

THE EFFECT OF FINANCIAL LEVERAGE ON DIVIDEND POLICY: EVIDENCE FROM AN EMERGING MARKET

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Abstract

Purpose – The purpose of the study presented in this paper is to provide empirical evidence on the association between dividend policy and capital structure of Romanian non-financial companies.

Methodology/approach - The present research is based on literature review as well as on data obtained from firms listed on the Bucharest Stock Exchange for a period of thirteen years from 2005 to 2017.

Findings – The findings show that financial leverage has a significant negative impact on dividend payout. The negative association implies less dividend payments done by high debt companies. The results also indicate that changes in earnings and the previous year's dividend yield have a significant impact on dividend policy in case of Romanian non-financial firms. Thus, managers can enhance the firm's profitability by handling correctly the cash conversion cycle and by keeping its components at an optimal level.

Research limitations/implications – This study was performed without considering the industries particularities which might have an impact on the companies' financial strategy. Nonetheless, the research provides important insights for managers in terms of dividend policy and at the same time is expected to contribute to the enhancement of the literature in the field.

Practical implications – The findings of this investigation imply that less debts financing by the companies lead to increasing the amount that could be paid to shareholders. Such findings can be used to guide managers in undertaking competitive dividend policies to improve business performance and to attract investors.

Originality/value – This paper investigates the link between dividend policy and corporate leverage of the firms from Romanian equity capital market. Corporate managers can enhance value for their shareholders by proper management of dividend policy.

Key words: dividend policy, leverage, dividend yield.

Introduction

The dividend policy remains one of the most important topics in corporate finance. Dividend policy is a set of guidelines a firm uses in order to decide how much of its earnings it will distribute to its shareholders. A rapid growing literature has investigated the dividend policies of companies from developed countries, while little research has yet been published exploring the dividend policies of firms from emerging countries (Kaźmierska-Jóźwiak, 2015).

The dividend policy is an essential corporate parameter, influencing not only the company but the managers, debt holders and shareholders as well (Eriotis et al., 2013). Eriotis (2005) states that dividend policy is significant because it affects its capital structure, since the retained earnings aim to fund the company and the firm's dividend decision may alter the value of its stock.

In order to cope with the growth occasions arisen from the external environment, almost every company takes into account various options and strategies such as balance between dividend payment, corporate leverage, issuance of new stocks and financial efficiency (Gill, Bigger, and Mand, 2013); (Asad, and Yousaf, 2014). This is one of the most important challenges that financial managers are dealing with (Asif, Rasool, Kamal, 2011). Financial leverage shows how much debt the corporation employs in its capital structure (Ikechukwu et al., 2016). Financial leverage is a two-edged sword—generating advantageous results when things go well and the reverse under adverse conditions (Ikechukwu et al., 2016).

In United Kingdom, Al Shabibi and Ramesh (2011) investigated the determinants of dividends using a sample of 102 non-financial companies. They found no significant relationship between the leverage and the companies dividend payouts. Ikechukwu et al. (2016), on the other hand, found that financial leverage has statistically significant effect on dividend policy of quoted conglomerates in Nigeria. Al-Kuwari (2009) studied the determinants of dividend policies for firms listed on Gulf Co-operation Council country stock exchanges and found a strong negative correlation between leverage and the dividend payout ratio. Vo and Nguyen (2014) examined the interrelationship among leverage and dividend policies on a sample of 81 listed firms on HCM City Stock Exchange during the period 2007–2012. The results indicated a negative relationship between leverage and dividend. Asif, Rasool, and Kamal (2011) investigated the relationship between dividend policy and financial leverage of companies listed with Karachi Stock Exchange during the period 2002 to 2008 and found that financial leverage had a negative impact on dividend payout. Ghasemi, Razak and Muhamad (2018) applied a simultaneous equations model on a sample of firms listed on the Main board of Bursa Malaysia during 2006–2014 and found that leverage had a negative impact on dividends. Vasiliou and Eriotis (2003) investigated the association of the dividend policy with the debt ratio for the firms listed on the Athens Stock Exchange during 1996 and 2001. Their regression results suggest that there is a positive association between dividend policy and leverage.

In this paper, we examine the relationship between dividend policy and financial leverage of non-financial companies listed on the Bucharest Stock Exchange Market for a period of thirteen years from 2005 to 2017. For this purpose, panel data analysis is applied to explore the impact of debt ratio on the dividend per share of the Romanian companies mentioned above. This research is valuable for both theory and practice by providing empirical evidence from an emerging market, namely Romania. No study, to the best of our knowledge, has examined the relationship between dividend policy and financial leverage on the Romanian market.

The rest of the paper is organized as follows: in the next paragraph the methodology is detailed, moreover, the empirical results are presented in the third section and, finally, the last section presents the conclusions.

Methodology

The goal of this paper is to investigate the relationship between dividend policy and financial leverage using multiple least square regressions. The financial data were gathered from the annual reports and financial statements of 171 Romanian non-financial companies listed on Romanian equity capital market over the period 2005-2017.

This study uses panel data analysis. The dependent variable, representing the company's dividend policy, is the dividend per share. The dependent variable is regressed against the independent variables, namely, debt ratio, dividend yield and change in earnings, based on the following equation (Asif, Rasool and Kamal, 2011):

$$DPS_{it} = \alpha_0 + \alpha_1 \cdot DR_{it} + \alpha_2 \cdot DY_{i,t-1} + \alpha_3 \cdot \Delta E_{it} + \varepsilon_{it} \quad (1)$$

where:

DPS_{it} – dividend per share of the company i at time t ;

DR_{it} – debt ratio of the company i at time t ;

$DY_{i,t-1}$ – dividend yield of the company i at time $t-1$;

ΔE_{it} – change in earnings

ε_{it} – error term.

The debt ratio is used to measure a company's financial leverage and represents the proportion of a corporation's assets that are financed by debt. The *DR* is defined as follows:

$$DR = \frac{TD}{TA} \quad (2)$$

where:

TD – total debt;

TA – total assets.

Dividend yield shows the amount of cash dividends distributed to the firm's common stock holders relative to share price. The *DY* is calculated as follows:

$$DY = \frac{DPS}{PS} \quad (3)$$

where:

PS – price per share.

Change in earnings is determined as the ratio of the change in operating earnings at the end of the year to the level of operating earnings at the beginning of the year. The ΔE is determined as follows:

$$\Delta E_{it} = \frac{OE_{it} - OE_{i,t-1}}{OE_{i,t-1}} \quad (4)$$

where:

OE_{it} – operating earnings of the company *i* at time *t*;

$OE_{i,t-1}$ – operating earnings of the company *i* at time *t-1*.

Results

Table 1 presents a broad description of the summary statistics of the variables used in this study. It reveals the statistical means and standard deviation.

On average, about 23 percent of the Romanian company's assets are financed with debt representing a higher percentage than that of Iranian (20 percent) companies (Emamalizadeh, Ahmadi and Pouyamanesh, 2013), but is lower than the average corporate indebtedness for the Pakistani (73 percent) companies (Asif, Rasool and Kamal, 2011).

The average value of dividends distributed to the Romanian company's shareholders relative to share price is lower than that of Pakistani (0.09) companies (Asif, Rasool and Kamal, 2011).

Table 1. Descriptive statistics of variables

	Mean	Std. Deviation
DPS	1.56	5.12
DR	0.23	0.22
DY	0.06	0.09
ΔE	0.58	3.72

Table 2 presents the results of estimating regression model by examining the relationship between dividend policy and financial leverage of non-financial companies listed on Romanian equity capital market. In order to estimate the effect of independent variables on the dividend per share, cross section weights and White's heteroskedasticity have been taken into account.

Table 2. Results of regression

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.369	0.041	32.682	0.000
DR	-1.345	0.184	-7.301	0.000
DY	-1.656	0.626	-2.643	0.008
ΔE	-0.028	0.005	-4.986	0.000
R ²	0.220			
Adj. R ²	0.216			

The results of this regression show that dividend per share and debt ratio have significant negative association. Thus, the lower the leverage the corporate employs, the higher the dividend per share that it distributes. This finding is in line with (Al-Kuwari, 2009); (Asif, Rasool and Kamal, 2011); (Vo and Nguyen, 2014); (Ghasemi, Razak and Muhamad, 2018) but does not agree with the findings of (Vasiliou and Eriotis, 2003); (Emamalizadeh, Ahmadi and Pouyamanesh, 2013) where they mentioned the fact that debt ratio is positively associated with dividend policy.

The analysis documents a negative relationship between last year dividend yield and dividend policy, which means that an increase in the dividend yield has an indirect impact on the next year's dividend. This findings is not consistent with (Vasiliou and Eriotis, 2003); (Asif, Rasool and Kamal, 2011); Emamalizadeh, Ahmadi and Pouyamanesh, 2013). It can be noticed a significant negative association between change in earning and dividend policy. This is not in line with (Vasiliou and Eriotis, 2003); (Asif, Rasool and Kamal, 2011).

Conclusions

This paper investigates the relationship between dividend policy and financial leverage using a sample of non-financial Romanian companies. The study is considered a model that links the corporate dividend policy with the debt ratio of the company, the dividend yield and the change in earnings of the firm. The results indicate that leverage has a significant and negative impact on the dividend policy of Romanian firms. This means that companies with lower leverage have a generous dividend policy. The relationship could be justified by the pecking order theory which states that internal financing is less costly compared to external financing. By conducting this study, we have contributed with knowledge regarding the factors that affect the dividend policy of companies on Romanian market which are useful for academics, analysts and investors.

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