



# Growth & Profitability of Private Commercial Banks: Major Indicator of Its Dividend Policy

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## To cite this article:

Yasir Khan, Liaqat Ali, Saima Batool, Azmat Ali. Growth & Profitability of Private Commercial Banks: Major Indicator of Its Dividend Policy. *American Journal of Operations Management and Information Systems*. Vol. 2, No. 4, 2017, pp. 92-96. doi: 10.11648/j.ajomis.20170204.12

**Received:** August 20, 2017; **Accepted:** September 5, 2017; **Published:** October 26, 2017

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**Abstract:** The study was conducted to check whether the growth and profitability is the major indicator of bank's best dividend policy. The research was conducted in the banking sector of Pakistan. The commercial banks working in Pakistan was taken as a sample of the study. On the basis of the dividend payment, 20 banks were selected for the data collection. The data was collected from 2008 to 2014. Bank size and leverage was taken as control variables. As per the results of chow test's, fixed effect in case of profitability & pooled OLS in case of growth is appropriate for the data analysis. White's test shows that the data is heteroskedastic so the final results were analyzed by fixed effect model with robust and no issue of heteroskedasticity in growth data. As per the results of fixed effect model; 1) DPO has negative and insignificant effects on bank dividend policy (null accepted); 2) Firm size has positive and significant effects on bank dividend policy; 3) Leverage has negative and significant effects on dividend policy; As per the results of pooled OLS for growth; 1) DPO has positive and significant effects on bank dividend policy (Alternate accepted); 2) Firm size has positive and significant effects on bank dividend policy; 3) Leverage has negative and insignificant effects on dividend policy.

**Keywords:** Growth, Profitability, Dividend Policy, Commercial Banks, Fixed Effect Etc

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## 1. Introduction

In the financial markets, the investors always invest their money for the sake of to acquire returns. The investors received the returns on their investment in the firms in two shapes i.e. capital gain and dividend. The capital gain can be stated as it is the positive difference between stock selling price and stock purchase price. The second part of return is dividend; which is the core interest of this study, investors get appropriate portion of profit on their stocks (Ajanthan, 2013).

In corporate finance dividend policy is highly controversial and puzzling area (Mehta, 2012). Brealey & Myers (2005) pointed dividend policy among the top ten (10) crucial unsettled issues in finance. Traditionally different theories are suggested that dividend is relevant while few financial scholars indicate that dividend is irrelevant. Miller & Modigliani (1961) proposed dividend irrelevant theory, pointed that dividend does not contribute in the firm's

valuation. James E. walter and Gordon hinted theories in the favor of dividend relevance (Relevant Theory), where they contended dividend is critical factor in the valuation of firm. Furthermore many other theories for the explanation of dividend policy are waving in the literature that exhibits how dividend decision influences the firm's value. For the explanation of dividend payout of the firm, there are three different approaches (a) at the conservative extreme financial scholars argued that both dividend payout and firm values are positively linked, (b) in contrast other radical group of scholars hinted a negative relation, means increase in dividend payout heads firm's value downwards and (c) the third moderate group of scholars claims no relationship among dividend payout and firm value (MM, 1961; Baker et al, 2001). After publishing the work of Miller and Modigliani (1961) researcher starts investigation to find the answer of MM theory. But still this field has a question mark in the

researcher's mind whether dividend policy really adds in the firm's valuation or not? What are determinants factors that lead the dividend policy?

Dividend policy is significant factor for any firm and this should be always in the favor of company but it is also important for shareholders, employees, consumers and regulatory bodies like government perspectives. Ali, et al (1993) argued that the dividend policy is the most significant factors which is needed by every firm to streamline their financial policies. This dividend decision announcement in the organization is in conjunction with the analysis that who much of the funds should be retained for future expenditure and opportunities and distribution among shareholders Ross et al (2002). Frankfurt and Mc Goun (2000) suggested dividend as a puzzle in value enhancing. Firm pay higher dividend when management expected that company cannot fulfill their expectation in future Mizuno (2007). Therefore dividend policy is the highly authoritative decision encountered by managers of the firms Barker and Powell (1999).

Companies use dividend policy as a guidelines and regulation in the payments of shareholders dividends Nassim and Ziv (2001). De Angelo & De Angelo (2006) proposed that firm's optimal dividend policy is based on free cash flow distribution. In their study investment opportunities Grullon, Michaely & Swaminthan (2002) and Fama & French (2001) and agency theory Jensen (1986) are combined in the life cycle theory. They also predict about optimal dividend policy alteration based on investment opportunities, and claim that traditionally lower dividend ratio were paid due to firm's higher opportunities and minimal earnings. But then later internal capital exceed firm's investment opportunities, therefore maximum dividends were paid due mitigate waste of free cash flows. Positive tendency has been observed among dividend and retained earning-total equity ratio De Angelo, Stulz & De Angelo (2006).

The practices of dividend policy of a firm not only alter over time period but also vary across unlike countries especially among developing, emerging capital market and developed Glen, et al (1995). In the study these scholars founded empirical evidence about dividend policy that there is significant variation in emerging markets, also described that ratio of dividend payout in the developing countries were only two third part in comparison with developed countries. There is also evidence discovered by Ramcharan (2001) minimal dividend payout ratio in the emerging capital markets. Brook et al (1998) on the basis of their study concluded that there is no single end present that affects the corporate dividend policy of a firm.

## 2. Literature Review

Different researchers argued in their studies that dividend policy is the significant factor which can affect the growth and value of the firm. The companies whose in the growing stage is not to suppose the pay more dividends, as compared to those firms which are at the matured level. According to

(Murhadi 2008) he was used up the sample firm allocating the dividend for the period of 1995-2005 listed in PT Jakarta Stock Exchange, used 1052 year observation. The country Jordan as a developing country, their policy for dividend is influenced by that sort of factors which is relating to developed countries like as company growth rate. Moreover, the actual elements influencing the possibilities of having to pay rewards are similar to individuals influencing the dividend policy (Al-Najjar 2009). The researcher studied 180 listed firms in the Karachi Stock exchange helps in which corporations will pay rewards following a specific level of growth. For the earlier period corporations focus on retained earnings (Mehtar 2003).

According to Kania and Bacon (2005) examined the profitability's impact growth risk, liquidity and expansion over on the dividend policy of a firm with the help financial data over 10000 public firm with Ordinary Least Squares (OLS). In the study by Kania and Bacon, they concluded the dividend payout ratio is having significant affect with the profitability (return on equity), growth, risk (beta), liquidity, control and expansion (growth in capital spending).

Ahmad & Javid (2009) found the determinants of dividend policy for the period of 2001 to 2006 of non-financial listed firm in Karachi Stock Exchange. In this study the examiner supported the Linter's policy in which they clearly demonstrated that to set the dividend payment they must observed the current earnings per share and past dividend per share. In this context we added that the profitability, market liquidity and ownership have positive impact on dividend payment and in the same study some variable have negative impact such as market capitalization and size of the firm on dividend payout policy. As a result it shows that the firm should prefer the investor to invest in the assets rather than pay dividends to the investor.

## 3. Methodology

The study was conducted in the banking sector of Pakistan. The sample banks in the study were selected on the basis of regular dividend payments to their shareholders. On the basis of dividend payments 20 commercial banks were selected for the data collection. The data from 2008 to 2014 were collected from the annual reports of the sampled commercial banks. Dividend payout ratio was taken as independent variable, firm size (log of total assets) and leverage (debt to equity ratio) as a control variables and profitability (return on assets) & growth (sales growth) as dependent variables of the study.

### 3.1. Variables and Their Measurement

- a. Profitability =  $\frac{\text{NetIncomeaftertaxes}}{\text{TotalAssets}}$
- b. Growth =  $\frac{\text{Currentyearsale} - \text{previousyearsale}}{\text{previousyearsale}}$
- c. Dividend payout ratio =  $\frac{\text{Dividendpershare}}{\text{Earningpershare}}$
- d. Firm size =  $\log \text{ of total assets}$
- e. Leverage =  $\frac{\text{Totaldebts}}{\text{Totalassets}}$

### 3.2. Hypotheses

H<sub>1</sub>: Dividend payout ratio has significant effects on

profitability.

H<sub>2</sub>: Dividend payout ratio has significant effects on firm growth.

### 3.3. Results and Discussion

Table 1. Diagnostic tests.

	Purpose	Profitability		Growth	
		p-value	Results	p-value	Results
Chow Test	Pooled OLS Vs Fixed Effect	0.000	Fixed Effect	0.163	Pooled OLS
Breusch Pagan Test	Pooled OLS Vs Random effect	0.488	Pooled OLS	0.312	Pooled OLS
Hausman test	Fixed Vs Random effect	0.003	Fixed Effect	0.338	Random Effect
White's test for heteroskedasticity	Presence or absence of heteroskedasticity	0.010	heteroskedasticity	0.093	Homoskedasticity

The above table shows the results of multiple diagnostic tests, which have been used for the selection of models or presence or absence of problem in the data. The chow test was used to choose among the pooled OLS and fixed effect model, the p-value of the chow test for profitability is 0.000 which recommend fixed effect and 0.163 for growth with recommend pooled OLS. The Breusch Pagan test for profitability & growth recommend pooled OLS. The p-value of hausman test for profitability recommend fixed effect model and for growth is 0.338 which recommend random effect model. The Whit's test for heteroskedasticity for profitability shows that you have use robust standard error to solve the problem of heteroskedasticity while the results for growth suggests that there is no problem of heteroskedasticity.

Profitability

Table 2. Regression analysis.

	Profitability (Fixed effect)		Growth (OLS)	
	Coefficient	t-value	Coefficient	t-value
Const	6.17 (2.59)	2.377**	-0.95 (0.82)	-1.15
DPO	-0.23 (0.23)	-1.00	0.13 (0.15)	8.7**
Rsize	0.27 (0.13)	2.04**	0.065 (0.012)	5.17**
Leverage	-2.53 (0.98)	-2.56**	-0.21 (0.28)	-0.75
R-square	0.2186		0.284	
F-value	6.22		6.809	
P-value	0.024		0.000	

Table 2 is the results of fixed effect model of profitability. The coefficient value of dividend payout ratio is negative which means that DPO has negative effects on profitability and this effect is insignificant. Different researchers conclude the negative association of dividend payout ratio with profitability. Kania & Bacon (2005) worked on what motivates the firm to pay dividends. They used OLS regression on 542 samples of firms. They found that the profitability relates negatively with payout ratio it means that the firm with higher profit will pay less dividends. Gill, Biger and Tibrewala (2010) worked on the manufacturing firms in the US market and they also found negative association. This concludes that the firm with higher profit will prefer to keep retain earnings rather than to pay to the shareholders. Farsio

et al, (2004) found no significant in the relationship of profitability and dividends. He argued that this association is based on the short term which might mislead the investors. The researcher proposed three scenarios which can conceptualize the association between dividend and future earnings. The first that the firm who are paying more dividends will face short of funds and reinvestment ratio of the firm will also decline. The firm without considering the investment needs of the firms will face lower future earnings which show negative association between dividend payout and future earnings. The firm size has negative relationship with profitability and this is significant. As per the discussion of agency theory, in large firms the shareholders are not able to monitor the firms operations because of ownership dispersion. Consequently, large organizations should pay more dividends to discourage agency costs (Jensen & Meckling, 1976). Holder, Langrehr & Hexter (1998) found that big firms have easy access to the market capital and they can raise their funds by external sources with minimum costs as compared to the small organizations. It is confirmed that larger firms will pay more dividends as compared to the smaller ones. The leverage has negative and significant effects on profitability. Fixed obligation to the creditors can be represent by debt financing, with the help of this the managers can be restrict to use cash flow for their personal gains (Jensen, 1986). By using high ratio of debt financing in the capital structure, the firm will face financial risk in the future. So the firm with high debt ratio will avoid paying more in dividend and keeping cash as a reserve (Rozeff, 1982). Rozeff (1982) & Jensen (1986) confirm the negative association of leverage with dividend payout. Aivazian et al, (2003) also found that the firm with higher leverage ratios will pay lower dividends. The value of R-square shows that DPO, firm size and leverage has 22 percent effects on firm's profitability. The f-value of the model is 6.2 which show that the model is statistically significant. The p-value of the model is 0.024 which is less and significant.

Table 2 is also the results of pooled OLS model of growth. The coefficient value of dividend payout ratio is positive which means that DPO has positive effects on growth and this effect is significant. As per the results of Kania & Bacon (2005), sales growth is the main variable of firm's dividend payout ratio. When the firms get more profit growth, they want to pay more to the shareholders in dividends to make

them satisfied. The firm size has positive relationship with growth and this is also significant. The leverage has negative and insignificant effects on growth. The value of R-square shows that DPO, firm size and leverage has 28 percent effects on firm's growth. The f-value of the model is 6.809 which show that the model is statistically significant. The p-value of the model is 0.000 which is less and significant.

#### 4. Conclusion

The study was conducted to look at the dividend payout ratio and their influence in profitability and growth. The study was conducted in the banking sector of Pakistan. The study come up with the findings that dividend payout ratio has insignificant effects on firm profitability which reveals to support null hypothesis while in the case of growth, the dividend payout ratio has significant effects on growth. In this case our alternate hypothesis is accepted. The study reveals that the firm with higher profitability will pay less in dividend to the shareholders and their motive will be to keep more in retained earnings. The findings are in line with Kania & Bacon (2005) & Gill, Biger & Tibrewala (2010). Fixed obligation to the creditors can be represent by debt financing, with the help of this the mangers can be restrict to use cash flow for their personal gains (Jensen, 1986). The firm with higher debt ratio will pay less in dividends. So the firm with high debt ratio will avoid paying more in dividend and keeping cash as a reserve (Rozeff, 1982). Sales growth shows the positive movements of operations of the firm. The firm with higher growth requires more funds to invest in the projects.

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