FIRM SPECIFIC FACTORS AFFECTING DIVIDEND PAYOUT OF PRIVATE INSURANCE COMPANIES IN ETHIOPIA

Haimanote Walle Melese[1]and Prof. Jaladi. Ravi [2]
[1]Research Scholar, Department of Commerce and Management Studies, Andhra University, Visakhapatnam, India
[2]Professor, Department of Commerce and Management Studies, Andhra University, Visakhapatnam, India

ABSTRACT

The objective of this study is to investigate the firm specific determinants of dividend payout in selected private insurance companiesin Ethiopia over the period 2006 to 2017. The study employed quantitative research approach and explanatory research design. Random effect panel regression model was employed for 8selected private insurance companies. The empirical results revealed that firm age,firm size, growth opportunity, lagged dividend, liquidity, profitability, risk and tangibility are significant factors for dividend payout ofprivate insurance companies in Ethiopia. On the contrary,leverage and premium are found to be insignificant factors to determine dividend payout of private insurance companies in Ethiopia.

KEY WORDS: Dividend payout,determinants, insurance companies, Ethiopia

INTRODUCTION

Awell-developed insurance market paves way for efficient resource allocation through transfer of risk and mobilization of savingsCharumathi (2012). Besides, insurance companies contribute substantially to the national economy by using capital gathered through premiums for investment (Gulsun&Umit, 2010).Therefore, the current business world in the absence of insurance companies is unsustainable, because risky businesses have no a capacity to retain all types of risk in current extremely uncertain environment.

Corporate investment, financing and payout decisions are the three main pillars (trilogy) of corporate decisions. Dividend policy is one of the major categories of corporate financial decisions that managers face, and they can affect shareholders wealth through their dividend policy decisions (Glen *et al*., 1995; Brealey and Myers, 2003). The “dividend puzzle” has initiated many researchers in finance to examine the extent to which dividend policy is influenced by corporate financial decisions. The puzzling aspects of dividend behaviour have empirically evolved from the diverse interpretations provided by corporate managers as well as investors regarding the dividend payout policy.

Even though, a number research has been conducted on dividend policy; gaps still exist from both theoretical and empirical perspectives. The dividend puzzle results from the existence of dividend policy in

a real world that is multivariate and complicated (DeAngelo*et al*., 2008). Frankfurter and Wood (1997) indicated that dividend policy is influenced by customs, regulations, public opinion, perceptions, general economic conditions, and several other factors. Besides,most of the empirical studies appear to focus on the dividend behaviours of companies in developed economies, but the evidence from developing economies is very limitedand the findings of the developed economies may not be directly applied to developing economies like Ethiopia due to differences in regulations, culture environment and nature of investors.Therefore, examining dividend policies of firms in developing countries particularly in Ethiopia will offer further insights into the firm specific factors that influence corporate dividend decision.The objective of this study was to examine the effect of firm specific factors on dividend payout of Ethiopian private insurance companies. Specifically, the study examined the effect of profitability, firm age, firm size, growth opportunity, premium income, leverage, liquidity, tangibility, and risk and lagged dividend on dividend payout of private insurance companies in Ethiopia.

EMPIRICAL REVIEW ON FIRM-SPECIFIC DETERMINANTS OF DIVIDENDPAYOUT

Dividend policy of a firm is either positively or negatively affected by different firm specific factors.

1. Profitability

According to the signaling theory of dividend policy, profitable firms are willing to pay higher amounts of dividends to convey their good financial performance (Ho, 2003; Aivazian *et al*., 2003). Benartzi *et al*. (1997) stated that dividend payments are used to signal current profitability, rather than futureprofitability, they reported a positive correlation between profitability and dividends. Consequently, the signaling theory of dividend policy supports the argument that profitable firms pay larger dividends to signal their good financial performance.Nuredin(2013) study of determinants of dividend policy of insurance companies in Ethiopia found that profitabilityhas positive and statistically significant effect on dividend payout.Moreover, a study conducted by Asefa (2018) on determinants of dividend policy of insurance companies in Ethiopia found that profitability has positively related to dividend payout.

2. Liquidity

Darling (1957) suggested that a firm's liquidity is crucial in determining its dividend policy within the capital budgeting process.Ho (2003) found that firms with higher cash availability pay higher dividends than others with insufficient cash availability.Amidu and Abor (2006) find a positive relationship between cash flow and dividend payout ratios. (Anil and Kapoor 2008) also indicate that cash flow is an important determinant of dividend payout ratio. Nuredin (2013) study on determinants of dividend policy of insurance companies in Ethiopia found that liquidity has positive and statistically significant effect on dividend payout. Moreover, a study conducted by Asefa (2018) on determinants of dividend policy of insurance companies in Ethiopia found that liquidityhas positively related to dividend payout.

3. Leverage

The empirical evidence regarding the effect of leverage on dividend payout is varied. Some studies found that firms with high debt ratios are willing to pay fewer dividends (Al-Malkawi, 2005; Faccio et al., 2001; Gugler & Yurtoglu, 2003) since they are committed to fixed payments to service their debt, which restrict the distribution of dividends. Nuredin (2013) study on determinants of dividend policy of insurance companies in Ethiopia found that, leverage has a negative relationship with dividend payout.Besides, a study conducted by Asefa (2018) on determinants of dividend policy of insurance companies in Ethiopia found that leverage ratio has positive and statistical significant effect on dividend payout in Ethiopian private insurance share companies.

4. Firm Size

Large size firms can obtain external finances because of their high asset value and better growth perspectives, therefore dividend payments are not reduced with high investment opportunities (Afza & Mirzan 2010).Redding (1997), Holder *et al*. (1998), Fama & French (2001), Aivazian *et al*. (2003), Mehta (2012), Al-Malkawi (2007), Mahdzan, *et al.* (2016), Jumah *et al*. (2008), and Sawicki (2005) found a positive relationship between dividend payout. On the other hand, in some countries the size of the firm has a negative influence on dividend payout; large firms want to meet investment needs internally rather than externally. They retain funds than distributing dividends (Ahmed & Javed 2009). Nuredin(2013) study on determinants of dividend policy of insurance companies in Ethiopia found that firm size has anegative but insignificant relationship with dividend policy.

5. Firm Age

Grullon et al. (2002) proposed an alternative explanation to Jensen's (1986) free cash flow hypothesis, known as the maturity hypothesis, which suggests that higher dividend increases are a sign of change in a firm's life cycle, particularly in a firm's transition from growth phase to a more mature phase. Since a firm gets older interms of age, its investment opportunities decline. This leads to slower growth rates, and therefore, reduces the fund's requirements of capital expenditure. However, mature firms tend to have steady earnings with high excess to external capital markets and they are able to preserve a good level of funds, which allows them to pay higher dividends. Moreover, a study conducted by Asefa (2018) on determinants of dividend policy of insurance companies in Ethiopia found that firm age haspositive and significant relation with dividend payout.

6. Growth opportunity

According to Myres and Majluf (2013), companies having high growth opportunities require more money to finance their future investment; as a result they pay fewer dividends and make more investments.Accordingly, Rozeff (1982) hypothesised that the relationship between anticipated investment

opportunities and dividend payout ratio is negative since firms prefer to avoid transaction costs related to external financing.La Porta et al. (2000), however, stated that the relationship between dividend policy and investment opportunities may significantly differ in countries with poor shareholders protections.Nuredin(2013) study of determinants of dividend policy of insurance companies in Ethiopia found that, Growth opportunity has negative and statistical effect on dividend payout. Furthermore, a study conducted by Asefa (2018) on determinants of dividend policy of insurance companies in Ethiopia found that growth opportunity has negative and statistically significant relation with dividend payout.

7. Gross Premium

Premium is a part of insurance companies earning collected from the insured persons and companies during a given financial year. An insurance company which generates high amount of gross premium pays high amount of dividend to its share holders. Uddin (2009) examined the factors that determinate the dividend payout of insurance sector of Bangladesh listed in both Dhaka stock exchange and Chittagong Stock exchange. The result of this study indicates, gross premium affects the dividend decisions of an organization. Moreover Mashiur, Dipak and Naznin (2013) found that gross premium has significant positive relation with dividend payout.

8. Risk

The higher the risk is, the more likely the firm will be bankrupt and hence the less the chance for firms to pay dividends (Al-Najjar, 2009). According to Holder et al. (1998), transaction costs of new issues in the form of under-writing fees are typically much larger for riskier firms. Further, Farinha (2003), Al-Najjar (2009) and Mehta (2012) reported a negative relation between business risk and dividend policy, which supports the notion that firms that have higher uncertainty about their earnings tend to distribute none or lower dividends. In this study underwriting risk is considered. Underwriting riska risk that the premiums collected will not be sufficient to cover the cost of coverage. Organizations that engage in risky activities are likely to have more volatile cash flows than entities whose management is more averse to risk-taking (Fama and Jensen, 1983).

9. Tagblity

Al Yahyaee (2006) carried out a study entitled as capital structure and dividend policy in a personal tax free environment in the case of Oman indicated that dividend policy can be affected by tangibility. Besides a study conducted by Asefa (2018) on determinants of dividend of private insurance companies in Ethiopia found that tangibility has positive and statistically positive relationship with dividend payout.

10. Lagged Dividend payout

Astudy by Asefa (2018) on determinants of dividend policy of insurance companies in Ethiopia found that lagged dividend and current period dividend payout has no relation. Besides, Hosain (2016), Rehman and Takumi (2012) on their study entitled as Determinants of dividend payout ratio: Evidence from Karachi Stock Exchange (KSE) found that lagged dividend payout and current year dividend payout has positive relationship.

MATERIALS AND METHODS

This study employed quantitative research approach and explanatory research design. The quantitative aspect of the research approach is through the financial statements of private insurance companies in Ethiopia from the year 2006 to 2017 and explanatory research design is employed since this design attempts to clarify the relationship between two aspects of a situation or phenomenon (Kumar, 2011). There are 16 private insurance companies operating in Ethiopia. Of these, 8 sample private insurance companies have been selected purposively on the basis of audited financial statements from the year 2006 to 2017. The financial statements of sample banks are gathered from National Bank of Ethiopia (NBE).

Table 1: Definition and Measurement of Variables

Type of variable	Variable	Measurement	Notation
Dep.Variable	Dividend payout	Annual dividend / Net income after tax	DPO
Firmspecific Variables	Profitability	Net income before tax / Total Assets	PRO
	Firm age	Year of Financial Report – establishment Year of a Company	FA
	Firm size	Natural logarithm of Total Assets	FS
	Growth opportunity	$\frac{\text{Current year revenue – previous year revenue}}{\text{Previous year revenue}}$	GO
	Gross Premium	income from underwriting to total assets	GP
	Leverage	Total debt to total assets	LEV
	Liquidity	Current assets to current liabilities	LIQ
	Tangibility	Total fixed assets to total assets	TANG
	Risk	claim incurred / premium earned	R
	Lagged Dividend	First lag of dividend payout	LAGDPO

Random effect panel regression model is used to estimate the coefficients of variables based on the result of Hausman test employed to test whether the random effect or fixed effect model is appropriate. As revealed in the following table, p-value of this test is 0.3215 which is insignificant at 5%.Hence the appropriate model is random effect panel regression model than fixed effect panel model.

Table 2: Correlated Random Effects - Hausman Test result

Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	18.238153	10	0.3215

Source: Own calculation using Eviews 9 software package

The Random effect regression model used in this study is;

DPOit = β 0 +β1(FA)it + β2(FS)it + β3(GO)it + β4(GP)it +β5(LEV)it + β6(LIQ)it + β7(TANG)it + β8(R)it + β9(PRO)+ β10(LAGDPO)it + εit

Where εit indicates the error term for insurance i at time t, β_1, β_2…. B_{10} are the coefficients of explanatory variables and β_0 is the constant. Regression models may encounter problem/s, e.g. wrong coefficient estimates and wrong standard errors etc. so as to achieve more reliable and consistent estimates, regression model demands to possess the classical regression model assumptions, which should be in line with OLS assumptions. Therefore, various regression diagnostic tests were made. Based the diagnosis tests result all the assumption of the classical linear regression model are satisfiedwith the exception of auto correlation. To remove the auto correlation problem, the first lag is taken. Correlation coefficient above 0.7 could cause a serious multicollinearity problem leading to inefficient estimation and less reliable results Kennedy (2008).

Table 3: Multicollinearity Test result

	FA	FS	GO	GP	LAGDPO	LEV	LIQ	PRO	R	TANG
FA	1									
FS	0.2968	1								
GO	-0.0621	-0.2273	1							
GP	-0.007	0.0151	-0.0133	1						
LAGDPO	-0.0501	0.2061	0.0622	-0.0729	1					
LEV	-0.0443	0.0897	0.0268	0.1081	-0.2438	1				
LIQ	-0.1489	-0.1242	-0.0064	-0.1595	0.1779	-0.2426	1			
PRO	0.0002	0.0855	0.3175	0.1085	0.2016	-0.4339	-0.066	1		
R	0.2861	0.0513	-0.0108	-0.0333	-0.1039	0.2639	-0.378	-0.0754	1	
TANG	-0.0501	0.0945	0.0503	0.6587	-0.005	0.2283	-0.111	0.1018	-0.0393	1

Source:Own calculation using Eviews 9 software package

As indicated in the above table, the results of the correlation matrix indicated that the highest correlation was 0.6587 (65.87%) which is between tangibility and gross premium.

As a result, sincethe correlation coefficient is below the above stated figures i.e 0.7 as noted by Kennedy (2008),we can conclude that this study have no multicollinearity problem.

RESULTS AND DISCUSSION

As indicated in Table 4 below, Prob. (F statistic) 0.000000 indicates that the model fitted the data at 1% significance level which enhanced the reliability and validity of the model used in this study. According to (Brooks, 2014), R square value measures the magnitude of the influence or ability of predictor variables simultaneously in describing the response variable. Therefore, the goodness of fit Rsquare is 0.40 which indicates 40.0% of changes in dividend payout is explained by the variables included in the model while the remaining change was explained by other factors which are not included in the model. The adjusted R square of 0.3852 indicated that 38.52% changes in the dividend payout is explained by the independent variables considered in the model. The advantage of using adjusted R square over the R square is that Adjusted R Square Value measures the magnitude of the influence or ability of predictor variables simultaneously in explaining the response variable by observing the standard error.

Table 4:Random effect panel regression model result

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.093408	0.027904	-3.347486	0.0008*
FA	0.000993	0.000253	3.923523	0.0001*
FS	0.009055	0.001368	6.617462	0.0000*
GO	-0.037375	0.011800	-3.167263	0.0016*
GP	-0.007237	0.007912	-0.914681	0.3605
LAGDPO	0.295783	0.024607	12.02021	0.0000*
LEV	-0.019114	0.018365	-1.040773	0.2982
LIQ	0.011712	0.006345	1.845801	0.065***
PRO	0.282915	0.032661	8.662037	0.0000*
R	-0.087217	0.007869	-11.08375	0.0000*
TANG	0.049041	0.011065	4.432263	0.0000*
Effects Specification				
Cross-section fixed (dummy variables)				
R-squared	0.400522	Mean dependent var		0.089183
Adjusted R-squared	0.385235	S.D. dependent var		0.048240
S.E. of regression	0.037823	Akaike info criterion		-3.694890
Sum squared resid	1.732449	Schwarz criterion		-3.607679
Log likelihood	2297.052	Hannan-Quinn criter.		-3.662081
F-statistic	39.56963	Durbin-Watson stat		1.996271
Prob(F-statistic)	0.000000*			

indicates significant at 1%, ** indicates significant at 5% and * indicates significant at 10%.* Source: Own calculation using Eviews 10 software package

Source: Own calculation using Eviews 9 software package

As indicated in the above table (table4) the coefficient estimate of the constant term of the regression (β_0) is -0.0934 shows that all other value of explanatory variables becomes zero; the value of the explained variable is decreased by -0.0934.

Besides, the above all variables are significant except GP and LEV.Growth opportunity and Risk are negatively and significantly related with dividend payout with the coefficient of - 0.037375 and -0.087217 respectively. This indicates that 1 Ethiopian Birr (ETB) increase in growth opportunity and risk decreases 3.737 and 8.721 cents in dividend pay our respectively and p value of 0.0016 and 0.0000 represents it`s significant at 1% level.

The above random effect regression result also revealed the effect of age of the firm on dividend payout with a coefficient of 0.000993 and p value of 0.0001 which is significant at 1% level.The positive coefficient of firm age indicates that there is a direct association between firm age and dividend payout. Other thing remains constant as firms` age increased by one year the dividend payout of private insurance companies also increased by 0.0993 cents. The same result is found by Al-Malkawi (2007),Asefa (2018).

Log of total asset as a measure of firm size has positive and significant effect on dividend payout at 1% with a coefficient and p value of 0.009055 and 0.0000 respectively. This indicates that a 1% increase in insurance size will increase dividend payout by 0.9055 cents and vice versa. Firm size has standard error of 0.001368 which indicates that the errors of coefficient estimates. The same result is found by Mehta (2012), Al-Malkawi (2007), Mahdzan, et al (2016), Jumah et al. (2008),Redding (1997), Holder *et al*. (1998), Fama & French (2001), Aivazian *et al*. (2003) and Sawicki (2005).

Moreover, the above random effect regression result table (table 4) revealed that LAGDPO has positive and significant effect on dividend payout with a coefficient and p value of 0.295783 and 0.0000 respectively. This indicates that the first lag of dividend payout (preceding year dividend payout) has positive and significant effect on the current year dividend payout (DPO). The same result is found byHosain (2016) ,Rehman and Takumi (2012).

Liquidity position of private insurancecompanies has positive and significant effect(at 10%) on dividend payout with a coefficient and p value of 0.011712 and 0.0652. As a result, an increase in 1 ETB in the liquidity position of private insurance companiesincreases dividend payout by 1.1712 cent. The same result is found by Mohamed, *et al*. (2008), Jumah *et al*. (2008),Asefa (2018),Amidu and Abor (2006) and Nuredin (2013).

Return on asset as a measure of profitabilityhas positive and significant effect on dividend payout at 1% with a coefficient and p value of 0.282915 and 0.0000 respectively. This indicates that 1 ETB increase in the profitability of private insurance companies will increase dividend payout by 28.29 cents and vice versa. The same result is found by Amidu and Abor (2006), Mohamed, *et al*. (2008), Al-Malkawi (2007), Mahdzan, *et al*. (2016), Jumah *et al*. (2008), Marfo-Yiadom and Agyei (2011).

Moreover, the above random effect regression result also revealed the effect of tangibility on dividend payout with a coefficient of 0.049041and p value of 0.0000 which is significant at 1% level.The positive

coefficient of tangibility indicates that there is a direct association between tangibility and dividend payout. The same result is found by Marfo-Yiadom and Agyei (2011) ,Asefa (2018).

CONCLUSIONS

The study examined the firm specific determinants of dividend payout of private insurance companies in Ethiopia. The empirical result of the study revealed that firm age, firm size, lagged dividend, liquidity, profitability, and tangibility have positive and significanteffect on dividend payout of selected private insurance companies in Ethiopia. Risk and growth opportunities have negative and significant effect on dividend payout. On the contrary, leverage and premium are found to be insignificant factors to determine the dividend payout of private insurance companies in Ethiopia.

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