



EFFECT OF DIVIDEND CHANGE ON STOCK PERFORMANCE: A CASE OF LISTED COMMERCIAL BANKS IN KENYA

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Abstract

Dividend decision has been a puzzle to many managers as to whether they should pay dividends or not. It is the dream of every manager of each listed company that its shares gain value and remain attractive to investors. The current study examined the effect of dividend change on stock performance. The study was carried out at the Nairobi Securities Exchange, Kenya and covered the years 2010 to 2015. It consisted of all the 11 listed commercial banks in Kenya. The study used a correlational research design and data was analyzed using GLM regression. The conclusion was that dividend change has significant effect on the stock performance. Increase in share prices was observed for the firms which increased their dividend in the current year as compared to the previous year. On the other hand, firms which lowered their dividend faced reduction in their shares prices. The study further concluded that firm size as a moderating factor has significant effect on the dividend change – stock performance relationship. The study recommends that firms should increase their dividend payout so as to increase the price of their stocks. This is because firms which declare increased dividends face an increase in their share prices.

Keywords: dividend change, stock performance, firm size

1.0 Introduction

Finance managers are usually faced with two very important decisions: investment and financing decision. Investment decision deals with what real assets a firm should acquire to enable it run its operations successfully. The other big question is how the acquisitions of these real assets are going to be financed. However, the third question arises when the firm starts to generate profit. Putting in mind that the firm is owned by shareholders, the question is whether to reinvest the funds back to the firms operation or to distribute them to its shareholders in terms of dividends. The main goal of corporate firms is to maximize the wealth of its shareholders. Therefore the managers have a role to play in making sure that the shareholders have confidence in their firms. It is important for financial managers not only to consider what to do with the profits but also to put into consideration the effect of these decisions to the share prices (Odhiambo, 2013).

Dividend change involves altering the amount of dividends paid on the current year as compared to the previous year. This could be due to various factors which include; the decision to invest the firms profit in other projects

or for expansion of business and can also be due to the decision by the management to issue out the excess funds in terms of increased dividend payout. At the NSE, banking stocks had been treasured by investors in the previous years until August 2016 when the bill to cap interest rates was passed. This caught the bankers and market players by surprise throwing them into spin. Due to this, most investors dumped the previously treasured banking stocks at the NSE leading to huge price fall. It is due to this that the managers of such sectors have to be informed enough concerning dividend decisions since any further provocation can trigger the reactions of the investors concerning the firms dividends and cause further share price fluctuation. This study therefore intended to identify the effect for this decision to the firms share prices which receive mixed reactions from the shareholders. The study identified how the prices react to increase of dividends compared to the previous year and also the effect of reducing the dividends paid.

In the Kenyan market, it is believed that dividend payout ratio is inversely connected to stock variation (Kenyoru, Kundu and Kibiwott, 2013). This means that if the dividend payout ratio is high, then the stock variations are low hence the share prices will be stable and vice versa. Such information therefore will be important to both the managers and investors who want to venture in the Kenyan market. It will assist them in making informed decision on dividend declaration and investment on shares respectively. The specific objective of this study was to investigate the effect of dividend change on the stock performance of listed commercial banks in Kenya. The study also sought to investigate the effect of firm size as a moderating factor in the dividend change – stock performance relationship. The finding of this study will be used by both the managers and investors to make decisions concerning dividend payout. The investors will be able to assess firms based on the dividend paid and decide where to invest their funds. Theoretically, if a company reduces the dividends it pays on stock, the stock becomes less attractive to investors (Muigai, 2012) and price of the stock will drop. The market reacts very quickly to any information about the change of dividends so even a hint about the change can take the stock prices down or vice-versa. However, Miller and Modigliani (1961) dividend irrelevance theory, argues that investors can affect their return on a stock regardless of the dividend. This then means that change in dividend has no impact on the prices of stock since investors are able to create their own cash flows by liquidating part of their holdings. Empirical evidence on the other side reveal mixed stock price reaction to dividend decisions. Whereas some researchers reported an inverse influence of dividend change on stock price variations (Muriuki, 2010), others reported a direct relationship between dividend change and stock performance (Muigai, 2012). This behavior contradicts the dividend irrelevance theory though it appears to verify the signaling theory by showing some relationship between dividend decisions and stock prices.

The dividend change – stock performance puzzle becomes more blurred when firm size is considered. Larger firms are perceived to be less risky by investors; creating demand in such stocks that would push its prices higher irrespective of the dividend change (Schneeman, 2010). Practically, the markets associate the stability in stock prices of some firms with their sizes (NSE, 2016). These equivocal theoretical prescriptions and empirical conclusions create a dilemma on the real effect of dividend change on stock prices. In this regard, this study endeavored to address the dividend change - stock performance puzzle as well as the moderating role that firm size would have on that relationship using data from listed commercial banks in Kenya. The main question which the study intended to answer was whether dividend change has any effect on stock performance. Many studies have been conducted to determine the effect of dividend change on stock performance in different scenarios. However, their findings are equivocal varying from market to market and author to author. Using a modified market model in Nigeria, Adelagan (2003) investigated whether the Nigerian stock market reacts efficiently to dividend change using price adjustments as the measure of stock performance. He found out that

the cumulative excess returns (CERs) for dividend paying firms are positive and significant for 30 days from the day of the declaration. The study concluded that Nigerian stock market was not an efficient market with respect to semi strong form. In the following year, Bittok (2004) evaluated the effect of dividend policy on the value of the firms quoted at the NSE for a period of six years from 1998 to 2003. The findings were that there is a relationship between the dividend payout ratio and the value of the firm. Mbaka (2010) studied the dividend signaling theory at NSE using dividend per share as measure dividend.

The study found that share prices increased for companies which announced increase in dividend while share prices decreased for companies which announced decreased dividend. Companies with no change in dividend were found to have mixed reactions towards dividend announcement. In the same year, Ngunjiri (2010) tested the relationship between the dividend payment policies and stock price volatility for companies quoted at the NSE in the period covering 1998 and 2008. Using the dividend yield and dividend payout ratio as measures for the dividend, he found that dividend payment decisions of a company alone do not affect prices in companies quoted in the Kenyan market. Muigai, (2012) carried out a study at NSE for the listed commercial banks and concluded that there is no pattern between dividend payment and stock performance. In the same year, Yasir, Zernigah and Muhammad (2012) carried out a study at Pakistan stock market to investigate the effect of dividend payout on the stock prices in the stock market. The study found a negative relationship between the dividend policy and the stock price. They concluded that the payment ratio is inversely connected to price changes. They also found a positive relationship between dividend yield and price changes hence concluded that signaling hypothesis is useful in Pakistan stock market. Kenyuru, *et al.*, (2013) assessed how the stock price in Kenya is affected by dividend payout and concluded that payout ratio was inversely connected to stock price variation. Accordingly, higher payments lead to lower volatility and the price of shares is more stable when dividend yield is higher. Kivondi and Oyugi (2013) in their study at the NSE found a strong positive correlation between increase in dividends and increase in share prices.

1.1 Commercial Banks listed in the NSE

Nairobi Securities Exchange (NSE) is the principal bourse in Kenya, offering platform for the listing and trading of multiple securities. Over the last six decades, it has consistently offered a well-regulated, robust and world class platform for the trading of equities and bonds. Currently, there are eleven listed commercial banks in Kenya namely: Barclays bank (k) ltd, CFC Stanbic Holdings Ltd, I&M Holdings Ltd, Diamond Trust Bank Kenya Ltd, HF Group Ltd, KCB Group Ltd, National Bank of Kenya Ltd, NIC Bank Ltd, Standard Chartered Bank Ltd, Equity Group Holdings and The Co-operative Bank of Kenya Ltd (NSE, 2016).

2.0 Theories of dividends

Dividend theories explain the rationale and major arguments relating to payment of dividends by firms. The study was anchored on the Signaling theory of Ross (1977) and Bhattacharya (1979) and Dividend irrelevance theory of Modigliani and Miller (1961),

2.1 The Signaling Theory

The signaling theory was introduced by Ross (1977) and Bhattacharya (1979). This theory argued that in an inefficient market, management can use dividend payment to signal important information to the market which is only known to them. If management increases dividend, it signals expected high profit and therefore stock prices will increase. According to this theory, firms paying the highest level of dividends are considered more profitable than other identical firms. This means that a firm with lengthy dividend each year is signaling to the market that its management and board of directors foresee a profit in the future. They further argued that

investors can also infer information about a firm’s future earnings prospects through the signal coming from dividend declaration. Therefore, dividend payment is associated with a brighter future of a company which leads to an abrupt increase of stock prices as the investors have faith in such stocks. Equally, reduction in a dividend value or non-payment of dividend may signal the investor that the management of the company is forecasting less or poor earnings in future. The prediction made by dividend signaling hypothesis is that dividend changes are optimistically associated with future changes in earnings which then lead to changes in stock prices. Based on this theory, it was therefore hypothesized that dividend decisions are relevant to stock performance of firms.

2.2 Dividend Irrelevance Theory

According to Modigliani and Miller (1961), investors are not concerned with a company’s dividend policy since they can sell a portion of their portfolio of equities if they want cash. The theory essentially indicates that an issuance of dividends should have little to no impact on stock price. This theory was first developed by Franco Modigliani and Merton Miller in their famous seminal paper of 1961. They argued that neither the price of firm’s stock nor its cost of capital is affected by its dividend policy. According to Modigliani and Miller, only the company’s ability to earn money and riskiness of its activity can have an impact on its value. The implausible set of assumptions upon which this theory is based are that financial markets are perfect and shareholders can construct their own dividend streams simply by buying or selling shares in the market as they desire (Modigliani and Miller, 1961). If they want cash, they can sell shares and if they don’t want, they can hold on to their shares. Based on this theory, the study hypothesized that dividend change has no effect on the prices of shares in the market.

3.0 Data and Methodology

This study adopted the correlational research design to analyze the relationship between dividend change and stock performance. The population was made up of all the 11 listed commercial banks at the Nairobi Securities Exchange as at 31st December 2015 except I&M which was listed in 2013 and therefore had incomplete data. Secondary data was used in the study and this was majorly gotten from the NSE share price schedules and financial statements of listed firms submitted to capital markets authority (CMA). The data was collected over a six year period covering the years 2010 to 2015. Similar to Mukora (2014), stock performance was measured using the share prices. This is because the performance of a company stocks usually reflects its stock price (Hamill, 2000). The study examined the volatility of share prices due to dividend decision of the commercial banks listed at the NSE. The share prices for each stock were recorded both five days before the dividends are declared and five days after the dividend declaration. An average of the ten days daily share prices were obtained to establish any pattern in relation to dividend decisions made. Dividends declared for the listed firms in the banking sector were collected for the years 6 years period. Data was analysed using both descriptive and inferential statistics at five percent significance level. Descriptive analysis was done using mean and standard deviation while regression analysis was done to test the various hypotheses (*z* – tests) and model the relationship between stock performance and dividend change. The following regression models were used to test the hypothesis:

$$SP = \beta_0 + \beta_1 DC_{i,t} + \varepsilon \dots \dots \dots (1)$$

$$SP = \beta_0 + \beta_1 DC_{i,t} + \beta_2 S + \beta_3 S_{i,t} DC_{i,t} + \varepsilon \dots \dots \dots (2)$$

Where: $\beta_0, \beta_1, \beta_2, \beta_3,$ and β_4 are regression parameters and ε is the error term. SP is the stock performance, DC is the dividend change. In the first model, it is expected that $\beta_1 \neq 0$ implying that stock prices will change with

change in dividends. In the second model, it is expected that $\beta_3 \neq 0$ implying that firm size moderates the relationship between dividend change and stock price. The descriptive statistics of the variables are presented in table 1.

Table 1: Descriptive Statistics

Variable	Obs.	Mean	Std. Dev.	Min	Max
Firm Size	60	207.7013	123.4329	29.2700	576.3000
Dividend Change	60	0.2317	1.0851	-4.0000	3.6800
Stock Performance	60	70.0233	81.2216	9.9300	341.8000

Source: Research data (2017)

4.0 Results & Discussion

The objective of this study was to determine the effect of dividend change on stock performance of listed commercial banks at the NSE. To test the hypothesis of the study, Generalized Linear Model (GLM) was used where Stock performance was regressed against Dividend change (Model 1) and against dividend change and the product of dividend change and firm size (Model 2). From the results, the study found a significant regression relationship in both models as indicated by the significant LR statistics. In model 1, the hypothesis that there is no significant relationship between dividend change and stock performance of listed commercial banks in Kenya was rejected. This is because the regression model returned a significant positive coefficient implying that dividend change positively affects stock performance. This means that increase of dividend declared as compared to the previous year lead to increase in share prices.

The findings confirms the prescriptions of signaling theory that dividends send a positive message to the investors that the firm is financially stable if it can pay increased dividend. The study also concurs with the findings by Mbaka (2010) and Kivondi & Oyugi (2013) findings that share prices increased for companies which announced increase in dividend. However, the findings differ with the dividend irrelevance theory which asserts that dividends have no effect on the stock performance since the shareholders have other avenues to generate cash flows.

Firm size was incorporated in the study as a moderating factor where the study sought to determine how firm size influence the relationship between dividend change and stock performance of listed commercial banks in Kenya. This effect was obtained by testing the hypothesis that firm size does not affect dividend change – stock performance relationship. The study failed to reject the hypothesis and concluded that firm size has no significant moderation effect on the relationship between dividend change and stock performance. This differs with the findings of Asghar *et al.*, (2013) that there is a positive relationship between dividend change and stock prices but it’s the firm size that shuffles such relationship. However, on its own, firm size did not significantly affect stock performance.

Table 4.3 Regression analysis

Dependent Variable: Stock Performance (ln. Stock Price)		
Method: Generalized Linear Model (Quadratic Hill Climbing)		
Included observations: 60		
Dispersion computed using Pearson Chi-Square		
Coefficient covariance computed using the Huber-White method with observed Hessian		
Convergence achieved after 1 iteration		
	Model 1	Model 2
Constant	3.6790**	5.3207**

	(30.7609)	(3.8726)
Dividend Change	0.3652**	0.5090**
	(3.1317)	(3.2472)
Firm Size	-	0.1051
		(0.8179)
Dividend Change*Firm Size	-	-0.3359
		(-1.8072)
LR. Statistic	12.6598	14.2255
Prob. (LR. Statistic)	0.0004	0.0026
Pearson SSR	42.4544	41.2440
Pearson Statistic	0.73197	0.7365
Dispersion	0.73197	0.7365

*Significant at 0.05; ** Significant at 0.01; Values in parenthesis (z-statistics)

Source: Research data (2017)

5.0 Conclusions

The study concluded any change in dividends paid by a firm will trigger an effect on its share prices at the stock market. Therefore, firms which pay increased dividends experience price rise in their shares while those which pay reduced dividends experience price reduction in their shares. The study also concluded that firms with large asset base will face lower price fluctuation irrespective of the dividend change. This is because the investors tend to have confidence in the firms with large assets base hence find attraction to those firms shares irrespective of the dividend decision. The study recommends that firms should increase their dividend payout so as to increase the price of its stocks. This is because firms which declare increased dividend face an increase in their share prices which is the goal of every company listed in the stock market. The management should also ensure that the asset base of the firm is kept within the necessary level and that is not too high or too low. This is necessary because the firm size has an effect on how the share prices respond to dividend decisions of the firm and at the same time, the liquidity of the firm also has to be considered.

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