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## **EFFECT OF DIVIDEND POLICY ON THE VALUE OF COMPANIES IN INDIA: AN EMPIRICAL STUDY**

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### **1 INTRODUCTION**

Dividend is the share of the net profit of a corporation made available to its shareholders as a return on their company investment. The shareholdings may be either paid in cash (where the cash is paid out or in stock (where the benefit is replenished and the bonus shares are given to the shareholders) or paid in cash and in stock. At the end of every financial year, net earnings that remain after other credits, including the payment of business revenue tax, the transfer to reserve accounts and retained earnings, shall be paid out as dividends, are of interest to investors. Dividend payment appears to increase the company's share value on the stock market due to its knowledge quality on the company's results.

On the other hand, retained profit can also be reinvested in the enterprise in order to benefit from economies of scale and economies of scope that would result in a greater output of the enterprise and also improve the company's long-term market value. Therefore, a successful dividend strategy is essential for a corporation to increase its shareholders' equity. Likewise, sufficient knowledge of companies' dividend policies will direct investors in their investment choice. The dividend policy is structured to determine the share of current income to be retained by the company and the proportion to be distributed to its shareholders.

In the last five decades, dividend strategy has drawn great interest of financial analysts worldwide. It was also a source of contention and a topic of intense theoretical and empirical research. One aspect of dividend policy remains puzzling the connection between dividend policy and share prices. The sum that shareholders are willing to pay for a company's shares will be affected by the company's dividend policy (Van Horne, 1998; Pandey, 2005). If management follows a dividend strategy that runs counter to shareholder interest, disgruntled investors sell their shares. Extensive sales would increase the supply of the company's market share and lead to low prices, thus impacting the value of the company. When a company retains profit instead of dividends, the price of the stock of the company will increase accordingly.

But shareholders who want a current return often produce "homemade" dividends by selling those shares and receiving the value appreciated. In addition, if all of the company's earnings are automatically allocated to the shareholders, the valuation of the business will be affected. Those shareholders who invest in capital growth and future income and expect the business to grow by reversing profits, might start selling their shares (Stulz, 2000). The effect of the dividend policy on the business value was verified by Mainoma (2001), Nishat and Irfan findings (2003).

At the end of each year, each traded company must determine if and how much cash will be returned to its shareholders by way of dividends. The private company owner must decide equally on the cash he or she wants to remove from the corporation and how much he or she can reinvest. This is the dividend decision, and we begin this chapter with three aspects of dividend policy. One is a strictly procedural question about how stockholders receive and receive dividends. The second is a study of commonly used metrics of how much a business pays for the dividends. The third is an empirical study of such patterns of dividend policy pursued by businesses. After laying this foundation, we are looking at three ways of thinking about dividend policy.

The irrelevance dividend school argues that dividends just don't matter since they don't impact firm value. This argument is based on two hypotheses. The first is that an investor does not have a tax disadvantage in collecting dividends, and the second is that businesses can raise new investment funds in the capital markets without substantial pollution costs. Second-school advocates claim that the average stockholder has a bad dividend because of the tax disadvantage it creates which leads to lower valuation. Finally, there are those in a third category who claim that dividends are obviously good because stockholders like them (at least some of them and react accordingly as dividends grow. While the dividends have historically been considered the primary path to returning capital or assets to its shareholders for publicly traded companies, they represent only one of the many ways that the business can achieve this goal. In particular companies can return cash to their shareholders through stock repurchases where the money is used to buy the company's outstanding shares and reduce the number of outstanding shares. Moreover, businesses will return some of their assets in the form of spinoffs and split offs to their investors.

A company's dividend policy is intended to determine the proportion of current income to be retained and the proportion to be distributed among its shareholders. This was a topic of insight and an extensive theoretical and analytical research. One aspect of dividend policy remains puzzling the connection between dividend policy and share prices. However the amount shareholders are prepared to pay for shareholdings in a corporation will be decided by the dividend policy of the company (Van Horne, 1998; Pandey, 2005).

The main aim of a corporation is to increase the shareholder's equity, which is expressed by generating value at the company's share market price. Value can be created by holding some reinvestment income and dividend growth in the future Pandey (2005). Most businesses aim to meet the shareholder's current income requirements through dividend payments. The businesses assume that paying dividends decreases risk and thus affects share prices as a measure of potential profits. However the amount required for internal financing is limited by the dividend payment. What the shareholders get in the short term thus represents a significant decision for the company's overall survival.

Dividend policy is the guiding documents on the calculation and payment of dividends for the corporation. Meanwhile, dividend policy is not the only indicator of company success, as shown by Jabbouri, by other means (2016).

Khan (2015) notes that a company's dividend policy can be calculated by two common suitable methods, the dividend yield and the dividend payout ratio. Changes in these two financial metrics are providing information on the risks faced by businesses and on the companies' potential growth profits. In addition to metrics of dividend policy, investors often see other financial indicators to make productivity choices, such as profits per share, retained profit, company size and book value (Chelimo & Kiprop, 2017).

Payout for dividends can be high or low. A low compensation means more profits retained which may lead to higher share prices, as it accelerates growth in income. Growth investors will produce their returns primarily in the form of potential capital gains. However the effect of dividend policy on potential capital gains is complicated and unpredictable, as it will arise in the far future. Low payouts could therefore not inherently result in higher prices. High payouts, on the other hand, mean more established dividends and less profits, which may lead to sluggish growth and maybe lower market share prices. Some shareholders, in particular minority, however have the main goal of getting dividends at the end of the era, while others are interested in growth with a view to potential capital gains. There are major variations between investors in their investment decisions.

Some investors are interested in quick returns and others are interested in capital growth and future sales. Whichever dividend strategy a business adopts may have a positive or negative effect depending on the mindset of its investor. It is quite rational that some investors prefer high-paid companies and others prefer low-paid companies. Management must also strike a balance between the company's competing interests and the shareholders. Therefore, deciding the optimum dividend payout ratio is critically critical for the company's survival. That is why there are many arguments now about the issue of capital gains and dividend payments (Ahmed & Murtaza, 2015).

Dividend policy (DP) is considered to be one of the three key financial management decisions. The company's decision as to how much profits could be paid as a dividend and how much the firm could keep is the business of DP. The DP dictates what share of profits is paid to shareholders by dividends and how much is reinvestment in the company itself. The implementation of this strategy would be strongly affected by the company's investment prospects and the dividend benefit against shareholders' capital gains. Each company should establish such a DP, which divides the net income into dividends and income, optimally to achieve the aim of maximising shareholders' wealth (Pandey & Ashvini, 2016).

Despite the number of studies on dividend reform, however the corporate finance dilemma remains unresolved. Several hypotheses have been suggested to justify the importance and effect of the dividend scheme, but no general consensus was reached. As a consequence, researchers continue to show divergent results on the relationship between dividend payments and valuation.

The management of emerging market companies is faced with the situation deciding the form of dividend policy to be followed to optimise shareholders' capital. Some studies and commentaries by Jarrel (1991) and Ikenberry et al (1995, 2000) show that little research has been done into the effect on share price of the dividend policy. One of the contentious topics in corporate finance remains the subject of dividends policy. Dividend policy is one of modern financial economics' most difficult subjects. It could not be resolved for forty years of study. Dividend policy analysis found that not only is a general theory of dividend policy vague, but the practise of dividends differs between companies and countries.

## **2 EFFECT OF DIVIDEND PAYMENTS ON THE VALUE OF COMPANY/TO SHAREHOLDERS**

### **2.1 MARKET CAPITALIZATION**

Market capitalization is the total value of a company. It's measured by the stock price times the number of shares issued. For example, a company that has 1 million shares that are selling for \$10 each would have a market capitalization of \$10 million. This means you could buy

that company for \$10 million if you had the money and all the current stockholders were willing to sell you their shares.

Market capitalization is usually called market cap for short. It also refers to the total value of a stock exchange.

## **2.2 SHAREHOLDERS' VALUE CREATION AND ITS LINKAGE WITH DIVIDEND POLICY DECISIONS**

Several research studies have recognized that a dividend policy can have an effect on the future value of the business if it is developed and carefully implemented. The purpose of optimizing wealth is a generally agreed goal of the group, as it reconciles the complex, frequently conflicting stakeholder interest. As a consequence of many recent developments, the interest in shareholder value is gaining momentum:

- The possibility of corporate takeovers by those searching for under-valued assets
- Remarkable support from business leaders who took the approach
- A growing awareness that the valuation of the company's shares does not consistently link to conventional accounting measures like EPS and ROI
- Reporting of returns to shareholders and other indicators of business press success.
- A growing understanding that managers' long-term compensation must be closely related to shareholders' returns.

The Shareholders Value method calculates the economic value of an investment by discounting expected cash flows by the cost of capital (e.g. company's shares, plans, mergers and acquisitions). These cash flows serve as a basis for shareholder dividend returns and the rise in share price. An ongoing concern must strive to increase its capacity to generate cash. The ability of a corporation to allocate cash to its different constituencies depends on the ability to raise capital from its activities and on the ability to receive additional funds from external sources. Two basic external sources are debt and equity funding. The credit power and market value of the shares depend on the capacity of a company to produce cash. The market value of the securities impacts directly on the second source of funding, namely equity financing.

The higher the share price for a certain amount of funds needed, the lower dilution would be borne by existing shareholders. The financial ability of management to deal successfully with corporate claimants therefore often stems from a rise in the valuation of shares. This rise in share value can be accomplished by rewarding shareholders with dividend returns and capital gains. The most famous statement about the relationship between the policy on dividends and corporate value stated that due to the investment policy of the company, the payout policy it opts to follow will not affect the present price or total return of its shareholders in the presence of perfect markets."

However, "market imperfections as differential rates of taxation, information asymmetries between insiders and outsiders, conflicts of interest between managers and shareholders, cost of transaction, cost of flotation and the irrational behavior of an investor may make the dividend decision of relevance"

Another market imperfection is information asymmetries, as opposed to information asymmetries between insiders (for example, managers) and outside parties (for example investors). Agency disputes, deriving from different priorities of company stakeholders, are the third market imperfections.

### **3. OBJECTIVES:**

The Company's value depends upon the value of its shares in the markets and the pace of increase in same. There are various other factors that impacts the value of the Company. Earlier few researches have been carried out on same and this research is carried out with the following objectives. The objectives of the study are as follows:

- To study the dividend policy determinants
- To study the impact of dividend policy determinants on market capitalization.
- To study the dividend distribution on value creation for shareholders.
- To study the dividend behavior pattern for companies under research.

### **4. RESEARCH METHODOLOGY:**

#### **4.1 RESEARCH DESIGN**

Experimental Research Design: Experimental research design is used to establish a relationship between the cause and effect of a situation. It is a causal research design where the effect caused by the independent variable on the dependent variable is observed.

#### **4.2 NEED OF STUDY**

Earlier researches have been focused on the company's opinion of dividend policies and their effect on wealth of shareholders, but this current analysis would speak about the shareholders' understanding of the corporations' dividend policies and their impact on wealth of shareholders. In addition, this analysis would also address the different reasons that cause citizens to invest in stocks rather than in other investment proposals. We would discuss how a corporation's dividend policy should be used to pick the company to be invested in.

The scientist selected the analytical analysis to assess the effect on the Indian stock market of dividend policy determinants. This analysis provides a sample of the balance sheet and profit and loss account for three sectors for 2007-2016. The variables have been empirically evaluated with hierarchical regression in three industries, including pharmaceutical, electricity and the medium. Thus a limit of 10-15 companies were chosen for each sector.

The reversal study would indicate the stock price to be influenced by aspects of dividend strategy, such as net profits ratio, gross profit ratio, earnings per share, dividend income, dividend, dividend payout ratio and asset returns. In order to evaluate the hypothesis the approximate p-value of the model is used. Where the values are important at 5 percent (i.e.) below 0.05, the alternative hypothesis is demonstrated, otherwise the null hypothesis is chosen.

#### **4.3 HYPOTHESIS:**

H<sub>0</sub>: There exists a positive relationship between dividend policy determinants and valuation of companies.

H<sub>1</sub>: There is no positive relationship between the dividend policy determinants and valuation of companies

H<sub>0</sub>:- There is a significant impact of dividend policy determinants on market capitalization.

H1:- There is no significant impact of dividend policy determinants on market capitalization.

H0: There is significant impact of dividend distribution on value creation for shareholders

H1:- There is no significant impact of dividend distribution on value creation for shareholders.

#### 4.4 THE DATA AND SAMPLE

The study is focused on three sectors IT, FMCG and Service sector (Banking Sector).

#### 5. UNIVERSE & SAMPLE SIZE.

The data analysis shall be undertaken from secondary sources. The whole project will be based on the secondary data based on the detail. The considered companies would be 30 of BSE

The data has been analyzed and available from the balance sheets and other financial statements made available in the “**PROWESSIQ**” software. This data is extensively used by market analysts, research scholars, fund managers and other financial market intermediaries to take informed decision regarding investments in these companies. The sample size is chosen from constituent companies of BSE sensitive index as on year 2002.

#### CONSTITUENT COMPANIES OF BSE SENSEX INDEX SINCE 2002.

Bombay stock exchange BSE is Asia’s oldest stock exchange. Based in Mumbai, India, BSE was established in 1875 as the native share and stock brokers association. Prior to that brokers and traders would gathered under banyan trees to conduct transaction (source: - “Bombay stock exchange website”).

**The BSE index represents every segment of industry and constituent of companies represents 65% of the market capitalization of the companies listed of BSE.**

#### 6 DATA COLLECTION

##### 6.1 SECONDARY DATA

Secondary data will be collected from the stock exchange and companies registered under company secretary office (CSO). Secondary data is the data that is readily available from other sources and consists of the information of the companies which are already registered under Bombay Stock Exchange.

- The data has been collected from software named as PROWESSIQ.
- Data frequency taken into consideration at the time of analysis is every fortnight
- The study is sectoral study of Indian firms which includes three sectors IT, FMCG & Service sector (Banking sector).

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