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Perception of Investors with Respect to Payment of Dividends

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ABSTRACT

This paper analyzes the perception of investors with respect to the payment of dividends using online survey. The questionnaire was sent to 10,000 recipients using email for collecting data. The total responses obtained were 79 with a response rate of 0.79 percent. Results from the survey show that majority of the investors agree that bonus issue is a substitute for the dividend, companies should have a target dividend payout and adjust it yearly towards the target, and reasons for changing dividend policy should be disclosed to shareholders. The investors disagree that a company announcing a high dividend despite a drop in profit signals positive information about the stock, and growth companies need not pay dividends. The investors were indifferent that high dividend reflects high growth prospect, non-payment of dividends despite good profitability reflect poor financial judgement, and higher dividend payout pushes the price of the stock.

1. INTRODUCTION

Dividends to equity shareholders are paid from out of profits of the company after paying preference dividends to preference shareholders. Management decides to give dividends based on the profits generated by the company, future plans, and current market situation. Management may declare a high payout when the company has shown high growth in earnings per share. Others could cut the pay-out when prospects of the company look bright. Some shareholders could view an issue of bonus shares as a substitute of payments of dividends. Against the backdrop of all these perceptions is the classical signaling theory of dividends payment which reflects that a manager interested in maximizing the wealth of the shareholders would make a lower pay-out when the prospects for the company look appealing.

Dividend to be declared by the company is decided by the board of directors. The question is would the quantum of dividend declare matter in so far as reflecting the confidence of the shareholders in the stock is concerned. This confidence is reflected in terms of discounting factor employed by the market as such as is traditionally known as price-earnings ratio. It is this ratio that the company would strive to maintain and improve to maximise the wealth of the shareholders. It is evident that an increase in earnings per share coupled with a higher price earnings ratio could boost stock values maximising the wealth of the shareholders in the process. Sometimes notwithstanding a lower pay-out stock price could move recognising higher earnings at other times a cut in payout could drive the prices down. It is this enigma that this research paper strives to answer why.

2. LITERATURE REVIEW

One of the pioneering works in the field of Dividends theory was performed by Lintner (1956). He found that dividends do not change with the increase in earnings. Managers are reluctant to increase the dividend unless and until they are confident that the same dividend payout will be maintained in future. Results also show that long-term sustainable earnings are tied to the level of dividends, and dividends increase slowly and gradually towards long term pay-out ratio.

Ross (1977) gave dividend signaling hypothesis which states that companies with the help of announcement of dividend pay-out signal its investors about positive or negative future prospects of the company. The increase in dividend payout signals positive future aspects while a decrease in dividend payout portrays a negative future performance by the company. Managers having great investment potential usually use the help of this to signal its investors.

Pettit (1972) was the first to investigate the efficiency of market reaction which comes from dividends announcements. The reaction of the market after the dividend announcements was tested by investigating abnormal returns around dividend change release dates. On the similar lines, Charest (1978) documented the risk and return behaviour of ordinary shares following dividends announcements in NYSE for the period 1947 to 1967. Using large unexpected dividend changes, he showed a 5.37 percent positive abnormal return over twelve months after the changes for the dividend increase group, and a –12.9 percent negative abnormal price adjustment over the same period for the dividend decrease group. He also mentioned that the NYSE fails to adjust fully to dividend information within a reasonable period. Furthermore, his findings revealed abnormal return equals to 1%.

Walter (1956) (Walter's model) on dividend policy believes in the relevance concept of a dividend. As Per this concept, a dividend decision of the company affects its valuation. Higher the dividends the companies pay have more value as compared to the companies that pay lower dividends or companies that do not pay the dividend at all. Firms whose internal rate of return is greater cost of capital indicates that there are high growth prospects in the company and the company has many opportunities to invest. In this case, it would be maximising the value of shareholders only if it retains its entire earnings. In another case, if the internal rate of return is less as compared to it cost of capital, then by distributing entire earnings as dividends, the company would be maximising its shareholder value.

It is suggested that dividends at a greater distant should be discounted at a higher rate than the near dividends. As per this theory, among the two companies given the one paying larger dividend will attract the higher price than the other, even though they hold the same position in general and same power to earn. It is also said that investors prefer near dividends as compared to future dividends as investors tend to avoid risk.

John and Kalay (1982) state that companies having more amounts of borrowed funds in their capital should pay less dividends. The lenders to the company would otherwise believe that company is maximising the wealth of the shareholders at the cost of lenders. It is the lenders who view that companies should pay less earnings as dividends as it would directly increase the wealth of the company and give more security to the shareholders.

Modigliani Miller dividend irrelevance proposition states that payout policy is irrelevant when it comes to firm's value in complete capital markets. The market value of a firm depends on the power of a firm to earn and the risk involved in the underlying assets. It also states that it is independent of the way a company finance its investments or distributes dividends. As any amounts of funds could be raised externally, the advantage it receives is neutralize by external financing (Miller and Modigliani 1961).

Dividends may resolve uncertainty in the minds of investors and, therefore, they prefer dividends and capital gains. Mansor and Subramaniam (1992) conducted a study to examine the effect of dividends and earnings announcements on share prices using a weekly data. The subsample was created where they looked at dividend increases, dividend decreases, earning increases, and earning decreases. In this research they found that dividend and earning increase is associated with positive effects whereas dividend and earning decrease lead to negative reactions. Then they created a new sample by further categorizing the original sample into four sub-sample: dividends and earning increase; dividend and earning decrease dividend increase but earning decrease; and dividend decrease but earning increase. From these new subsamples, they found that none of the abnormal returns provide a significant effect when dividend and earning changes are in opposite direction.

Grullon and Michaely (2002) find that firms in the US finance repurchases with funds that would otherwise have been used to increase dividends. The research what they did supports the hypothesis that firms substitute dividends towards repurchases. This paper examines the relation between share repurchases and dividend changes in a dividend imputation tax environment, where dividends are not as tax disadvantaged about capital gains as they are in a classical tax system such as the US. They show that share repurchases in the US grew at an average rate of 26.1% over the period 1980 – 2000 and surpassed ordinary dividends in the dollar value of cash distributed to shareholders from 1999 onwards.

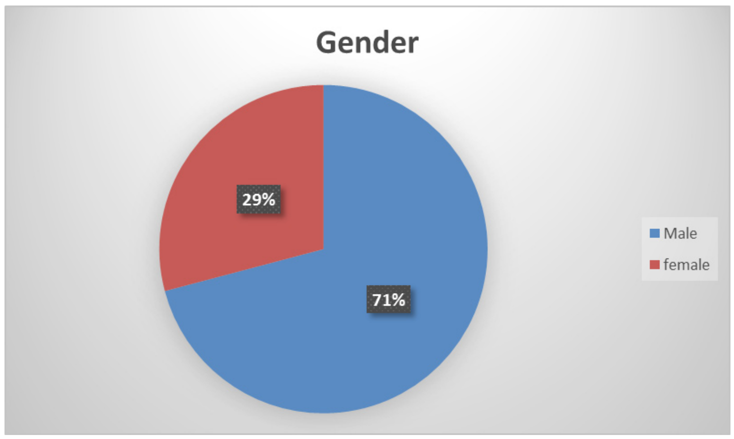
Guo (2013) attempts to substantiate empirical evidence on the topic of dividend pay-out policy with a focus on its interaction with ownership structure and stock market abnormal return and subsequent earnings growth in the Chinese market. Influence of the ultimate controlling shareholders, including their types and control rights, on the cash dividend payout announcement, using a sample of 1,200 Chinese listed firms. Results show that cash dividend policy is related to ownership structure in the Chinese market. Specifically, the level of the ultimate controlling shareholders' control rights, defined as the aggregate direct and indirect shareholdings, is positively correlated with the likelihood and magnitude of the cash dividend payout.

3. DATA AND METHODOLOGY

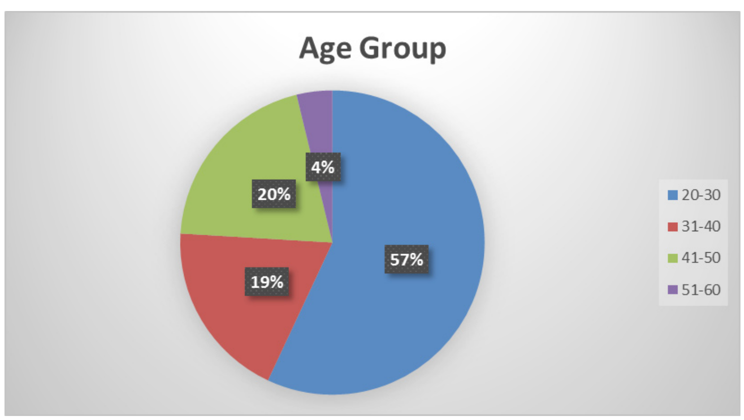
In the present research work, survey methodology was used to collect the primary data from investors to understand their perception on dividend announcements. We prepared a questionnaire based on the various theories given by previous researchers on the distribution of dividends. We sent the mail to ten thousand recipients and obtained 79 surveys with a response rate of 0.79 percent. The emails were sent to highly net worth individuals who invest in stock market. We have also used the Likert scale in our questionnaire to identify their level of agreeableness ranging from 1 to 5 (1 being highly disagreed and 5 being highly agreed).

4. RESULTS

The results obtained from the 79 filled questionnaires are provided in the subsequent section. The graph below gives the information about the gender ratio for the recipients. The data was collected from 23 females (29 percent) and 56 Males (71 percent).



The pie chart below provides the information about the age groups of the investors. We can see that the majority of the investors are young (57 percent) and falls in the age group between 20 and 30 years. Nearly equal (20 percent each) responses were obtained from the investors between the age group 31 to 40 years and 41 to 50 years. Least number of responses (4 percent) are obtained from the age group 52 to 60 years.



In the following paragraphs, we will describe the results obtained for the questions specifically target to the investors related to dividends announcements. The bar chart 1 provides the response to the question, “Does high dividend percentage reflect higher growth prospects?”. The results show that majority of the investors are indifferent on the higher growth prospect for the future. Bar chart also indicates that a significant number of investor supports the fact and a nearly equally number of investors disagree that high dividend percentage reflect higher growth prospects.

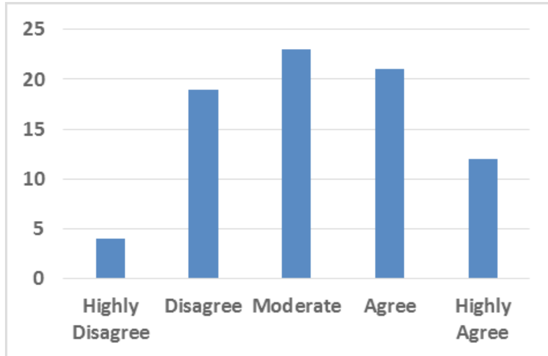


Chart 1: Response to the question "Does high dividend percentage reflect higher growth prospects?"

The bar chart 2 below provides the response to the question, "Does non-payment of dividends despite good profitability reflects poor financial judgement on the part of company's management?". Results show that investors are indifferent and a majority of them disagree on the aspect that non-payment of dividends despite good profitability reflects poor financial judgement on the part of company's management.

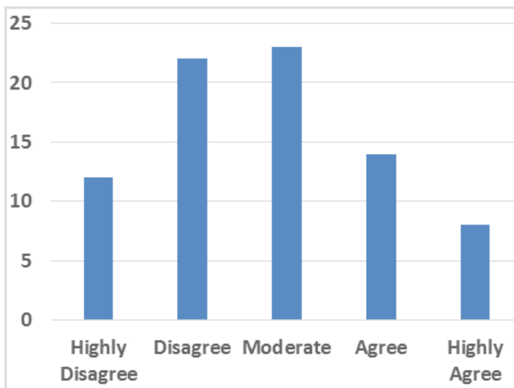


Chart 2: Response to the question "Does non-payment of dividends despite good profitability reflects poor financial judgement on the part of company's management?"

The bar chart 3 below provides the response to the question, "Is a bonus issue of equity, in your opinion, a substitute for dividends?". The results show that majority of the investors agree that a bonus issue is a substitute for dividends. It may be due to the fact that the price of the stock is equally affected by the announcement of both the dividends as well as when the bonus issue.

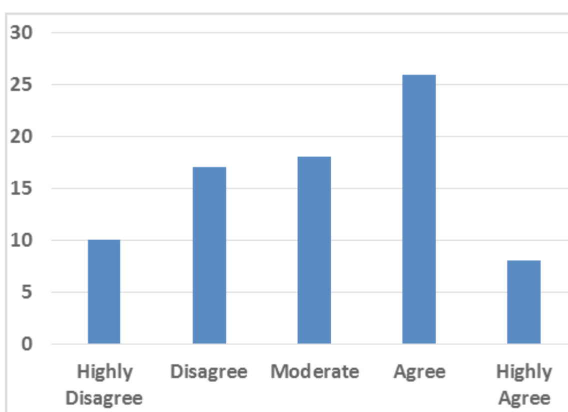


Chart 3: Response to the question "Is a bonus issue of equity, in your opinion, a substitute for dividends?"

The bar chart 4 below provides the response to the question, "Growth companies need not pay dividends?". A large number of investors disagree on the belief that growth companies may be exempted from giving the payments. It may be due to the fact that investors love a continuous income and belief that dividend announcements are positively related to the growth prospect of the company.

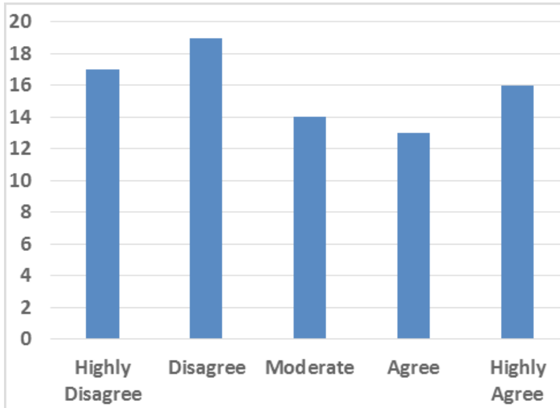


Chart 4: Response to the question "Growth companies need not pay dividends?

The bar chart 5 below provides the response to the question, "A company should have a target dividend pay-out and adjust it yearly towards the target, depending on its performance". The results show that majority of the investors favour the target dividend payout policy by the companies. Investors are happy to know about the dividends well in advance and believe that the target dividend may be adjusted for the next year depending on the financial performance of the company.

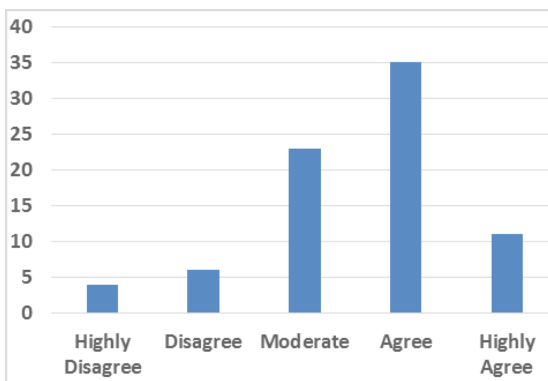


Chart 5: Response to the question "A company should have a target dividend pay-out and adjust it yearly towards the target, depending on its performance?"

The bar chart 6 below provides the response to the question, "Higher dividend payout pushes the price of the stock". The results show that majority of the investors believe that a high dividend payout increases the price of the share. Generally, as the dividends are announced the share price decreases. We feel that majority of the investors believe that high dividends are a reflection of high profits and better future growth potential; therefore, they believe that high dividend payout pushes the stock price.

The bar chart 7 below provides the response to the question, "Should the reasons for changing dividend policy be disclosed to the investors". The results show that investors prefer to be informed about the changes in the dividend policy of the company. We believe that investors must be communicated about such changes for proper corporate governance in the company.

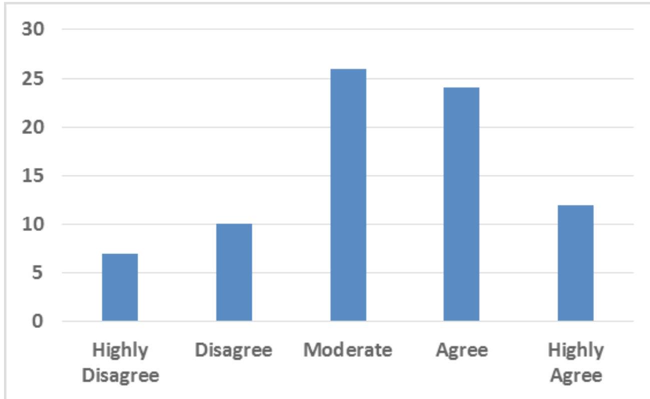


Chart 6: Response to the question "Higher dividend payout pushes the price of the stock".

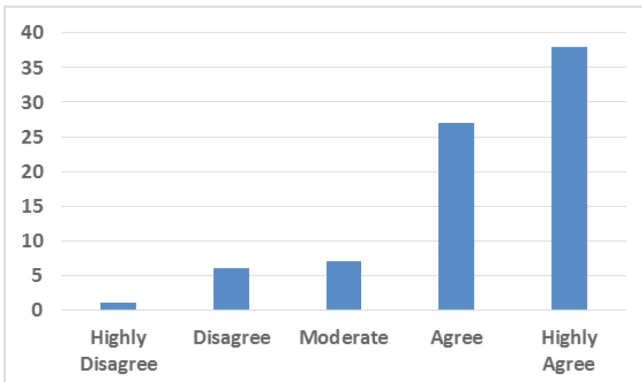


Chart 7: Response to the question "Should the reasons for changing dividend policy be disclosed to the investors?"

The bar chart 8 below provides the response to the question, "A company announcing a high dividend despite a drop-in profit signals positive information about the stock". The results show that majority of the investors believe that high dividends are announced when high profits are generated by the company. Both, high profits and high dividends reflect the growth future potential of the company. But if the high dividends are not accompanied by the high profits the beliefs of the investor's changes. Investors don't prefer high dividend announcement along with reducing profits.

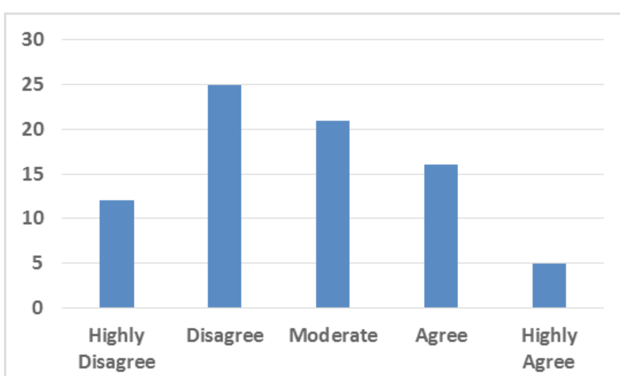


Chart 8: Response to the question "A company announcing a high dividend despite a drop-in profit signals positive information about the stock"

The table presented below provides a brief summary of the various propositions given by researchers along with the explanation and the question number in the questionnaire that pertains to the specific proposition.

Proposition	*Explanation*	*Question that pertains to the following explanation in the questionnaire.*
Lintner's Model – Lintner (1956)	Dividends increase not with increase in earnings.	Question 4
	Dividends increases with increase in sustainable earnings.	Question 4
	Dividends increase slowly and gradually toward the organisation goal.	Question 5
Dividend Signalling Hypothesis-Ross (1977)	Companies use dividend pay-out to signal information about the company to its investors.	Question 1
Dividend Irrelevance Theorem-Modigliani & Modigliani (1961)	Dividend pay-out doesn't affect the firms value in a complete capital market.	Question 6, Question 2
Walter's Model- Walter (1956)	Growth companies should not pay dividends whereas non-growth companies should pay dividend in order to maximise its value.	Question 8
Gordan model- Gordon (1962)	Investors prefer near dividend than distant dividend in order to avoid risk.	
Dividend Substitution Hypothesis-Grullon and Michaely (2002)	Firms use dividends for repurchase rather than to increase dividends.	Question 3

5. CONCLUSIONS

A survey was conducted to understand how investors perceive the dividend announcements. The results show that the investors have a mixed view about the dividends as a signal about the future prospects of the company. Investor view dividends as an important signal about future prospects of the company but not depends solely on dividends as the mode of information. They are neutral with respect to the Dividend signalling hypothesis as investors find payment or non-payment of dividend indifferent in determining the strength of the management. Investors prefer dividends from growth companies (Walter's Model). Investors are in support of Lintner's model. They believe that dividends should not be increased seeing an inconsistent pattern of dividends payment. Investors believe that dividends can be substituted with bonus issue. Bonus issue can be seen as an alternative for dividends (Dividend substitution hypothesis). Information about change in dividend policy should be disclosed to shareholders such that transparency is maintained and information does not remain confined with the management and board of directors. Investors view about high dividend payout and increase in stock price may not be true in every case, for some situation it might increase and for some it might not.

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Appendix 1
Questionnaire

- Name:
- Age:
  - 20-30
  - 31-40
  - 41-50
  - 51-60
  - 60+
- Gender:
- Current Position:
- Highest Qualification:
- Contact Number:
- Email ID:
- Does high dividend percentage reflect higher growth prospects?

Highly Disagree	*Disagree*	*Moderate*	*Agree*	*Highly Agree*

- Does non-payment of dividend despite good profitability reflect poor financial judgement on the part of company's management?

Highly Disagree	*Disagree*	*Moderate*	*Agree*	*Highly Agree*

- Is a bonus issue of equity, in your opinion, a substitute for dividends?

Highly Disagree	*Disagree*	*Moderate*	*Agree*	*Highly Agree*

- Growth companies need not pay dividends-agree?

Highly Disagree	*Disagree*	*Moderate*	*Agree*	*Highly Agree*

- A company should have a target dividend pay-out and adjust it yearly towards the target, depending on its performance.

Highly Disagree	*Disagree*	*Moderate*	*Agree*	*Highly Agree*

- Higher dividend pay-out pushes the price of the stock.

Highly Disagree	*Disagree*	*Moderate*	*Agree*	*Highly Agree*

- Reasons for changing dividend policy should be disclosed to the investors.

Highly Disagree	*Disagree*	*Moderate*	*Agree*	*Highly Agree*

- A company announcing a high dividend despite a drop-in profit signals positive information about the stock.

Highly Disagree	*Disagree*	*Moderate*	*Agree*	*Highly Agree*