# St. MARY'S UNIVERSITY
# SCHOOL OF GRATUATE STUDIES
# DEPARTMENT OF ACCOUNTING AND FINANCE



## FACTORS AFFECTING CORPORATE DIVIDEND PAYOUT DECISIONS

(Evidence from Ethiopian Private Commercial Banks)

A Thesis

Submitted in Partial Fulfillment of the Requirements for the Award of Master of Business Administration(MBA) in Accounting and Finance

By

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# DECLARATION

I certify that this work has not been accepted in substance for any other degree, and is not concurrently being submitted for any degree other than that of MBA. Being studied at St Mary's University. I also declare that this work is the result of my own investigations except where otherwise identified by references and that I have not plagiarized another's work.

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## CERTIFICATION

This is to certify that this thesis titled **"Factors Affecting Corporate Dividend Payout Decisions: Evidence from Ethiopian Private Commercial Banks"** is the authentic work of Mr. Belisti Jemberie who carried out the research under our guidance. Certified further, that to the best of our knowledge, the work reported here does not form part of any other project report or dissertation on the bases of which a degree or award was conferred on an earlier occasion on this or any other candidate.

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# ABSTRACT

*Dividend policy is among the widely addressed topics in modern economics and finance literatures. The inconclusiveness of dividend theories and empirical studies on the determinants of corporate dividend payout decisions has made it one of the most debatable topics for researchers. As is the case, this study aimed to empirically investigate the factors that determine the dividend payout decisions in the case of Ethiopian private commercial banks. Panel data covering ten years period 2005 to 2014 were analyzed within the framework of fixed effect technique. The results showed that profitability, liquidity and leverage were the most statistically significant factors which positively influence dividend payout decisions of banks in Ethiopia. On the other hand, growth and size influenced bank dividend payout negatively and significantly. Lagged dividend payment and capital had no influence in determining the level of dividend payment in banks. This study confirms some of the previous studies and provides strong support to the signaling, agency cost and pecking order dividend theories and partly consistent with the free cash flow hypothesis though, no support was found for the transaction cost theory. Bank Managers and board of directors should give due attention to the major bank dividend payout determinants. Investors who want to select the dividend paying banks might have to look in to the major determinant factors before selecting the private banks. Finally, private banks to give special emphasis for agency costs and firm are reputation.*

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## LIST OF ACRONYMS AND ABBRIVATIONS

BODs                                        Board of Directors

CLRM                                        Classical Linear Regression Model

EPS                                         Earnings per Share

FEM                                         Fixed Effects Model

GC                                          Gregorian calendar

NBE                                         National Bank of Ethiopia

OLS                                         Ordinary Least Square

REM                                         Random Effects Model

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## CHAPTER ONE

## INTRODUCTION

## 1.1.    Background of the Study

Ethiopia has continued to maintain the double digit growth it has started since the last eight years. The robust and broad based economic growth places Ethiopia among the top performing African and other developing Asian countries (NBE Annual report 010/2011). In the rapidly growing economies of Ethiopia, as in many other emerging markets, the banks are expected to play a crucial role Dividend payout has been a subject of debate in financial literature. Academicians and researchers have developed many theoretical models describing the factors that managers should consider when making dividend policy decisions. The dividend decisions have presented different issues to academicians and practitioners (Olowe, 2011). Dividends which represent the distribution of the company's after tax earnings to shareholders have important implications for financing and investment decision of the firm as well as the company's share price.

Being financial institutions, banks acts as an engine force in modern trade and commerce for business firms and individual traders. Banks largely depend on competitive marketing strategy that determines their success and growth. The modalities of the banking industry have been changed a lot in the new millennium era as compared to the way they used to be in the years by gone (Hussain and Bhatti, 2010).

When a company makes a profit there are mainly two alternatives in which the company can make   use of the profit. The first alternative is to retain the earnings within the company in order to improve something internally. The second alternative is to pay out the profit to the shareholders and if the company chooses this approach there are two alternative ways in which the company can distribute the profits to the shareholders, either to pay dividends or they can buy back their outstanding stocks (Hellstrom & Inagambaev, 2012). The study will also provide new evidence of various determinants influencing the amount of dividends paid by firms from a developing country perspective. This is important, as one would expect that the dividend payout policy in developing country would be different from that of the developed nation.

## 1.2. Statement of the Problem

Dividend policy is one of the most controversial issues in modern corporate finance. Black (1976) states that "the harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together". This mystery led to the emergence of a handful of competing theoretical and empirical research to explain why companies pay or do not pay dividends. After two decades of non-stop research, the dividend policy is still listed as one of the unresolved issues in the world of finance in which no consensus has been reached (Brealey & Myers, 2003)

Dividend policy has attracted by many researchers, although researchers studies as a base to dividend decisions, the issue as to why corporations distribute a portion of their earnings as dividends is yet resolved. The issue of dividend policy has inspired much debate among financial analysts since Lintner's (1956) seminal work. He measured major changes in earnings as the key determinant of the companies' dividend decisions. Miller and Modigliani (1961) illustrated under the condition of perfect capital market and zero taxes, dividends were irrelevant. And also Gordon (1962) and Walter (1963), stated dividend to be relevant for the valuation of the firm and hence the shareholders are seen to be not at all indifferent as to the payment of dividend and retention of profits as cited in Muhammed(2012).

In Ethiopia no major source on the determinants of corporate dividend payout decisions in all financial (Banks, Insurances and micro-finances) and non- financial (manufacturing, construction, agriculture and service) sectors of the economy; this business type the need to identify the driving elements of dividend payout policy through theoretical and empirical analysis. Therefore, a study on factors affecting corporate dividend payout decisions shall be a relevant decision in view of these phenomena.

Muhammed (2012) studied on the determinants of dividend policy of Ethiopian insurance companies and the result shows that dividend decisions are relevant and profitability and liquidity the significant factors which positively influence dividend policy of insurance companies in Ethiopia; size and leverage are insignificant influencing the dividend policy of insurance companies in Ethiopia.

Tewodros (2011) also the first relevant Ethiopian study which dealt with the determinants of dividend payout factors on Ethiopian bank industry and concludes that firm size, liquidity and the previous year's dividend payment are among the major determinants of dividend payout

decision variables in Ethiopian private commercial banks. The above issues coupled with the gap in the literature call for research in the area of factors affecting corporate dividend payout decisions and statistical techniques of correlation and regression were included identify the relationship between variables. At the end, the present study provides insight into the factors that influence the dividend payout decisions of Ethiopian private commercial banks.

## 1.3. Objectives of the Study

### 1.3.1. General Research Objective

The general objective of the study is to investigate the determinants of private bank dividend payout in Ethiopia by using different variables.

### 1.3.2. Specific Research Objectives

This study is attempted to achieve the following specific objectives by using the above variables;

- ❖ Examine the impact of capital adequacy on dividend payout of Ethiopian private Banks.
- ❖ Investigate the effect of profitability on dividend payout of Ethiopian private Banks.
- ❖ To assess the impact of Liquidity on dividend payout of Ethiopian private Banks.
- ❖ Analyze the impact of firm size on dividend payout of Ethiopian private Banks.
- ❖ Investigate the effects of firm growth on dividend payout of Ethiopian private Banks.
- ❖ Examine the impact of leverage on dividend payout of Ethiopian private Banks.
- ❖ To assess the impact of last year dividend on dividend payout of Ethiopian private Banks.

## 1.4. Hypothesis

The researcher has used the following hypothesis

*HP 1: Firm growth is expected to be negatively and significantly affect dividend payout.*

*HP 2: Liquidity is expected to be positively and significantly affect dividend payout.*

*HP 3: Last year's dividend is expected to be positively affecting current years*

*HP 4: Profitability is expected to be positively and significantly affect dividend payout.*

*HP 5: Firm size is expected to be positively and significantly affect dividend payout.*

*HP 6: leverage is expected to be negative and significantly affect dividend payout*

*HP7: Capital adequacy is expected to be positively and significantly affect dividend payout*

## 1.5. Significance of the Study

The study will have significance from various directions. it enhances the stock of information about the determinants of dividend payout in banking sector of Ethiopia and expected to have a contribution in identifying the factors that affect the dividend payout of the private commercial banks in Ethiopia and provide an insight to the management of the specific banks, and also help investors, policy makers and banks to understand about significant factors that determine the dividend payout decisions.

## 1.6. Scope of the Study

The necessary data have been sourced from the National Bank of Ethiopia. Assessing the determinants of both financial and non-financial sectors dividend payout decisions as whole is very important to shed some light on the issue of these sectors in Ethiopia. However, due to time and budget constraints and availability of the required data, only included those companies in the sample that had continuously paid dividend during the study period and have excluded financial institutions/finance companies and government owned companies. There are 16 private banks but the study was focus exclusively on banking industry particularly on six private commercial banks on which their business operation is ten and more than ten. In this regard, the period of study covered from the year 2005 up to 2014 G.C

In addition the dividend payout decision is influenced by external factors like absence of secondary market and well developed financial system of a country, this study does not consider

the possible effect of absence of secondary market and well developed financial system on dividend policy.

## 1.7. Structure of the Study

The paper was organized in five chapters. Chapter one deals with introduction of the study; chapter two assesses review of literatures by taking theoretical and empirical findings; Chapter three introduces the way how the study is undertaken, which is the methodology section of the study. Furthermore, Chapter four explains analysis and result of the study. Finally, chapter five indicates Conclusion and Recommendations.

# CHAPTER TWO

# LITRATURE REVIEW

## 2.1. Dividend Theories

Many theories have been developed on dividend policy. Some of the selected theories for this purpose are the bird- in- hand theory, signaling theory, tax preference theory, agency theory, Clientele effect, pecking order theory, free cash flow hypothesis, life cycle theory, and Transaction Cost Theory.

In 1961, two noble laureates, **Merton Miller and Franco Modigliani (M&M)** showed that under certain simplifying assumptions, a firms' dividend policy does not affect its value. The basic premise of their argument is that firm value is determined by choosing optimal investments. The net payout is the difference between earnings and investments, and simply a residual (Kapoor, 2009). M&M concluded that given firms optimal investment policy, the firm's choice of dividend policy has no impact on shareholders wealth.

**The bird-in-hand** theory argues that because of uncertainty of future cash flows, investors will often tend to prefer dividend to retained earnings. Therefore, higher payment of ratio will reduce the required rate of returns and have increased the value of the firm Rafique (2012).

The **signaling** theory posits that share prices do not react to dividend payout rate in itself but to the information that investors believed changes in dividend levels have for the future prospects of the firm. Lasher (2000) points out that a decrease in dividend, for example, is taken as terrible news. It generally comes after sustained reduction in earnings, and tells the market that management does not expect the company to have the cash it had in the past.

**Tax preference** theory states that dividends are subject to a higher tax cut than capital gains. This theory further argues that dividends are taxed directly, while capital gains tax is not realized until a stock is sold. Therefore, for tax-related reasons, investors prefer the retention of a firm's profit over the distribution of cash dividends. The advantage of capital gains treatment may lead investors to favor a low dividend payout, as opposed to a high payout. Studies by Litzenberger and Ramaswarny (1979) and Barclay (1987) as cited in Yiadom and Agyei (2011) have research findings in support of the tax preference theory. Due to tax advantages, investors may prefer to

have companies who retain most of their earnings. If so, then low payment companies than otherwise similar higher- payment companies would be preferred.

The **Clientele effect** is another theory related to dividend policy. This theory recognizes that different groups /clientele prefer different dividend payment policies. For example, while one may want the firm to pay out a higher percentage of its earnings another may prefer otherwise. If dividend income is taxed at a higher rate than capital gains, investors in high tax bracket may prefer non dividend or low-dividend paying stocks, and vice-versa. Extant studies that present evidence on clientele effect includes Pettit (1977) and Dhaliwal, Erricsson and Trezevant (1999) the other most important theory is the **agency cost** theory. The relation between shareholders and managers of a company is an agency relation. The shareholders are the principals and the managers are the agents. The managers are charged with acting in the best interest of the owners. However, there are possibilities for conflicts between the interests of the two. The key thrust of the agency theory is that managers may take actions in accordance with their own interest which may not always be beneficial to shareholders. Empirical studies in support of agency explanation on dividend include Lloyd, Jaherer and Page (1985) and Jensen, Solberg and Zorn (1992). The payment of dividend therefore is seen as a means of reducing the amount of excess money available to managers which may not be used in the best interest of shareholders.

The **life cycle** theory is also developed as one of the explanations for dividend payment. The theory explains that as firms pass through the various stages in their lives, they tend to alter the dividend policy depending on the financial needs of each stage. Implied in this theory is the fact that firms that are in their growth stages are less likely to pay more dividends as compared to firms that are at their maturity stages. Old firms therefore, because they do not have a lot of growth opportunities to fund are expected to pay more dividends. Murhadi (2010) and Yiadom& Agyei (2011) reveal that companies which enter in growth phase tend not to pay a lot of dividend, compared to companies at matured stage.

Another important theory is the **Transaction Cost** Theory. 'Transaction Cost' is an important theory which was initiated by Rozeff (1982) who assumed that the more dividends which were paid, the lower would be the agency cost incurred. However, he added that if the company paid high dividends, this would lead to an increase in the transaction cost. Al-Najjar&Hussainey (2009) argued that smaller companies will have more transaction costs than larger ones, because the small companies would mostly rely on debts to finance their activities and payment of

dividends. They concluded that firm size can be a determinant of dividend policy of the company. This theory is tested by the firm size variable.

**Bankruptcy Theory**, They thought that bankruptcy costs had no influence on the dividend policy of a company. A general bankruptcy cost occurs when the firm faces great difficulty in meeting its long-term obligations (Al-Najjar&Hussainey, 2009). As a result, firm ownership has to be transferred and the capital structure is likely to have a new form. Some researchers found that the business risk toward bankruptcy costs is associated with the dividend policy in a particular firm (Ho, 2003; Aivazian et al. 2003). This theory can be examined by the firm risk which is measured by firm beta.

 The 'Pecking Order Theory' is one of the corporate leverage theories (Murry and Goyal, 2003). It contains two assumptions which are as follows. First, there is asymmetric information between managers and outside shareholders. The second assumption is that the firm will follow a pecking order to finance its activities (Al-Najjar&Hussainey, 2009). They indicated that the firm will depend first on the retained earnings in financing and distributing the dividends. They added that if the retained earnings are not enough, the firm will use debt to borrow, rather than issuing new shares. This is consistent with Myers and Majluf (1984) in that the company prefers internal funding, rather than external sources for dividend distribution. This is also consistent with Necur et al. (2006) who argued that internal sources of finance are given priority to be spent as dividends, but if these are insufficient, the firm can depend on the debt and finally on equity issuance.

## 2.2. Empirical Review

The first empirical study of dividend policy was formed by Lintner (1956). Through his interview with managers of 28 selected companies, he has shown that firms have long-run target dividend payout ratios and place their attention more on dividend changes than on absolute dividend levels. He also finds that dividend changes follow shifts in long-run sustainable earnings (managers' smooth earnings) and managers are hesitant to make dividend changes that may later need to be reversed. Managers also try to stabilize dividends and avoid dividend cuts. The seminal article by Miller and Modigliani (1961) first proposed dividend irrelevance theory. On the other hand, theories which support dividend relevance include tax preference, signaling,

and agency explanations. Some studies have identified various factors affecting dividend policy of companies as:

A. *Profitability*

The financial literature states that a firm's profitability is a significant explanatory variable of dividend policy (Rafique, 2012). However, there is a significant difference between dividend policies in developed and developing countries. This difference has been stated by (Glen, Karmokolias, and Miller, 1995) showing that dividend payout rates in developing countries are approximately two-thirds of those in developed countries. Moreover, emerging market corporations do not follow a stable dividend policy; dividend payment for a given year is based on firm profitability for the same year. Yiadom and Agyei (2011) found that Profitability positively affects the dividend paid by banks. Banks which are profitable are more likely to pay dividends as compared to banks that are not profitable.

Pruitt and Gitman (1991) as cited in Rafique (2012), surveyed financial managers of the 1,000 largest US firms about the interaction among the investment, financing, and dividend decisions in their firms. Their evidence suggested that important influences on the amount of dividends paid were current and past years' profits, the year-to-year variability of earnings, and the growth in earnings. Ahmed and Javid (2009) also found that firms having high profitability with stable earnings can afford larger free cash flows thus payout larger dividends and they conclude that the net earnings positively affect the dividend yield.

The positive and significant relationship between profitability and dividends is well documented in financial literatures (Al-Malkawi (2007), Fama and French (2001), Amidu and Abor (2006),Jeong (2008), Moradi, Valipour, and Mousavi (2012), Al-Kuwari (2009)). A firm's profitability is considered to be an important factor that affects dividend policy. This is because profitable firms are willing to pay higher amounts of dividends and hence a positive relationship is expected between firm's profitability and its dividend payments.

Tewodros in 2011 conducted his study on the determinants of dividend payout in Ethiopian private commercial banks and finds that profitability was not statistically significant, suggesting that industry profitability effect seem to have no influence on the payment of dividends. However, a year later in 2012, Muhammed carried out a study on the determinants of dividend policy of Insurance companies in Ethiopia and concluded that dividend decisions are relevant

and profitability is statistically significant factor which positively influences dividend policy of insurance companies in Ethiopia

### B. Liquidity

The general view regarding with the relationship between liquidity and dividends is that liquidity should have a positive impact on the company's dividend payout ratio. Jensen (1986) as cited in Hellstrom and Inagambaev (2012) explains the positive relationship by referring to the agency conflict between managers and shareholders. The agency conflict contributes to that shareholders prefer dividends instead of retained earnings if the company has excess free cash flow. A firm's liquidity is an important factor that affects the distribution of cash dividends.

Liquidity measures the extent to which a firm is able to meet its payment of obligations. High liquid firms, that means firms with higher cash availability and near cash assets, pay higher dividends to shareholders than those with insufficient cash. According to Amidu and Abor (2006), cash dividend distribution does not only depends on the profitability of firms but also depends on the free cash flow which is the amount of operating cash flow left over after the payment for capital expenditures. The empirical results of this study indicates a significantly positive relationship between cash flow and dividend payout ratios and thus the liquidity or cash-flow position can be considered as an important determinant of the dividend payout ratio. Chay and Suh (2005) also consider cash flow as a determinant of dividend payments where firms facing high levels of cash flow uncertainty are likely to pay low dividends fearing cash shortfalls in the future. (Brav, Graham, Harvey, and Michaely, 2004) in their research report stated that more than two-third of Chief Financial Officer of dividend-paying firms stated that stability of future cash flow is an important factor affecting dividend decision. Al-Kuwari (2009) examined the Determinants of the Dividend Policy in Emerging Stock Exchanges: The Case of Gulf Co-operation Council (GCC) Countries. The study used a panel dataset of non-financial firms listed on the GCC country stock exchanges between the years of 1999 and 2003.The result suggested that free cash flow was the only agency theory explanatory found to have no influence on dividend policy and the positive association between liquidity and dividend payout cannot supported. Alam and Hossain (2012) carried out their study in a case of UK and Bangladesh based companies and they found that liquidity influence company dividend rate negatively and significantly. Franklin and Muthusamy (2010) supported the negative and significant influence of liquidity on dividend payment of companies. Mehta (2012) conducted empirical study on

Analysis of Determinants of Dividend policy evidence from United Arab Emirate (UAE) companies and the study does not support the relevance of liquidity as a most important consideration of dividend policy, and finds that it is insignificant in influencing the dividend payout decisions. Yiadom and Agyei (2011) conducted their study in case of Ghanaian banking industry and unfortunately found liquidity influences negatively and significantly banks dividend payment.  In Ethiopia, Tewodros (2011) has carried out his study on the determinants of dividend payout and found that liquidity has negative and significant effect on banks' dividend payment.  Muhammed (2012) also conducted his study regarding with the determinants of dividend policy of Ethiopian insurance companies and finds that a positive and significant effect on dividend payment.

### C. Leverage

The debt-to-equity ratio, also known as risk, gearing or leverage, shows the relative proportion of equity and debt in the company's capital structure. The empirical evidence regarding the relationship between leverage and dividend payout is mixed. The higher the leverage of the firm the lower is the dividend payout; this could be because of the debt covenants.

Rozeff (1982) as cited in Manos (2001) points out those firms with high financial leverage tend to have low payout ratios in order to reduce the transaction costs associated with the external financing. Similarly Al-Malkawi (2007) confirmed that the firm's financial leverage is significantly and negatively related to its dividend policy, whereas Kania and Bacon (2005) cited in Mehta (2012), Yiadom and Agyei (2011), Kapoor (2009), Baker and Powel (2001), and Karam and Goyal (2007) as cited Ahmed and Javid (2009) have found a significant positive relationship, bringing out the fact that the firms have higher debt funds to pay off more dividends. Al-Kuwari (2009) conducted a research among companies listed on Gulf-Cooperation Council stock exchanges (GCC), which includes six countries at the Arabian Peninsula. The study showed that a strong relationship could be established between the companies leverage and dividend payout ratio. He explains the result by stating that companies with higher leverage face higher transaction costs connected to external financing. But no significant relationship between dividend payout ratios and companies free cash flows, growth and risk (beta) was revealed.

Hellstrom and Inagambaev (2012) carried out their study on the determinants of dividend payout ratios, a study of Swedish Large and Medium Caps and found a negative relationship could also

be established between the dividend payout ratio and leverage. Amidu (2007) supports the negative and significant effect of leverage on company's dividend. Ahmed and Javid (2009) found that the relationship between the leverage and dividend payout is negative and insignificant and conclude that leverage is not the determinant of dividend payout policies in listed firms of Karachi Stock Exchange (KSE) in Pakistani. In Ethiopia, Tewodros (2011) also stated that leverage was not found to be one of the determinants of dividend payments. Muhammed (2012) from his study found that leverage is insignificant in influencing the dividend policy of insurance companies in Ethiopia.

### D. *Firm size*

The size of a bank may have an impact on specific bank risk. In a non-competitive environment, if larger banks have a greater proportion of the domestic market, lending rates may be high while deposit rates for larger banks will be lower because large banks are perceived to be safer and consequently larger banks may enjoy higher profits. This indicates that large firms can afford to pay higher dividends than the smaller ones. In other words, firm size can serve as an index for the cost of external debt financing, and hence a positive relationship is expected between firm size and dividend policy, indicating that large firms will have less issuing costs. Eddy and Seifert (1988), Jensen et al. (1992), Redding (1997) as cited in Tewodros(2011) and Fama and French (2001) indicated that large firms distribute a higher amount of their net profits as cash dividends, than do small firms. Several studies have tested the impact of firm size on the dividend-agency relationship. They found that firm size as important explanatory variable, as large companies are more likely to increase their dividend payouts to decrease agency costs.

The big size companies pay higher dividends and smaller size companies pay fewer dividends, as they find it difficult to raise funds, as compared to large companies who have easier access to the capital market and hence they are less dependent on the internal funds, leading to more capability to pay the dividends. Besides, Al-Twaijry (2007) as quoted in Ahmed and Javid (2009) also supported the same view and concluded that there is a positive association between dividend payouts and firm size.

Moradi et al. (2010) conducted their study on factors affecting corporate dividend policy, Empirical evidence of Iran and the result shows that there is no meaningful relationship between dividend policy and a company's size. Mehta (2012) stated that the Size of the firm is

significantly and positively related to the dividend payout of the firm in the UAE and concludes that the larger size firms pay out more dividends as compared to firms with smaller size. Thus, the hypothesis that size has positive relationship with dividend payout ratio has been supported by the results of the analysis. In Ethiopia, Tewodros (2011) also supported that there is a positive and significant relationship between firm size and dividend in Ethiopian banks but Muhammed (2012) concludes that size has a negative and insignificant impact on Ethiopian insurance dividend policy.

### E. Business Risk

Lot of studies has been conducted in order to determine the relationship between the riskiness of company's operation and the dividend payout. But the variables used in order to measure the risk have been different.

Some previous studies have used beta as a measurement of the company's market risk Lloyd et al. (1985); Rozeff (1982) as cited in Yiadom and Agyei (2011). Amidu and Abor (2006) used the variance in cash flow based on the assumption that volatility of earnings reduces the accuracy of earnings predictability and they found a negative relationship between payout and beta. Hellstrom and Inagambaev (2012) used beta as a measure of firm risk in their study. Franklin and Muthusamy (2010) carried out their study on the Leverage, Growth and Profitability as Determinants of Dividend Payout Ratio-Evidence from Indian Paper Industry. On their work to measure the riskiness of Indian paper industry. The result shows that the price earnings ratio is found to be negatively and significantly associated with dividend payout. They suggest that high price earnings ratio may be associated with high risk and low dividend payout, whereas low price earnings ratio may be associated with low risk and high dividend payout.

Moradi et al. (2012) conducted their study on the determinant factors of dividend policy in firms listed in Tehran Stock Exchange (TSE) and measure the riskiness of firms. They stated that risk earnings, may block the business unit ability to provide return which stock holders expected. Furthermore, the higher the business risk, the higher the probability of bankruptcy is and the possibility and probability of firm's dividend pay reduces. The result shows that there is a negative relationship between dividend pay and business risks from the research findings of Al-Najar and Hossinie (2009).

F.   **Previous years dividend**

The variability of dividend paid for previous years can have an effect on the dividend to be paid for the recent year. Companies that vary their payments indicate that at least some level of dividend would be paid. Lintner (1956) developed his partial dividend adjustment model and asserted that current year's dividend is not only depends on current year's earnings but also previous year's dividend paid.

Farrelly, Baker and Edelman (1986) as cited in Tewodros (2011) concluded that the major determinants of dividends payment are anticipated level of future earnings and the pattern of past dividends. This is confirmed by Vasliou and Eriostis (2003) as cited in Muhammed (2012) who postulate that firms set dividend policy not only by the net distributed earnings, but also by change from previous year's dividend.

Ahmed and Javid (2009) used the lagged dividend payment as one explanatory variable that affect the payment of the current year dividend. The result of their study shows that the lagged dividend yield has a positive and highly significant relationship with the dividend yield of the current year by using the pooled time series and cross-section with common effect model, fixed effect model and random effect model. This evidence suggests that dividend yield of the current year depends on dividend yield of pervious year and is supported by the findings of Amidu and Abor (2006) and opposite from the findings of Reddy (2006) as cited in Ahmed and Javid (2009). Musa (2009) presented the study to investigate the dividend policy of a cross-section of 53 firms quoted on the Nigerian Stock Exchange (NSE) during the period 1993 to 2002. The model employs five metric variables-previous dividends, current earnings, cash flow, investment and net current assets, and three non-metric variables- growth, firm size and industry classification. The empirical result reveals that the five metric variables have significant aggregate impact on the dividend policy of the quoted firms. The relationship between previous dividend and dividend changes is however not consistent.

Tewodros (2011) reported that firms previous year's dividend payment was also found to be statistically determinant variable of dividend payout ratio of Ethiopian banking sector.

### G. Firm's Growth

If the firm is growing rapidly, there will be a high demand of capital. Beside the higher the growth opportunities, the more the need for funds to finance expansion, and the more likely the firm is to retain earnings rather than to pay them as dividends (Chang and Rhee 1990) .However, Amidu and Abor (2006) also stated that growth in sales was found to have statistically significant and negative associates with dividend payout ratios. According to them, growth in sales is used as proxies for the firm's future prospects since growing firms require more funds in order to finance their growth and therefore would typically retain greater proportion of their earnings by paying low dividends. Jeong (2008) also supported the findings of Amidu and Abor where sales growth is expected to be negatively related to the degree of dividend smoothing in terms of dividend payout. In his study on 299 firms listed on Korea Stock Exchange over a twenty-six years period starting from 1981 to 2006, he used the signaling theory to imply that firms with growth opportunities or the sales growth of the companies are more likely to pay dividends in order to convey this information to the market. The higher the growth opportunities, the more the need for funds to finance expansion, and the more likely the firm is to retain earnings rather than to pay them as dividends (Chang and Rhee, 1990) cited in Muhammed (2012) and hence minimize the agency conflict. Olowe and Moyosore (2011) stated on the determinants of dividend payout in the Nigerian banking industry over the period 2006 to 2008, by regression techniques using the data of the Nigerian quoted banks. The result of this study shows that revenue growth negatively and significantly influences dividend policy of Nigerian banks. In Ethiopia, Muhammed (2012) also finds that the relationship between firm growth and dividend payout policies is negative and significant at five percent significance level. He stated that growing insurance companies require more funds in order to finance their growth and therefore would typically retain greater proportion of their earnings by paying low dividends. Thus, the insurance companies with large investment opportunities pay fewer dividends. Tewodros (2011) also concluded that there is no relationship between company's growth and the dividend payout.

### H. Capital Adequacy

Capital adequacy is an important variable in determining bank profitability, and thus, dividend policy. The equity-to-asset ratio measures how much of bank's assets are funded with owner's funds and is a proxy for the capital adequacy of a bank by estimating the ability to absorb losses. As the literature review pointed out, academic research is mixed regarding the relationship between the equity-to-asset ratio and firm's dividend payout. Flamini, McDonald, and Schumacher (2009); Athanasoglou, Delis and Staikouras (2006); Berger (1995) as cited in Olowe and Moyosore (2011) found a positive and significant association between capital adequacy and dividend payout. They argued that as banks become more profitable, some portion of their earnings will be paid to shareholders as distributions (dividends). The positive and significant association between capital adequacy and firm's dividend payout is also supported by Amidu and Abor (2006). On the other hand, if the firm is growing rapidly, there will be a high demand of capital. Besides, the higher the growth opportunities, the more the need for funds to finance expansion, and the more likely the firm is to retain earnings rather than to pay them as dividends( Chen, and Dhiensiri, 2009) and hence minimize the agency conflicts. Consequently, firms with high growth opportunities are likely to retain a greater portion of their earnings to finance their expansion projects as against these dividends to shareholders. Thus, a negative association is expected between capital adequacy and thus dividend. Olowe and Moyosore (2011) carried out their study on the determinants of dividend payout in Nigerian Banking Industry. Capital adequacy is used as one explanatory variable that affects banks dividend payout and it had a negative and significant impact on dividend payout of Nigerian banks.

# CHAPTER THREE

# RESEARCH METHODOLOGY

## 3.1. Data type and source

This study used Secondary data and Quantitative in nature. The data was collect from annual reports of sampled private banks and National bank of Ethiopia. Thus, the main Secondary data of the study were financial statements of the banks. The data sets in this study were balanced panel data. Balanced panel data means, each cross sectional units of banks have same number of time series observations.

For the purpose of the analysis, the type of data that is going to be used in this study was entirely being balanced panel data (cross sectional & time series) and quantitative in nature. Because the study is mainly based on secondary data sources, the researcher was collected secondary data from audited financial statements and annual reports of banks. Information from books, journals and online publications produced by academicians will also be used.

## 3.2. Research Design

This study used the co relational research design since it sought to establish the relationships between the dependent and independent variables (i.e. dividend payout and the determinants). Since the aim is to establish relationships between different variables in order to detect certain patterns, the explanatory type of research study is the most appropriate for this study.

## 3.3. Sample Selection

The researcher was used Purposive sampling technique for selecting the sample from the total population. The investigator was taken six private banks out of the total of sixteen private banks. The rationale behind selecting six banks out of the total population is based on; only private commercial banks', time of establishment (only banks' who have ten and above ten years of experience in the banking industry), Banks continuously paid dividend during the period of study (2005 up to 2014), the researcher was also ignore stock dividends (if any) and will examine only cash dividends.

Taking the above criteria into consideration, the researcher has select six banks they are fitting the above criteria as sample (Awash International, Wogagen, Dashen, Abyssinia, United and Nib

International) banks from the total of sixteen private commercial banks they are currently in operation. The period of the study was cover ten years from 2005 to 2014 in G.C. The selection of this period is based on latest period of the available data.

## 3.4. Data analysis and presentation

The data were collect from secondary sources  classified, summarized and presented using text, tables, graphs and diagrams, regression analysis technique was used to provide descriptive statistics ( to determine the mean and standard deviation of each construct variables). Data analysis were done by using a statistical package called STATA 10.0

### 3.5. Variable Construction

Panel data involves the pooling of observations on a cross-section of units over several time periods and provides results that are simply not detectable in pure cross-sectional or time series studies (Gujarati, 2004). The general form of the panel data can be specified more compactly as:

$$Yit = \alpha i + \beta X it + \varepsilon it \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (1)$$

Where, Yit represents the dependent variable in the model, which is bank's dividend payout. Xit contains the set of explanatory variables in the estimation model, the subscript i denotes the cross-sectional dimension and t represents the time-series dimension; $\alpha i$ is the constant term; $\beta$ represents the slope coefficients and $\varepsilon it$, represents the errors term. In light of the above model and on the basis of selected variables the current study used model as shown below:

$$DPO = f \; (PROF, GROW, LIQ, LDPO, SIZE, LEV, CAP)$$

$DPO_{i,t} = \alpha_0 + \beta_0 PROF_{i,t} + \beta_2 \, GROW_{\ i,t} + \beta_3 LIQ_{\ i,t} + \beta_4 LDPO_{\ i,t} +$
$\quad\quad \beta_6 SIZE_{i,t} + \beta_7 LEV_{i,t} + \beta_8 CAP_{i,t} + \varepsilon_{i,t}$.............................................................(2)

Where, DPO= Dividend payout; PROF= Profitability; GROW= Bank Growth; LIQ = Liquidity; LDPO = Lagged dividend payout; SIZE= Bank Size; LEVE= Leverage and CAP =Capital adequacy.

## 3.6. Definition of Variables

Once the analytical procedures and its requirements are known, it is necessary to identify the potential explanatory and outcome variables and describe their measurement. Different variables are expected to affect banks dividend payout (dependent variable) in the study area. The major variables that are expected to have an influence on banks dividend payout are presented and explained below with the direction of their effect following the definition of dependent variable.

## 3.7. Dependent Variable

Dividend payout, which is the dependent variable, is defined as the cash dividend paid divided by net income after tax. Since all Ethiopian private commercial banks pay only one cash dividend once a year, and where both stock dividends (bonus shares) and shares buyback (share repurchases) are not popular ways of payout in Ethiopian case , it is a better proxy variable than dividend per share used by Tewodros (2011)and other developed countries researchers.

### 3.7.1. Explanatory Variables

A. **Profitability**: it measures the earning power (business performance) of the company. The     size of a firm's profit has been a long standing determinant of dividend payout. It is defined as the ability of a firm to generate profit. Return on assets (ROA) is used to measure profitability of banks.

B. **Liquidity**: It is the ability of a company to convert its current assets into cash without significant concession of price and time which can be measured by current ratio. A firm's cash flow is a good measure of the firm's liquidity and it is very important to compare a firm's liquidity position in relation to its dividend payment. Liquidity measures the extent to which a firm is able to meet its payment of obligations. Current assets to current liabilities are used as a measure for cash position (liquidity).

C. **Leverage**: it is the level of debt used by the firm. Debt level is a ratio which shows the extent to which a firm is financed by external funds. Agency theory suggests that dividend payments and capital structure can reduce the problems related to information asymmetry. Dividends and debt financing can serve as a mechanism to

reduce cash flow under management control, and help to mitigate the agency problems. The firm's leverage is measured by the ratio of total debt to the book value of total assets.

D.  **Firm size**: Firm size indicates the total size of assets financed by internal and external sources to produce or generate revenues. Firm size variable has become a key influential variable in prior research works to explain the firm's decision to pay dividends. This indicates that large firms can afford to pay higher dividends than the smaller ones or it can serves as an index for the cost of external debt financing. To test the hypothesis, a proxy for firm size is the natural logarism of total assets is used and to control for size differences across the sampled banks.

E.   **Firm growth**: Growth is one of the factors which should be considered in determining the level of dividend of a company. Growth can be measured in terms of sales (revenues), EPS, and market share on annual basis. For this study, to measure the growth of firms, the annual change in total assets is used as a measurement. Assets growth is computed as the ratio of the difference between current year's assets and previous year's assets to previous year's assets.

F.  **Previous year's dividend**: Previous year's dividend is the company's cash dividend paid in last year's. Usually companies stable dividend policy and base current dividends on the previous year's dividends. The variability of dividend paid for previous years can have an effect on the dividend to be paid for the recent year. The lagged dividend paid by banks is used to measure the extent to which the previous dividend payment affects the current dividend payout.

G.   **Capital Adequacy**: Capital adequacy is defined as equity capital over total assets. It is an important variable in determining firm profitability, and thus, dividend policy. The equity-to-asset ratio measures how much of bank's assets are funded with owner's funds and is a proxy for the capital adequacy of a bank by estimating the ability to absorb losses.

## 3.7.2. Development of Hypothesis

Hypotheses are predictions the researcher holds about the relationship among variables. They are numeric estimates of population values based on data collected from samples. Alternative type of hypothesis is used under this study since it is popular in journal articles and the investigator makes a prediction about the expected outcomes for the total population of the study (Creswell, 2009, pp.165-167). This prediction often comes from prior literature and studies on the topic that suggests a potential outcome that the researcher may expect. Therefore, under this study, based on existing literature, the following hypothesized relationships are predicted for each variable with respect to dividend payout.

*HP 1: Firm growth is expected to be negatively and significantly affect dividend payout.*

*HP 2: Liquidity is expected to be positively and significantly affect dividend payout.*

*HP 3: Last year's dividend is expected to be positively affecting current years*

*HP 4: Profitability is expected to be positively and significantly affect dividend payout.*

*HP 5: Firm size is expected to be positively and significantly affect dividend payout.*

*HP 6: leverage is expected to be negative and significantly affect dividend payout*

*HP7: Capital adequacy is expected to be positively and significantly affect dividend payout*

Generally, the study considered the above seven bank specific dividend payout determinants. The next table summarizes the above specified dependent and independent variables of the study with their respective notation, measurement and hypothesized signs.

**Table 3.1 Proxy variable definition and expected sign**

|  | Variable | Notation | Measurement | Expected Sign |
|---|---|---|---|---|
| Dependent variable | Dividend payout | DPO | Yearly cash dividend/Net income after tax for bank *i* over time *t* | |
| Independent variables | Profitability | ROA | Net income after tax/Total Assets for bank *i* over time *t* | Positive |
| | Liquidity | LIQ | Current Assets/current Liabilities for bank *i* over time *t* | Positive |
| | Leverage | LEV | Total Debt/Total Assets for bank i over time t | negative |
| | Firm Size | FS | Natural logarism of Total Assets for bank *i* over time *t* | Positive |

| | | | |
|---|---|---|---|
| | Firm growth | FG | Annual changes in Total Assets for bank i over time t | negative |
| | Lagged dividend paid | LDPO | Lagged dividend paid divided to net income after tax for same year for bank i over time | Positive |
| | Capital Adequecy | CAPAD | Total Equity/Total Assets for bank i over time t | Positive |

# CHAPTER FOUR
# DATA ANALYSIS AND INTERPRETATION

In this section the results from descriptive statistics are discussed. Generally, the data that were collected for this study were secondary in nature. The descriptive statistics was used in order to get insight about the variables of the determinants of banks dividend payout among the sampled banks and it was used as a base to forward recommendations after determining the relationship between the variables from correlation and regression analyses.

## 4.1. Descriptive Statistics

In this section the results from descriptive statistics are discussed. Generally, the data that were collected for this study were secondary in nature. The descriptive statistics was used in order to get insight about the variables of the determinants of banks profitability among the sampled banks and it was used as a base to forward recommendations after determining the relationship between the variables from correlation and regression analyses.

**Table 4.1 Descriptive Statistics for the study variables**

| Variable | Observations | Mean | Std. Dev. | Min | Max |
|---|---|---|---|---|---|
| dpo | 60 | .509 | .3407554 | .05 | 1 |
| roa | 60 | .5928333 | 1.307133 | 0 | 5.1 |
| liq | 60 | .6535 | .3153466 | .2 | 1.23 |
| lev | 60 | .8455 | .0927074 | .68 | 1.06 |
| bs | 60 | 3.796833 | .3078603 | 3.03 | 4.34 |
| fg | 60 | .2583333 | .1204253 | .04 | .59 |
| capad | 60 | .2543333 | .2473409 | .02 | .87 |
| ldpo | 60 | .5003333 | .3525066 | .05 | 1 |

**Source:** STATA Summary Statistics Result for sampled private banks, 2015

The above table indicates the mean, standard deviation, minimum and maximum values of variables. A balanced datasets of 60 observations provides the basis for descriptive analysis. The dividend measure used in this study namely the dividend payout; the cash dividend by the net income after tax.

The mean of dividend payout was 50.9 percent with the standard deviation of 34 percent. This means that private commercial banks in Ethiopia under the period of study have paid out 50.9 percent of their net income after tax as dividends.

Return on assets (ROA) was used to measure profitability and to know the relationship between profitability and dividend payout of banks. For the total sample, the mean value of ROA was 59 percent with a minimum of 0 percent and a maximum of 5.1 percent. That means, the most profitable banks among the sampled private banks earned 5.1 percent profit after tax for a single birr invested in the assets of a firm. On the other hand, the least profitable banks of sampled banks earned 0 percent profit after tax for each birr invested in the assets of the firm, with the standard deviation of 130 percent under the period of study.

The average value of liquidity as measured by current ratio was 0.65 which means that, for each one birr current liability there were 0.65 birr current assets to meet short term obligations. The maximum and minimum values were 1.23 and 0.2 respectively with standard deviation of 0.32.

Leverage as measured by debt ratio (total debt to total assets) and showed that the mean value for the sampled private banks was 84 percent. It reveals that debt represents nearly 84 percent of the capital of banks and which indicates the assets of banks were financed through debt under the study period. In a relatively fast growing economy like Ethiopia, equity financing alone is not enough to support high growth. Consequently, Ethiopian private banks resorted more to debt financing to sustain the high growth during the sampled period. The maximum debt ratio for a bank in a particular year was 106 percent and the minimum debt ratio was 68 percent.

Bank Size; total assets of each bank were proxy to their natural logarithm values .The average value of this variable was 37.97   birr during the study period with standard deviations of 0.31 birr. This shows that there was moderate discrepancy between banks in terms of total assets

when their logarithms values have taken. Since logarithms values minimize the variations in terms of total assets. The minimum and maximum values were 3.03 and 4.34 birr, respectively.

Over the study period, the average value of the growth variable as measured by the change in total assets was 25 percent. This means that on average, the banking industry assets were increased by 25 percent during the study period. The maximum value of growth was 59 percent and the minimum value was 4 percent, with a standard deviation of 12 percent.

The ratio of equity capital to total assets was a proxy of bank capital adequacy with mean value of 25 percent, which indicates that capital contribution by share holders to finance company's assets was low as compared to the debt. The maximum and minimum values were 87 percent and 2 percent with the standard deviation of 24 percent.

The mean value of the previous year's dividend was 50 percent. The maximum and minimum values were 1 percent and 5 percent respectively, with the standard deviation of 35 percent.

## 4.2. Correlation Analysis

Correlation matrix between study variables is presented in Table 4.2 below. As can be seen in Table 4.2, there were fairly low data correlations among the explanatory variables. These low correlation coefficients among explanatory variables show that there had not Multicollinearity in the regression model suggests substantial correlations among independent variables. This phenomenon introduces a problem because the estimates of the sample parameters become inefficient and entail large standard errors, which makes the coefficient values and signs unreliable. In addition, multiple independent variables with high correlation add no additional information to the model. It also conceals the real impact of each variable on the dependent variable (Anderson et al., 2008). Hair et al. (2006) argued that correlation coefficient below 0.9 may not cause serious multicollinearity problem. Also, Cooper and Schendlar (2009) suggested that a correlation above 0.8 should be corrected for. In addition, Malhotra(2007) stated that multicollinearity problems exists when the correlation coefficient among variables should be greater than 0.75. Lagged dividend payout is 0.8911 which indicates that the presence of multicollinearity problem which makes the estimated coefficients and the standard errors of the model biased and which needs further remedial action in the regression model next.

Table 4.2. Correlation Coefficients among study Variables

| | dpo | roa | liq | lev | bs | fg | capad |
|---|---|---|---|---|---|---|---|
| dpo | 1.0000 | | | | | | |
| roa | -0.0405 | 1.0000 | | | | | |
| liq | 0.5705 | 0.4301 | 1.0000 | | | | |
| lev | -0.0679 | 0.2443 | 0.3868 | 1.0000 | | | |
| bs | -0.0988 | 0.3366 | 0.2504 | 0.3424 | 1.0000 | | |
| fg | -0.0397 | -0.1039 | -0.0575 | -0.1227 | -0.6902 | 1.0000 | |
| capad | 0.5319 | -0.2817 | 0.6317 | 0.4526 | -0.0003 | -0.0027 | 1.0000 |
| ldpo | 0.8911 | -0.0341 | 0.5989 | -0.0850 | -0.1162 | 0.0206 | 0.5541 |

**Source:** STATA result for the study variables, 2015

## 4.3. Econometric Analysis

This section of the study presents the results and discussions of the regression /econometrics analysis. So far the study has established a framework of literature and data analysis including descriptive statistics and correlation analysis in order to investigate the determinants of bank dividend payout on sampled private banks in Ethiopia. To shed more light on the determinants of bank dividend payout linear panel data (analysis of cross sectional and time series) regression models have been run. Before running the regressions, the data sets were checked for certain tests.

## 4.3.1. Test of Normality

The normality of the data checked by using the kernel density estimate rule.

Table 4.3. The kernel density estimate for normality test
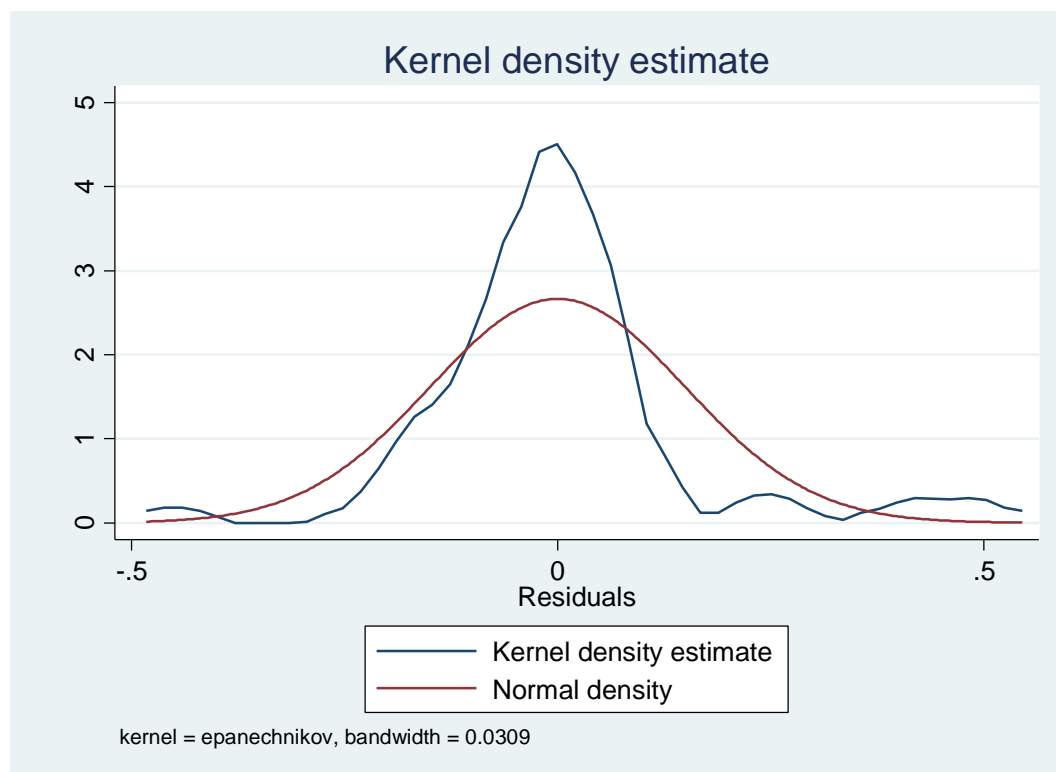


Source: Stata results from financial statements of sampled banks (2015)

The above graph shows that normality assumption holds and it implies that the inferences made about the population parameters from the sample parameters tend to be valid.

## 4.3.2 Test of Multicollinearity

Multicollinearity indicates a linear relationship between explanatory variables which may cause the regression model biased (Gujarati, 2003, pp 342). So as to examine the possible degree of multicollinearity among the explanatory variables, Variable Inflation Factor (VIF) technique was employed to detect the multicollinearity problem and strengthen the analysis. Besides to correlation analysis multicollinearity problem is also identified by Variable Inflation Factor

(VIF). Theoretically, a VIF greater than 10 may suggest that the concerned variable is multi collinear with others.

Multicollinearity between explanatory variables may result in the wrong signs, or implausible magnitudes, in the estimated model coefficients, and the bias of the standard errors of the coefficients. To avoid this problem, the Variance Inflation Factor (VIF) test was used. The results of this test are presented in next Table 4.4. The mean VIF was 4.29, which is much lower than the threshold of 10. The VIF for individual variables was also very low. This indicates that explanatory variables were not substantially correlated with each other.

Hence, the VIF's result in Table 4.4 below shows none of the VIFs is excessively high, suggests that there is no perfect or strong collinearity between the explanatory variables.

**Table 4.4. Variable Inflation Factor (VIF) Technique to detect Multicollinearity**

| Variable | VIF | 1/VIF |
|----------|------|----------|
| capad | 7.84 | 0.127516 |
| liq | 7.34 | 0.136182 |
| roa | 4.76 | 0.210078 |
| bs | 2.76 | 0.362885 |
| lev | 2.62 | 0.382314 |
| ldpo | 2.57 | 0.389818 |
| fg | 2.15 | 0.464610 |
| **Mean VIF** | 4.29 | |

**Source:** STATA result for study variables, 2015

### 4.3.3 Test of Heteroskedasticity

If the error terms do not have a constant variance, we say that the assumption of homoscedasticity has been violated. This violation is termed as heteroscedasticity. In this study, hettest test used to test for existence of heteroscedasticity across the range of explanatory variables.

Hettest; Breusch-Pagan/Cook-Weisberg test for heteroscedasticity

     Ho: Constant Variance

     Variables: Fitted values of dpo

        $Chi2\ (1)$      =    1.85

        $Prob > Chi2$   =   0.1742

*Source: Stata results from financial statements of sampled banks (2015)*

The Stata result of the above reveals that the absence of heteroscedasticity, we accept the null hypothesis, since the values were considerably greater than 0.05

All tests illustrated above were testimonials as to the employed model was not sensitive to the problems of violation of the CLRM assumption. Generally, the problem of heteroscedasticity and multicollinearity are not serious problems in panel data methodology since we can minimize their effect on the model in the fixed effects regression techniques.

## 4.4. Regression Results

There are two estimation models for panel data analysis, the Fixed Effect Model (FEM) and the Random Effect Model (REM) (Gujarati, 2004). The FEM assumes that the slope coefficient of the explanatory variables is all identical for all firms. The intercept in the regression model is allowed to differ among individual firms in recognition of the fact that each individual or cross-sectional unit may have some especial characteristics of its own. Fixed effect model (FEM) controls for all time invariant differences between the individuals; so the estimated coefficients of the model can't be biased because of omitted time invariant characteristics. Fixed effect models are designed to study the causes of change within a person or an entity.

The REM is sometimes known as the error component model (ECM). In REM, it is assumed that the intercept of an individual unit is a random drawing from a much larger population with a

constant mean value. The individual intercept is then expressed as a deviation from this constant mean value or the variation across entities is assumed to be random & uncorrelated with the independent variables included in the model. It solves the problem of fixed effect models by including time invariant variables.

The choice between fixed effect model over a random effect model or vice versa is based on the use of the Hausman test. The Hausman's test, a model specification test was employed for this study to decide the more appropriate model from the fixed effect model (FEM) and Random Effect Model (REM). The null hypothesis states that the unobserved effect (Random errors (Ui) are correlated with the explanatory variables. The result from Hausman test shows in favor of fixed effect model than random effect since the unobserved effect is correlated with the explanatory variables. The FE estimator is, therefore, more efficient than the RE estimator and hence the researcher would prefer to use it instead.

**Hausman test results for Fixed and Random Effects model**

```
Test:  Ho:  difference in coefficients not systematic

        chi2(7) = (b-B)'[(V_b-V_B)^(-1)](b-B)
              =        31.10
        Prob>chi2 =    0.0001
        (V_b-V_B is not positive definite)
```

*Source: Stata results from financial statements of sampled banks (2015)*

The Hausman test showed that the fixed effect method is the preferred regression technique. The Stata result in the above showed that the p-value for the test was less than 0.05(5%), which indicates that fixed effect method was more preferable than the random effect method. Accordingly, the fixed effect regression model was employed to estimate the relationships between the dependent and independent variables. Table 4.6 below shows the regression results between the dependent and independent variables. Mostly, researchers use the fixed effects model whenever they are only interested in analyzing the impact of explanatory variables over the outcome (dependent) variable that varies over time within each entity; since FE models are designed to study the causes of changes within an entity, and it explores the relationships between predictor and outcome variables within an entity. The fixed effects R-square within

estimator (*80.7%*) showed that the total variation in the outcome variable was explained by the predictor variables that vary across time within an entity (a bank or each bank) in the model. The F-statistics value (6.03) and the p-value of zero in the regression model attached to the test statistics implies that the null hypothesis that all of the coefficients are jointly zero should be rejected implying that the independent variables in the model were able to explain variations in the dependent variable. Since the prob > F is less than the level of significance (0.05), suggesting that the model is useful to determine the variation in the measure of dividend payout. This test (F) is to see whether the entire coefficient in the model is different than zero.

**Table 4. 5.  Regression result-Fixed Effect Model**

| dpo | Coef. | Std. Err. | t | P>t |
|---|---|---|---|---|
| _cons | 1.562615 | .5278033 | 2.96 | 0.005 |
| Roa | .0962738 | .0643662 | 1.50 | 0.001* |
| Liq | .3248623 | .1735892 | 1.87 | 0.068*** |
| Lev | .2099372 | .4022044 | 0.52 | 0.034* |
| Bs | -.2689763 | .1003209 | -2.68 | 0.010** |
| Fg | -.390819 | .2180089 | -1.79 | 0.079*** |
| capad | -.8663291 | .5264041 | -1.65 | 0.106 |
| ldpo | -.0875096 | .1832232 | -0.48 | 0.635 |

*No. of observations= 60*
*R-sq: within=0.8070=80.7%*
*F-statistic = 6.03 Prob > F = 0.000*
*\*, \*\*, \*\*\* indicates significant at 1%, 5% and 10% significant level respectively.*

*Source: Stata results from financial statements of sampled banks (2015)*

From the above table, profitability, liquidity and leverage had positive and statistically significant relationships with dividend payout. On the other hand, growth and Bank size were found to be negatively and significantly related with dividend payout. Lagged dividend payment and capital adequacy variables were found to be statistically insignificant.

## 4.5. Discussion of Results

This part of the chapter discusses some of the main implications of results. The analysis is based up on the regression results between the dependant and independents variables as depicted in table 4.5 above.

# Profitability

Based on the existing literature, this study hypothesized that profitable firms are more likely to pay dividend. As predicted, the result of this study shows profitability was statistically significant positive relationship with dividend payout at five and ten level of significance .this means that the profitable Ethiopian private banks with relatively stable earnings are often able to predict approximately what its future earnings will be and therefore are more likely to pay out a higher percentage of its earnings as dividends. This is related with the signaling theory of the dividend policy. Which means the more profitable the bank is, the higher the possibility to pay dividends.

The positive and significant relationship between profitability and dividends is well documented in financial literatures (Al-Malkawi (2007), Fama and French (2001), Amidu and Abor (2006), Jeong (2008), Moradi et al. (2012), Al-Kuwari (2009). A firm's profitability is considered to be an important factor that affects dividend payout. This is because profitable firms are willing to pay higher amounts of dividends and hence appositive relationship is established between firm's profitability and its dividend payments.

Tewodros in 2011 conducted his study on the determinants of dividend payout in Ethiopian private commercial banks and found that profitability was not statistically significant; suggesting that industry profitability effect seem to have no influence on the payment of dividends and Tewodros's study was inconsistent with the previous studies which supported the positive and

significant association between firm profitability and dividend payout. However, a year later in 2012, Muhammed carried out a study on the determinants of dividend policy of Insurances companies in Ethiopia and concluded that dividend decisions are relevant and profitability was statistically significant factor which positively influences dividend policy of insurance companies in Ethiopia.

## Liquidity

In table 4.5, the results indicates that a positive and statistically significant relationship between liquidity and dividend payout at ten percent significance level. The result of this study reveals that, a good liquidity position increases banks' ability to pay dividends. Generally, banks with good and stable cash flows are able to pay dividends as compared to banks with unstable cash flow position. This positive association between liquidity and dividend is supported by prior studies, and agency costs in conjunction with free cash flow hypothesis. According to Amidu and Abor (2006), cash dividend distribution does not only depends on the profitability of firms but also depends on the free cash flow which is the amount of operating cash flow left over after the payment for capital expenditures. The results of this study indicate a significantly positive relationship between cash flow and dividend payout and thus the liquidity or cash-flow position can be considered as an important determinant of the dividend payout.

Chay and Suh (2005) also consider cash flow as a determinant of dividend payments where firms facing high levels of cash flow uncertainty are likely to pay low dividends fearing cash shortfalls in the future. It related to Brav et al. (2004) and, in their research report; they stated that more than two-third of Chief Financial Officers of dividend-paying firms stated that stability of future cash flow is an important factor affecting dividend payout decisions. Olowe and Moyosore (2011), Gupta and Banga (2010), Ahmed and Javid (2009), Musa (2009), Hellstrom and Inagambaev (2012) revealed in their studies a positive and significant relationship between firm's liquidity and dividend payout.

And also Alam and Hossain (2012), Yiadom and Agyei (2011) and Franklin and Muthusamy (2010) stated the negative and significant influence of liquidity on dividend payment of companies. In Ethiopia, Tewodros (2011) show that liquidity has negative and significant effect on banks dividend payment. Muhammed (2012) also conducted his study regarding the

determinants of dividend policy of Ethiopian insurance companies and found positive and significant effect on dividend payout. Thus, the result of this study supports the positive and significant association between liquidity and dividend payout.

**Bank Growth**

It expected that firms with high growth or investment opportunities tend to retain their current earnings to finance their investment, thus paying less or no dividends. The result of this study shows a negative and significant relationship between bank growth and dividend payout at ten percent level of significance. This indicates that, the growths of private banks require more funds in order to finance their growth and therefore would typically retain greater proportion of their earnings by paying low dividends. This means that private banks with high investment opportunities pay lower dividend.

This is supported by the findings of Hellstrom and Inagambaev (2012), Olowe and Moyosore (2011), Lloyd et.al. (1985), Gaydevi and Mallik (2013), Amidu and Abor (2006), Jeong (2008), and the overall literature portrays a negative and significant relationship between the dividend payout and firm growth.

In Ethiopia, Muhammed (2012) found that the relationship between growth and dividend policy was negative and significant at five percent level of significance. He stated that this is indicative of the fact that, growing insurance companies require more funds in order to finance their growth and therefore would typically retain greater proportion of their earnings by paying low dividends. Tewodros (2011) on the other hand, stated at the conclusion that there was no relationship between banks growth and the dividend payout. Tewodros's finding was inconsistent with previous empirical studies which documented that growth opportunities are significant determinants of corporate dividend payout ratio. Unlike Tewodros, the results of this study support the negative and significant relationship between bank growth and dividend payout, and it is related with the pecking order theory of dividends.

**Leverage**

A number of previous studies reported that there is a negative and statistically significant relationship between leverage and dividend payout. Al-Malkawi (2007); Al-Kuwari (2009); Hellstrom and Inagambaev (2012); Amidu (2007) argued that a firm's leverage is a key factor for explaining firm's decision to distribute dividends to shareholders. They found that there is a negative association between firm's leverage and payout.

For this study, leverage had a positive and statistically significant association with dividend payout, and a positive relation between leverage and dividend payout is related with the findings of Yiadom & Agyei (2011), Kapoor (2009) and Baker .According to Baker and Powel (2001), and Karam and Goyal (2007), debt –equity ratio has a positive and statistically significant relationship with the dividend payment. According to their findings, while the firms with high payout ratios tend to be debt financed, firms with low payout ratios tend to be equity financed.

In Ethiopia, Muhammed (2012) showed in his conclusion that leverage is insignificant in influencing the dividend policy of insurance companies in Ethiopia. Tewodros (2011) also reported that leverage was not found to be one of the determinants of dividend payments in Ethiopian private banks.

The finding of this study shows that the level of debt held by a bank positively influences their dividend payout decisions. Contrary to this expectation debt increases the profitability of firms and also debt reduces the agency cost; higher debt is much more likely to indirectly allow banks to pay more dividends from the enhanced earnings. But this is contrary to some earlier studies which stated that firms that are highly leveraged tend to pay lower dividends because they retain most of their earnings to payoff future debt obligations. In other hand, if there is an increase in leverage, the banks will tend to pay higher dividends to shareholders since they are getting external funds for the business and there will be a surplus of internal funds for dividend distribution to shareholders.

**Previous year's dividends**

In table 4.5, the result of this study indicates that last year's dividend payout was negative relationship as predicted and statistically insignificant with current year's dividend payout. The insignificant result implies that current year's dividend payment was not influenced by the dividend that was paid last year or a bank's dividend payment last year has no influence on the payment of dividend in the current year. Thus, no support was found for the previous research findings which showed the negative and insignificant association between last year's dividend and current year dividend payment. Therefore, this implies that Ethiopian private banks have declared and paid annual dividends, and to maintain the stability of dividend payout based on current earnings without too much depends on the payment and variation of last year's dividends.

**Bank Size**

In table 4.5, the result of this study indicates that bank size was negative relationship and statistically significant with current year's dividend payout. Logarithms of total assets (LOGTA) were incorporated so as to measure the elasticity of LOGTA. The result exhibited a negative magnitude and significant at the five percent level. This indicates that the relation of LOGTA and dividend payout might be non-linear due to possible bureaucratic bottlenecks and managerial inefficiencies suffered by banks as they become "too large". Therefore, the positive effect of bank size goes up to certain limit beyond that the size variable would shows negative results.

Firm size is a statistically significant determinant of the dividend policy consistent with the findings of Fama and French (2001) that the probability of paying dividends increases with firm size. Larger firms pay higher cash dividends for several reasons. Large firms face high agency costs as a result of ownership dispersion (Rozeff, 1992). As a result of the weak control in monitoring the management in large firms, a large dividend payout increases the need for external financing, which in turn leads to the increased monitoring of these firms by the creditors. Large firms have easier access to capital markets, and they are able to raise funds with lower issuance costs for external financing (Lloyd et al., 1985; Fama & French, 2002). Consequently, large firms are better able to distribute higher dividends to shareholders than small firms.

In Ethiopia, Tewodros (2011) decides on his finding large firms have better access to raise fund and distribute dividend to shareholders better than smaller firms.

**Table 4.6. Comparison of the test result with the expectation**

| Independent variables | Expected relationships with DPO | Actual results | Statistical significant test | Hypothesis accepted or rejected |
|---|---|---|---|---|
| Profitability | + | + | significant | Accepted |
| Liquidity | + | + | significant | Accepted |
| Growth | - | - | significant | Accepted |
| Bank size | + | - | significant | Accepted |
| Leverage | - | + | significant | Accepted |
| Capital | + | - | insignificant | Rejected |
| Previous year's dividends | + | - | insignificant | Rejected |

# CHAPTER FIVE
# CONCLUSION AND RECOMMENDATION

## 5.1. Summary

Dividend is the main issue in business that addressed in modern economy .It is the concern of any business and shareholders of the company how much and when dividend distributed to their members. The main purpose of the study was to examine the relationship between dividend payout and certain bank selected factors.

The main purpose of this study was to investigate factors affecting corporate dividend payout decisions of financial firms, particularly private commercial banks in Ethiopia. In order to achieve this objective, nine literature driven hypotheses have been developed .To test these hypotheses and to achieve the broad objective of this study, the study used the deductive research approach and quantitative research method, with the adoption of co relational research design. More specifically, the analysis was performed using panel dataset acquired from audited financial statements of the selected Ethiopian private commercial banks for the period 2005 to 2014. Six private commercial banks were selected as sample from sixteen private banks currently in operation in Ethiopia. The fixed effect model was used to estimate the regression equation. In this study, profitability, liquidity, growth, lagged dividend, size, leverage and capital were considered as independent variables while dividend payout was considered as dependent variable.

## 5.2. Conclusion

The result of the regression analysis for this study showed that positive and significant relationship between dividend payout with profitability, liquidity and leverage.

The results suggested profitable private banks tend to pay higher dividends and support was found for the signaling theory. The positive and significant association between liquidity and dividend payout indicates that a good liquidity position increases banks ability to pay dividends and the result supports the agency cost theory and free cash flow hypothesis. Again, a positive and significant relationship between leverage and dividend payout implies that, probably debt increases the profitability of firms and also debt reduces the agency cost; higher debt is much more likely to indirectly allow banks to pay more dividends from their enhanced earnings. Firm

size statistically significance, it indicated that the firms to pay more dividends when firm size were large; this supports agency cost theory were divided are used as a tool to agency conflict, it also implies large firms have better access to raise fund and distribute dividend to shareholders better than smaller firms.

The results also showed that significant and negative association between growth and dividend payout. The result portrays that, growing banks require more funds in order to finance their growth and therefore they would typically retain greater proportion of their earnings by paying low dividends. Contrary to the theoretical prediction, the result found that capital and lagged dividend payment were insignificant in influencing the dividend payout decision of private banks in Ethiopia.

More to the point, the result suggested that more profitable, high liquid and more levered private banks coupled with strong external control by share holders tend to pay more dividends, while private banks with high growth opportunities together with the need to increase the capital amount inclined to pay lower dividends. Also the study clearly determined that profitability, liquidity, growth, leverage and size were among the major determinants of dividend payout decisions of private commercial banks in Ethiopia.

In overall, the results suggest that dividend does matter. If this is correct, banks cannot decide dividend payout without taking consideration the integral part of business strategies including both financial and investment decisions since dynamic and characteristic change in banks may require the bank to change its dividend payout if they want to maximize value for shareholders.

## 5.2. Recommendations

Based on the above findings and conclusions the study forwarded the following possible recommendations.

- Ethiopian private commercial banks managers and Board of Directors (BODs) should give special consideration to the major bank dividend determinants of profitability, liquidity, growth, leverage and size when they fix their dividend policy since these variables are found to be the most significant variables that affect dividend payout decisions of banks in Ethiopia. This in turn helps them to make their dividend payout decisions efficient, effective and flexible which, in the long run will help them to achieve their objective (maximizing shareholders value) and to satisfy employees and anyone who have stake in banks.

- Knowing factors affecting the corporate dividend payout decisions has significant implications on individual investor's investment avenues depending on his or her dividend preference. Since, in the absence of secondary market and well developed financial systems, searching and brokerage costs are high, it is difficult for an individual investor to shift easily and construct his or her own investment portfolio by buying and /or selling existing stocks. Besides, investors who want to select the paying dividend banks might have to look in to the major mentioned factors before selecting the private banks.

- Private Banks registered under NBE and are paying dividends continuously should take into account agency costs and firm's reputation, more than transaction costs. Since the result of this study indicated that dividend payout decision is a relevant decision and serves as an instrument to reduce agency. In addition, banks used dividends as a device to signal information to the market to maintain their good public image (reputation) as relatively high quality banks basically may pay dividends to signal the quality to the market.

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