested and what proportion should be distributed to shareholders as dividends. While making this decision the management considers available investment opportunities that would increase future earnings and if such opportunities are not available the management should distribute the earnings to shareholders. In other words, dividend policy is a decision made by an organization to determine the amount of dividend to be paid and the level of profit to be retained. The dividend paid will be a form of return to the shareholders who invest in the organization [2], while the profit to be retained is known as retained earnings which is being reinvested by the firm in business operation or growth [3].

It is believed that dividend policy can help to reduce the agency costs associated with the separation of ownership and control [4, 5]. Separation of ownership and control occurs when owners who are the shareholders of a company (the principal) appointed a manager (the agent) to manage the company on their behalf. However, this relationship of principal-agent has created a problem that is a conflict of interest between shareholders and managers. Managers' interest might not be always aligned with shareholders' interest. And this conflict caused a company to incur agency cost [6] where more time and money is spent in monitoring the management to prevent inappropriate behavior. In addition, agency cost can also be explained by free cash flow theory where excess cash flow can be used to fund all projects that have positive net present values (NPV) when discounted at the relevant cost of capital [7]. This theory believes that insiders tend to take self-serving actions if there is excess cash in a company [5]. According to [7], those insiders with personal interest intend to invest excess cash in unnecessary investment activities which are not beneficial to the shareholders. It also indicated that conflict of interest between agents and principals is especially severe when there is favorable free cash flow. Therefore, a firm should pay dividends instead of retained it so that the firm will not have so much excess cash and thus, reducing the cost incurred from agency problem.

There was extensive research on dividend policy, yet to date, there is no general consensus on what factors influence dividend policy and how these factors interact [8]. The reason(s) why do firms pay dividends still remain unsolved [9]. Prior studies also recognized that dividend policy of a company is influenced by a lot of factors [10]. However, there are limited studies which focus on the determinants of dividend policy especially in developing countries. In addition, it is vital to understand how these determinants relate to dividend decision and can help to reduce agency cost. Thus, this study is conducted to examine the factors which influence the

dividend policy in Malaysian listed companies. This study extends and contributes to the literature related to dividends especially in Malaysia. It could be used as a comparison or as supporting of views with other studies in other countries. In addition, the results also provide understanding to both shareholders and managers about the factors which may affect their dividend decisions.

The remainder of the paper is structured as follows. Section 2 gives a review of the relevant literature. Section 3 describes the sample and methodology used for the study. Section 4 presents and discusses the empirical results, and finally section 5 provides the conclusions of the study.

## **LITERATURE REVIEW**

Dividend policy is very important and of concern to the top management in a firm. It is believed that dividend policies convey information to outside stakeholders about a firm's current earnings, and thus indirectly act as a signal of future earnings of the firm [8]. This is known as signalling explanations that dividends convey private information about a firm's future prospects [11]. For instance, investors may predict that a firm is most probably going to earn more profit when the firm reduces dividend payment because the reduction portion might be invested in a new project. However, asymmetric information might happen between shareholders and managers when managers hold more or timely information than the shareholders [12]. According to agency theory, the managers who have more information can take advantage of the shareholder's lack of knowledge. This results of shareholders' inability to control the desired action of the managers [13].

Prior literature indicates that agency problem may be mitigated or reduced through the dividend policy of the organization. According to [14], dividend policy is a mechanism that reduces the agency costs and prevents the agents from taking advantage on their principals. To reduce agency problems from happening, a company must also reduce the temptation attracting the agents to do misappropriate behaviors. The temptation is substantial cash flow. As posed by [7], substantial cash flow caused the agency problem to occur. Thus, free cash flow must be distributed to the shareholders to reduce the amount of resources available to be used discretionary by the managements on activities unbeneficial to shareholders.

It is claimed that it is also important to examine the factors which influence the dividend policies of the organizations, as this would help the shareholders to understand the decision made by the companies. It is posited that different companies with different characteristics may adopt a different policy. Among the characteristics highlighted by the literature are the liquidity condition of the organizations, investment opportunity, profitability, leverage and size of the organizations. These factors are examined in this study.

## **FACTORS INFLUENCING THE DIVIDEND POLICY DECISIONS**

### **Liquidity of Organizations and Dividend Payouts**

Liquidity is an important determinant of dividend payouts [15]. Less liquid firms tend to pay lower dividends due to shortage of cash [8, 15]. On the other hand, high liquidity means excess in cash flow which can be used by the management to fund all projects that have a positive NPV when discounted at the relevant cost of capital [7]. However, management might misuse the excess cash for personal interest or pursue unprofitable investment projects [16]. In [17] claims that excess cash may be wasted on unprofitable or negative NPV projects, which will lead to conflict of interest between principals and agents. Dividend payout is believed to alleviate the overinvestment problem and minimize agency problem accordingly [17, 18]. Therefore, a firm should pay a dividend to reduce the cash availability. This is also supported by [19, 20] which suggested that companies with high free cash flow or high liquidity should pay more dividends to reduce agency costs.

Prior studies by [21] showed that liquid companies indeed the ones that are more likely to pay dividends. In [15] suggested that a good liquidity position increases a firm's ability to pay dividends. In [8, 16, 18] found that liquidity does have significant influence on dividend payouts of listed firms in the Tunisian stock market, Thailand and Greece respectively.

However, there are also studies which found a negative relationship between liquidity and dividend policy. In [22] examined listed firms in Jordan's Amman stock exchange and found a negative and statistically significant relationship between liquidity and dividend policy. Some prior studies found mixed result between liquidity and dividend policy. For instance, in [1] suggested that liquidity is irrelevant to a dividend payment. In [23] examined how Indonesian firms control agency cost of free cash flow. They categorized their samples of firms into two groups, which are firms that have less than 5-years dividend payment period and firms that have 5-years dividend payment period. Their result showed negative but statistically insignificant for the first group while positive and statistically significant for the latter group. This indicates a firm will not increase dividend payment, even though there is free cash flow if the payment period is less than 5 years. On the other hand, in [20] who examined determinant factors of dividend policy in firms listed in Tehran found that liquidity has direct and significant association to dividend policy.

### **Investment Opportunity and Dividend Payouts**

Investment opportunity means the chance to make an exceptional return on an investment. To make an investment, a company needs capital. Normally, a firm is financed by either debt or equity [17]. Thus, a company can obtain capital by debt which is external financing from creditors like banks or retains a portion of the profit as internal financing. A firm would normally prefer to retain a greater proportion of cash for investment [16]. They explained that a firm would bear with high transaction costs such as interest payments if they rely on external financing to have sufficient funds for investment. As [5] said external financing is costly. Thus, only a smaller proportion of cash will be distributed as dividends and largely is retained as internally generated funds. In [8] also supported that firms with a higher investment opportunity requires higher fund. Hence, the firms will payout lower dividends to reduce their dependence on external financing. They indirectly indicated that the firms would like to avoid the transaction cost associated with external financing. Thus, dividend payouts reduce firms' available funds for investment activities [17] provided they have the high investment opportunity. Conversely, dividend payout helps to reduce free cash flow in a firm if the investment opportunity is poor [23]. In [24] claim that cash flow increases the agency costs of firms with a poor investment opportunity. Therefore, the cash flow should be distributed to shareholders to prevent overinvestment problems.

This notion is supported by [7] which posited that low investment opportunity are likely to have an overinvestment problem. A firm would normally retain cash for investment. If there is low investment opportunity and since there is excess cash, management might invest it in NPV projects without considering it is positive or negative. Thus, the excess cash should be distributed as dividends to the shareholders to eliminate overinvestment problem. From this, it indicates that low investment opportunity would lead to higher dividends paid. In [8, 15, 22] also claimed that lack of investment opportunity will cause excess cash in hand might lead to either overinvestment or agency problems.

However, there are arguments among studies which found a reverse relationship between investment opportunity and dividend policy. In [25] who have done similar studies in India found that trends of investment opportunity do not mirror the declining dividend pattern in listed firms of India. This is supported by [16] who identified that Tunisian firms with better investment opportunities are more likely to pay dividends if the firms have highly institutional ownership. In [18] has also found a positive relationship between investment opportunity and dividend policy in Thailand companies. However, in [26] found an insignificant relationship between investment opportunity and dividend policy of listed firms in Karachi stock exchange.

### **Profitability and Dividend Payouts**

Dividends are paid out of annual profits gained by a firm [17]. When profit increases, it means there is more cash flow available to the managers to increase investment or firms' growth. In [18] stated that higher profitability should be able to generate free cash flow. However, this may cause agency problems because managers might not invest the excess cash flow in profitable projects. The dividend must then be paid out of the profit in order to reduce excess cash flow. This is supported by [7, 14]. According to them, agency theory suggests that the payment of dividends reduces the free cash flow available to the managers and attempts to minimize agency problems. Shareholders also expect highly profitable firms to pay higher dividends in order to reduce the agency costs [8].

Most of past studies concluded that more profitable firms are more likely to pay dividends [1, 15]. In [8, 10, 17, 20] also found a positive relationship between profitability and dividend payouts when examining factors influencing corporate dividend decision.

### **Leverage and Dividend Payouts**

In agency theory, dividend and debt are substitutes to control agency problem. In another word, dividend and debt are competing with each other for the available cash [27]. When there is high leverage, it is said that a firm is associated with more liabilities. It incurred transaction costs to the company which they need to pay the principals borrowed together with interest charged [8]. Thus, a firm would have to think shall they retain cash for transaction cost of debt or shall they distribute it as dividends. According to [17], leverage entails risk as a firm bears interest payments and the principal amount when they acquire debt financing. Failure in meeting these obligations may lead the firm into liquidation [7]. That is why firms would prefer to finance investment internally by retaining profit [28].

Prior studies found that leverage is negatively related to dividend payouts [10, 17, 16, 22]. In [8, 20] who examined determinants of corporate dividend policy in Greece and Tehran respectively also supported the result of obtaining a significant negative relationship between leverage and dividend payouts. However, in [18, 23] found a positive relationship between leverage and dividend policy for listed firms in Thailand and Indonesia respectively. In [26] found an insignificant association between leverage and dividend policy in Karachi.

### **Firm Size and Dividend Payouts**

It is claimed that larger firms are more likely to pay higher dividends [18, 21] because larger firms tend to be more mature and have higher cash flows. In [26] who examined the dividend payout of listed non-financial firms of Karachi stock exchange also found that firm size has a positive and significant influence on dividend payouts.

However, there is the case where large firm has more liabilities. According to [29], debt-holders and creditors have more confidence in large firms. The firms can access to capital market and raise funds easier with lower cost and fewer constraints as compared to small [8, 17, 30]. Therefore, larger firms would payout low dividend so that the profits can be retained to support the costs of debts. This negative relationship between firm size and dividend payouts is supported by [16] who studied the ownership structure and dividend policy of listed firms in the Tunisian stock market. However, in [20, 22] found that firm size has no impact on dividend policy.

Most prior studies consider the size of the firm as a control variable when examining corporate dividend policy [2, 31, 32, 33]. However, later studies in 1990s started to realize that firm size alone does influence dividend payouts. Thus, this study will include this variable as one of the independent variables.

## METHODOLOGY

Data for the study were collected using secondary sources. The secondary data were hand-collected from the companies' annual reports which were available at Bursa Malaysia's website (<http://www.bursamalaysia.com.my>). About 100 samples were drawn randomly from 854 companies listed in Bursa Malaysia's main market (as at 25th March 2013). Five years (2007-2011) data was gathered for the purpose of the study. However, the companies classified under finance sector were excluded from this study because of their unique features and business activities, as well as differences in compliance and regulatory requirements [34]. In addition, the sample also must have complete information for all the five years period.

The data were checked for normality and multicollinearity. Multiple regression analysis was employed to analyze the data. The regression model used in the study is as follows:

$$DIV = \alpha_i + b_1LIQ + b_2INV + b_3ROE + b_4LEV + b_5SIZE + \epsilon_i \quad (1)$$

where DIV = dividend payout ratio (div pershare/NPAT pershare),  $\alpha$  = Intercept, LIQ= current ratio (current assets/current liabilities), INV= market to book ratio (market value of equity/book value of equity), ROE= return on equity (NPAT/total equity), LEV = leverage (total liabilities/total equity), SIZE= natural logarithm of total assets and  $\epsilon_i$ = error term.

## FINDINGS AND DISCUSSION

### Sample companies

The sample companies range from small to large companies. Almost 55% of the sample companies have total assets between RM1 million to RM5 million. Almost 16% of the companies have total assets of less than RM1 million, about 9% of the companies have total assets between RM5 million to RM10 million and another 10% of the companies have total assets of more than RM10 million.

In terms of their performance, more than half of the companies (53%) enjoy net profit after tax between RM100000 to RM500000, about 21% of the companies have a net profit after tax of less than RM100000, almost 13% of the companies have a net profit after tax between RM500001 to RM1 million and another 13% of the companies have a net profit after tax of more than RM1 million.

### Descriptive Statistic

Table 1 presents the descriptive statistics of the variables used in the analysis. The mean of DIV shows that averagely firm pays out of 47.1% (standard deviation = 36.7%) of its earnings in dividends as a whole for five years. Among the independent variables, LIQ has the highest standard deviation (2.147) where the data are widely spread around the mean (3.346). The ROE has obtained the lowest standard deviation (0.102) where its data are bunched up closely to its mean (0.156). A detail checked on the skewness and kurtosis of the variables in the study indicate that the data appear to be normally distributed as the skewness and kurtosis values are between -3 to +3 [35].

Table 1: Descriptive statistic

Variables	Mean	Median	Std. Deviation	Variance	Min	Max
DIV	0.471	0.368	0.367	0.134	0.000	2.250
LIQ	3.346	2.668	2.147	4.610	1.020	18.67
INV	1.389	1.056	1.224	1.497	0.005	8.950
ROE	0.156	0.138	0.102	0.010	0.003	0.087
LEV	0.844	0.605	0.766	0.587	0.060	4.680
SIZE	6.393	6.317	0.585	0.342	5.060	7.880

Dependent variables: Dividend payout (DIV)

Independent variables: Liquidity (LIQ), Investment Opportunity (INV), Profitability (ROE), Leverage (LEV), Firm Size (SIZE)

Table 2 presents the pairwise correlation coefficient of all the variables used in the study. The results indicate that there is no multicollinearity problem, as the correlations are below the threshold value of 0.8 [36].

Table 2: Correlation results

Variable	DIV	LIQ	INV	ROE	LEV	SIZE
DIV	1.00					
LIQ	0.061	1.00				
INV	0.224***	-0.010	1.00			
ROE	0.008	-0.102**	0.386***	1.00		
LEV	-0.007	-0.591***	-0.041	.118**	1.00	
SIZE	0.054	-0.246***	-0.184***	-0.290***	0.351***	1.00

Notes: \*\*\*significant at 1% level, \*\*significant at 5% level, \*significant at 10% level(see variable definition in Table 1)

### Multiple Regressions

Table 3 presents the regression results of the study. The results in Table 3 indicate that the value of the R-squared and adjusted R-squared are 0.071 and 0.061 respectively with the F value of 6.894 ( $p < 0.000$ ). This result shows that about 6% of the variation in the dividend payout can be explained by the model. This result is similar to another study by [26], who did an analysis of dividend payout of listed companies in Karachi stock exchange which obtained an R squared of 4%.

Table 3: Results of multiple regressions

Model (Overall)	Unstandardized Coefficients	Standardized Coefficients	t	Sig.
	B	Beta		
(Constant)	-0.073		-0.329	0.743
LIQ	0.018	0.105	1.855	0.064
INV	0.080	0.268	5.416	0.000
ROE	-0.221	-0.061	-1.166	0.244
LEV	0.019	0.039	0.656	0.512
SIZE	0.061	0.098	1.876	0.061
R-squared		0.071		
Adj R-squared		0.061		
F-statistics		6.894		
P-value		0.000		

Notes: \*\*\*significant at 1% level, \*\*significant at 5% level, \*significant at 10% level(see variable definition in Table 1)

The results in Table 3 show that LIQ, INV and SIZE significantly influence the dividend payout, while ROE and LEV have an insignificant relationship with a dividend payout.

### Liquidity (LIQ)

The result in Table 3 indicates that liquidity has a positive and significant relationship with dividend payout. This result is consistent with the findings from prior studies in other countries such as studies by [8, 16, 18, 21]. This positive relationship found in this study also support the argument in agency theory which posit that companies which are highly liquid would pay more dividend to avoid the cash from being misused by the management in unprofitable or negative NPV projects. Dividend payout is believed to alleviate the overinvestment problem and minimize agency problem accordingly [17,18].

### Investment Opportunity (INV)

The second significant variable in Table 3 is an investment opportunity. The result indicates that there is a positive and significant relationship between investment opportunity and dividend payout. Prior studies suggested that a company should reduce dividend payout to retain available cash if there is an opportunity to invest in NPV projects. Vice versa, they should increase the dividend payout to prevent overinvestment that lead to agency cost. Surprisingly, the result shows a significant positive relationship between the two variables which suggests that the companies with a positive investment opportunity preferred to pay dividends. This result is consistent with the earlier finding by [37] which found a positive relationship between investment opportunity and dividend payout of Malaysian industrial sector companies. They conjectured that the positive outcome between the two variables might be affected by the positive relationship between dividend payout and share price. It also explained that high investment opportunity indicate good signs to the investors which lead to increase in the share price and in turn affect the dividend payout. This result is also consistent with findings in other countries as found by [18] in Thailand and [16] in Tunisia. In addition, in [16] argued that companies that have high institutional ownership are more likely to pay dividends when there is better investment opportunity. This is similar to a Malaysian business environment which is claimed to be concentrated and have a high portion of institutional ownership, and supported by another study by [4] which found the presence of institutional

shareholders results in higher dividend payout in Malaysia. However, this result of positive relationship between investment opportunity and dividend payout contradicts the agency theory which posits that excess cash is better paid to shareholders as dividends when firms have a low investment opportunity.

### Firm Size(SIZE)

The study expects the positive relationship between firm size and dividend payout. The result in Table 3 indicates that firm size has a positive and significant relationship with dividend payout. This result is consistent with the findings from prior studies in other countries such as studies by [18] in Thailand, [38] in London, [39] and [26] in Pakistan.

The other two variables namely ROE and LEV are not significant in their relationship with dividend payout. The result indicates that there is the insignificant negative relationship between profitability and dividend payout. This result appears to suggest that profitable firms tend to pay less dividends. This may be explained by the argument stated by [26] which claim that the relationship between profitability and dividend payout might differ due to different dividend policies between developed and developing countries. It is because developing countries do not follow a stable dividend policy. However, further studies may be required in this area before any conclusion made.

The result of the study also indicates an insignificant positive association between leverage and dividend payout. This result suggests that highly leveraged firms are likely to pay more dividends. A study by [23] also found a positive significant effect of leverage on dividend and [18] suggested that firms might use debt financing to pay dividends. Furthermore, it is claimed that firms in emerging markets seem to be more reliant on borrowings for their dividend payout [18, 40, 41]. This explanation may be applicable to Malaysian firms as Malaysian market is one of the emerging markets in the world where its economy is still developing and in rapid pace.

## CONCLUSION AND RECOMMENDATIONS

The objective of this paper is to examine the factors that influence the dividend policy of Malaysian listed firms. The results show that investment opportunity, liquidity and firm size significantly influence the dividend policy of these firms. However, the organizational performance and leverage are not significant in influencing the dividend decisions of the firms.

The conclusions drawn from this paper should be interpreted in a limited way, which would potentially represent opportunities for further investigation in future research. This study only selects 100 samples from the companies listed in Bursa Malaysia. Furthermore, it covered only five years data. Future studies may gather more samples and observation years. Future studies may also consider examining the determinants of dividend policy by focusing on the specific sector/industry. It may provide interesting results because the companies in the same sector would have more similar characteristics.

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