Effect of Dividend Policy on Profitability of Firm – An Empirical Study of Indian Banking Sector

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ABSTRACT - The main aim of the present study is to investigate the effect of dividend policy on profitability of Indian banking sector. The study includes Top 11 Indian banks on the basis of market capitalisation in Indian banking industry. Dividend policy was measured by the variables dividend payout ratio and dividend per share whereas Return on Equity was used as a proxy of profitability. The data of 21 years from 1996 to 2017 was taken for the study. Linear regression model was applied to achieve the objective by devising SPSS. The findings of the study conclude a significant positive relationship between dividend policy variables and profitability of banking sector. The results provides valuable insights for the companies other than banking sectors also.

Keyword – Return on Equity, Dividend Payout Ratio, linear Regression, Indian Banking Sector

I. INTRODUCTION

In today's hypercompetitive and fragile business environment, shareholders play a cardinal role in the organization. Shareholders inject their hard earned money into their target investment venture with an expectation that their investment will burn bright. On the same lines of thought, the prime motive of any business remains to reinforce the value of shareholders' wealth. Azhagaiah and Priya (2008) observed the significant influence of sales growth, increase in profit margin on shareholder's wealth. In this context, Baker and Powell (1999) examined that dividend policy is one of the major strategic management decisions that managers have to take. Dividends are the part of corporate earnings which are distributed among shareholders as a compensation for their investment in the company. Dividend policy is about to make crucial decision about the amount of dividend and the mechanism of distributing the dividend among shareholders. The most curious question about dividend policy is whether the company should pay the dividend or not. Researchers already have examined the consequences of paying and not paying the dividends to shareholders. Many answers have been developed for this question still the canvas is blurred. Mizuno (2007) examined the reason behind paying dividends is of lack of suitable investment venture for the companies for reaping high return more than the required rate of return (expectations of the shareholders). The effect of dividends on the profitability of companies has gripped the attention of many financial analysts. Many researchers opine that dividends provide the stability to the cash flow of firm. Dhanani (2005) conducted a survey to grip theopine and attitude of the corporate managers about the dividend policy of firm. He observed that dividend policy of firm helps in enhancing the market value of firm. The opinion of researcher's depicts different scenario about dividend policy and its short term and long term effect of firm performance. The present paper makes a sincere attempt to measure the effect of dividend policy of commercial banks on their profitability. Some researchers made efforts in this context but their studies remained confined to non financial sectors. The present paper provides an opportunity to explore the effect of dividend policy on the banking sector in India.

The rest of the paper is organized as following sections: The subsequent section provides a detailed overview of the previous research studies in this area. Section Three discuss the research methodology and empirical data analysis part of research paper. The next section (section four) deals with the findings and implications of the results of the study.

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II. REVIEW OF LITERATURE

In the previous studies, many researchers took their stand on different aspects of profitability and dividend policy. The following section is an attempt to present their views in this context.

Brigham (1995) observed a significant effect of dividend policy on the profitability of firm. Farsio et al. (2004) found the non existence of significant relationship between dividends and corporate earnings for long run and find a positive relationship for short term. Amidu (2007) noticed a positive effect of dividend decisions of firm on the profitability of firm. He used Return on Assets as a proxy of profitability of firm. The study found a positive significant relationship between Return on Assets, Return on Equity and Dividend Policy of firm. Howatt et al. (2009) concluded a positive relationship between the future dividends and future real earnings per share. Gordon (1963) noticed an inverse relationship between dividend payout ratio and return on equity. He identified that with increase in dividend payout ratio the required return on equity decrease as shareholders are not ensure about the capital gain. Miller and Modigliani (1961) observed that the value of business does not influence by the dividend decisions of the firms as the value of firm depends upon the risk in the associated business and its earning capacity. Nissim and Ziv (2001) stressed upon significant positive relationship between current dividend and future earnings. Black & Scholes (1974) emphasized on the non significant effect on the share price of firm with increase in dividend per share. The change in stock price may be on temporary basis but it can't be seen long term effect. Fairchild, Guney and Thanatawee (2014) asserted on the positive effect of dividend policy on the financial performance of firm i.e. Retrun on Assets. The study indicates a significant and positive relationship between dividend policy and sales growth and return on equity. Liew (2013) documented that an increase in dividend bring a positive change in future earnings per share of the company. Booth and Zhou (2015) examined the relationship between the profitability of companies and their dividend pay-out ratio. The study conducted on the sample of companies that were listed in the Nairobi Securities Exchange during a period 2002 to 2010. They applied linear regression analysis and suggest a positive significant relationship between dividend payout ratio and profitability of firm. The empirical results suggest that positive dividend payout ratio can be considered as major influencing factor for the profitability of firm. That further confirms the direct relationship between these two variables. Ahmad and Wardani (2014) determined a positive relationship between dividend policy and earnings per share. Renneboog and Szilagyi, (2015) observed a positive influence of dividend policy on debt in their study conducted on the firms under financial distress.

After minutely scrutinize the above research studies, it was observed that rare studies have been conducted on banking sector in India. The present study tries to bridge this gap and examine the effect of dividend policy on the profitability of Indian banking Industry.

III. RESEARCH METHODOLOGY

3.1 Research Objective

The following research objective was established for the present study:

- To measure the effect of dividend policy on profitability of banks

3.2 Hypothesis

The following Null hypothesis and Alternative hypothesis were developed to achieve the objective of study:

- H_0: Dividend policy has positive significant effect on profitability on banks
- H_1: Dividend Policy does not have positive significant effect on Profitability on banks

3.3 Sample Frame

Top 11 Indian banks (Public and Private Sector Banks) were selected on the basis of market capitalization in Indian banking industry. The data was collected from the Capitaline database.

3.4 Time Frame

The historical annual secondary financial data has been collected of FY from 1997 to 2017.

3.5 Research Variables

Dependent Variable – Profitability of Banks was taken as the dependent variable in the present research study. Return on Equity (ROE) was taken as proxy for the profitability of banks.

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3.5.1 Independent Variables

Dividend Payout Ratio = It shows the percentage of earnings per share that company distribute among shareholders.

$$\text{Dividend Payout Ratio} = \frac{\text{Dividend per Share}}{\text{Earnings per Share}}$$

Dividend per Share

3.6 Statistical Tools

Linear regression model was applied to measure the effect of dividend policy on profitability of firms. SPSS was devised to perform the linear regression model.

Variance Inflation Factor (VIF) was applied to measure the multi collinearity among independent variables. The VIF values lower than 10 indicates the non existence of multi collinearity among independent variables and indicate that data is reliable for study.

IV. Data Analysis

The following section indicates the statistical results and interprets their significance in context of the present study

Table – I Collinearity Analysis

Variables	Tolerance	VIF
Dividend Payout Ratio	0.998	1.02
Dividend Per Share	0.943	1.06

Source: SPSS Output

The above table - I depicts the statistics related to the collinearity among the independent variables. As the VIF values for both the independent variables (Dividend Payout ratio – 1.02 and Dividend per Share – 1.06) lies below 10. It confirms the non existence of collinearity among the independent variable. It was also further cemented by the tolerance value as tolerance value for both the variables lies above 0.01.

Table – II Regression Statistics

Statistics	Value
R	0.804
R- Square	0.648
F- Value	4.474
Sig.	0.013
Durbin Watson	1.895

Source: SPSS Output

The statistics output in the above table –II depicts the regression statistics of the research data. The R- square value (0.648) indicates that 64.8 percent of variation in the profitability (ROE) shows regression model is fit. The significant value (0.013) is lower than 0.05 that indicates the model is fit. The value of Durbin Watson test (1.895) lies between 1.5 and 2.5 that confirms the non existence of auto correlation among the independent variable.

Table III - Regression Model

Statistics	Unstandardised Coefficient		Standardised Coefficient	t	Sig,
	B	Std. Error	Beta		
Constant	11.986	1.428		8.396	0.000
Dividend Payout ratio	0.110	0.062	0.122	1.794	0.047*
Dividend Per Share	0.186	0.080	0.158	2.319	0.021*

**Dependent Variable – ROE*

The above statistics propose the regression model for the given data. The significant value of both the variables (Dividend Payout Ratio – 0.047 and Dividend Per Share – 0.021) is lower than 0.05. It signifies that independent variables have significant effect of dependent variable.

Regression Equation

Firm Value (ROE) = 0.110* Dividend Payout Ratio + 0.021*Dividend Per Share

V. Findings

The above statistics observed a positive relationship between dividend policy and firm value. The proxies of dividend policy (dividend payout ratio and dividend per share) have significant impact on valuation of firm.

VI. Conclusion and Implications

Dividend Policy and Profitability of firms has gained the attention of researchers across the globe. The present paper is an attempt to explore the effect of dividend policy on the profitability of banks in India. The study gives insightful findings that may help the future researchers as guidelines in conducting their study in Indian context. The study concludes that Dividend per Share and Dividend Payout Ratio as a measure of dividend policy have significant

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effect on Return on equity that is used as proxy of profitability in banks. The findings of study does not remain confined to only banking sector, it can be implemented on other sectors also.

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