

## Dividend policy and practice in South Africa

### INTRODUCTION

For over twenty years the rationale underlying a firm's dividend decision has attracted the attention of financial analysts and academics and has led to an extensive body of theoretical and empirical research. In broad terms, this continuing interest has two sources, both based on the neo-classical theory of a firm's objective to maximise shareholder wealth. Firstly, what effect does a firm's dividend policy have on its valuation, and secondly, is the decision chiefly influenced by its financing policies or its investment policies? Divergent views have been and continue to be expressed. It is an inescapable fact, however, that dividends flow from the decisions of the firm's directors and that such decisions must reflect management's perception of their responsibilities and objectives. What are the factors which influence their decision? Within what framework or context is their decision taken? It is to these questions that this study is addressed.

This paper therefore examines the so-called pragmatic approach to a firm's dividend policy. To do this, we undertook a survey of a representative sample of South African companies quoted on the Johannesburg Stock Exchange. The survey took the form of a short questionnaire addressed to the financial executives of these companies. The first section of our paper gives a very brief introduction to the current literature and views extant on the dividend problem. We do this because some of the views published have influenced us in the design of our survey. Next, we formulate five hypotheses and this is followed by a discussion of the survey and the responses which it elicited. Finally, we summarise our findings and suggest some conclusions to be drawn.

### THE DIVIDEND DECISION

There are two broad schools of thought to a firm's dividend policy – the theoretical (or normative) approach and the practical (or pragmatic) approach. The literature extant is overwhelmingly the work of academics and as a result is concerned with the theoretical debate. Much of the earlier works, a direct result of the input of neo-classical theory, such as that of Modigliani and Miller (1961), Gordon (1962 and 1963), Solomon (1963) and Walter (1967) revolved around the impact of the dividend decision on the valuation of the firm and the consequential relevance or irrelevance of this decision.

Protagonists of the school that support dividend relevance base their propositions on empirical investigations that have been carried out to identify the variables that influence share prices. These investigations seemed to indicate that current dividends alone explain a considerable proportion of variations in price. On the other hand, the classic dividends-irrelevance proposition of Miller and Modigliani was that, in a perfect capital market, dividend policy cannot matter. The important point here is that in a perfect capital market the value of any asset depends upon real economic considerations (earnings and investments) and not the manner in which the return from the asset is packaged (dividends and capital gains). However, the assumption of a perfect capital market is not consistent with reality. The two

most important imperfections in the market which might systematically bias investors in favour of one specific form of return are:

- 1 transaction costs; and
- 2 differential income taxes (as between classes of investors and forms of return – dividends and capital gain).

There are several researchers who have used the tenets of portfolio theory and efficient market theory to demonstrate that these imperfections do not alter the basic proposition. Black describes a rational investor as one who "will buy a well diversified portfolio, and hold on to it. He will generally sell only to establish tax losses, or when he needs the money. He may borrow against his portfolio when he needs money, instead of selling, to avoid realising capital gains. He will minimise investment expenses, brokerage costs, and taxes" (1971, p.457).

Thus, according to this theory a rational investor will pursue a passive portfolio strategy and similarly a rational management controlling a firm's funds in an efficient market would pursue a 'passive residual' dividend policy.

*"... a firm would invest the internal funds it generates either within the firm or by acquiring assets of another firm, subject only to the constraint that each new investment has a net present worth greater than zero, i.e., that the expected yield on internal investment is higher than the capitalisation rate for earnings of the quality expected. After all such investment opportunities have been exhausted, any internal funds remaining would be distributed to shareholders as cash dividends."* (Solomon, 1963, p.139)

More recent research has concentrated on market imperfections being the underlying cause for whether dividends do not matter in practice. Elton and Gruber (1970), Black and Scholes (1974), Pettit (1977) and Miller and Scholes (1978) are examples of this type of research. Another area of recent interest has been that of the information content of dividend announcements in that dividend changes (or stability) act as signals from management to the market. Authors in this field include Laub (1976), Gonedes (1978) and Taylor (1979). Cadle (1981) contends that in fact the initial debate has been resolved and maintains "the dividend controversy thus revolves around market imperfections – transaction costs, taxes and redistribution of wealth among security holders." It is not our intention to review the debate but the results of the research studies are extremely important to the establishment of company dividend policy. What position do management appear to take?

The literature in respect of surveys of company dividend policies appears to be very sparse and we have been able to identify three in the past twenty-five years and these are by Lintner (1956), Thomson and Walsh (1967) and Hawkins and Walsh (1971). All three studies were conducted in the USA and thus reflect the American attitude. The Hawkins and Walsh study was undertaken for the Conference Board and we have been unable to trace the original work and have relied on Cadle's survey.

No comparable survey has been undertaken in the UK but we understand one is presently being conducted by Theobald and Cadle of the University of Manchester. The results and conclusions of the three American surveys have a great deal in common and the major factors influencing the practices of USA companies may be summarised as follows:

- 1 The dividend decision is regarded as an active and primary variable and not as a passive residual.
- 2 The company's earnings and future prospects is a dominating influential factor.
- 3 The maintenance of a continuous record of dividend payment and a stable rate of dividend per share is a significant factor.
- 4 The company's cash flow, current liquidity and future cash needs are regarded as important considerations.
- 5 The needs and expectations of shareholders are given due recognition.
- 6 There is some evidence of consideration of a (long-term) target pay out ratio.
- 7 The availability of investment opportunities does not appear to be a matter for serious consideration.

As Thomson and Walsh (1967, p.688) state:

*"For the most part the companies desire to give shareholders a steady and dependable return without losing sight of the companies' long-term and short-term needs for funds. When deciding whether to distribute earnings, either in the form of cash or stock, or to retain them for future growth, most companies strive to follow policies that meet the shareholders' needs for income or capital appreciation, and at the same time, preserve the soundness of company finances."*

#### THE HYPOTHESES FORMULATED

The purpose of our survey was generally to gain some basic insight into the dividend policies and practices of South African companies and more specifically to determine whether the factors which influence dividend policies in South Africa were the same as those identified in the USA.

In addition, we wanted to establish to what extent a theoretical belief in or the acceptance of a theory, subject to the constraints inherent in that theory, would affect practice.

In our view, the South African economy and its industrial structures are not very dissimilar to those prevailing in the USA. South Africa has a complex capital market with a wide range of financial institutions, a broad section of sophisticated investors and an active and reputable stock exchange. There are, however, two differences to be mentioned. That is the nature and degree of exchange control regulations and the system of taxation. However, we suggest that these differences do not affect the major factors which are taken into consideration by management when making their dividend decisions.

Accordingly, we formulated the following hypotheses:

- 1 Management would follow dividend policy which can be described as an active variable. This is to say, irrespective of the number of desirable and acceptable investment opportunities which could be financed from the company's internally generated funds (retained earnings), the payment of a dividend would be of paramount importance.
- 2 That the majority of financial executives would not believe in the efficiency of The Johannesburg Stock Exchange as a capital market.

- 3 That those executives who did believe in the efficiency of The Johannesburg Stock Exchange would support (or advocate) a dividend policy which is a passive residual and they would hold the view that shareholders should be indifferent between dividend income and capital gains.

- 4 That in ranking those factors which influence a company's dividend policy continuity of payment of a dividend would be placed first followed by a stable rate of dividend payment.

- 5 That the most important factors influencing a dividend policy would be the company's past and prospective earnings.

#### THE SURVEY

Our survey was conducted in 1980. It consisted of a short questionnaire of six questions addressed to the financial executives of a sample of companies listed on The Johannesburg Stock Exchange. A copy of this questionnaire with a summary of the responses received is attached as an Appendix to this paper. The sample used was drawn from those companies used as constituents in the JSE Actuaries Index as at 30 April 1980. The constituents of the index number 145 companies out of 491 listed companies.

From this sample of 145 companies, responses were received from 70 companies (48%) but 8 of the respondents were clearly from the same group (with the same financial executive) and if all eight were included there would be an obvious bias. We have accordingly reduced our sample size by 7 to 138 companies and our number of respondents to 63. These respondents were from 25 separate sectors of the stock exchange. Thus, we have a response rate of 46%. We regard this as satisfactory and the respondents as sufficiently representative of South African companies. It will be noted that the questionnaire was short and simple and this was done in the knowledge of the heavy demands already made on senior executives' time. We would like to express our thanks to those who responded so readily to our survey.

We will now comment on the responses.

#### 1 Dividend policy pursued

In order to establish whether management view the dividend as relevant or irrelevant perhaps the most direct way of finding out is to pose the question *"Is the dividend policy pursued by your company best described as an actual variable or a passive residual?"* This was question 1 of our questionnaire.

Of the 63 valid respondents, 57, that is 90%, stated that their companies pursued a dividend policy which is an active variable. This is a very high proportion but nevertheless in line with our expectations. It also confirms our first hypothesis. In our opinion, this very high response is significant in that it indicates that companies' managements see dividends as having a positive role in investors' perceptions of a company, an indication which is supported by many of the respondents' replies to questions 4 and 6.

Of the six companies whose financial executives stated they pursued a dividend policy which can be described as a passive residual only one gave completely consistent responses to the remaining questions. That one respondent believed in the efficiency of The Johannesburg Stock Exchange, believed that shareholders should be indifferent as between dividend income and capital gains and also in question 5 gave the most important

ranking to "the opportunities for investments" with "anticipated need for funds" second. Although all the other five respondents believed in the efficiency of The Johannesburg Stock Exchange, none believed that shareholders should be indifferent between dividend income and capital gains and only one ranked as the two most important factors "the opportunities for investment" and "anticipated need for funds".

## 2 The efficiency of markets

Reference to the copy of the questionnaire (see Appendix) will show that question 2 was divided into four parts. The question was designed to test hypotheses 2 and 3. The responses were perhaps surprising in view of the answers to the first question – 53 of the respondents (84%) believed in the efficiency of the capital markets of which 47 (75%) also believed The Johannesburg Stock Exchange to be efficient in the sense of the semi-strong form of the efficient markets hypothesis. Of these 47 respondents, 41 were companies that viewed the dividend as an active variable. Thus, it would appear that while directors do believe a dividend should be an active variable they do not consider this belief as inconsistent with their belief in The Johannesburg Stock Exchange being efficient. Some of the reasons for this can be found in the responses to the next question where, of the 47 respondents who believed the exchange to be efficient, 42 (90%) believed that shareholders should not be indifferent as between capital gains and dividend income. In question 2(iv) 17 (40%) of the 42 respondents elaborated on the reason for their response. The reasons given are enlightening and highlight the imperfections in the market:

*"directed by controlling company" (Property Constituent)*

*"our majority shareholder expects a dividend income" (Electronics, Electrical and Batteries Constituent)*

*"our upstream shareholders are investment companies requiring dividend income" (Sugar Constituent)*

*"eventual owner is a US multinational that prefers international type acquisitions and requires funding through dividends equalling profits" (Building and Construction Constituent)*

These imperfections do not affect the concept of market efficiency in the sense that such imperfections are all publicly available information and would have been impounded into share prices.

It is clear from the responses to question 2 that hypotheses 2 and 3 are rejected. It would seem company executives are of the opinion that while the market is efficient it is not perfect and that these imperfections result in the fact that an active and positive dividend policy satisfies the needs of (the majority?) shareholders. Thus, the existence of imperfections take priority over possible investment opportunities, a decision which may not be consistent with the objective of maximising shareholder wealth.

## 3 Factors affecting dividend policy

Questions 3 and 5 were designed to test hypotheses 4 and 5. Recall that the USA findings indicated that "continuity of payment of a dividend" followed by "a stable rate of dividend" were ranked top of the scale and in our hypothesis 4 we reflected this scaling in South Africa. Similarly, in the USA the determining influence factor was a company's "earnings and future prospects." This is also reflected in our hypothesis 3. The results were unequivocal. The question 3, on a percentage first ranking basis, 60% placed "continuity of payment" first,

19% "stability of rate" and 6% "stability of amount" second. Thus 85% placed continuity and stability as the most important factors. If the ranking is done on a point scale with 5 points for the first ranking and 1 point for the fifth ranking, then the rating is – "continuity" 31%, "stability of rate" 24% and "stability of amount" 23%, a total of 78%.

Question 4 asked respondents to give their reasons for the top ranking in question 3. Only 4 out of the 63 respondents failed to comment. All the responses were related to shareholders' attitudes and needs. For example, the phrase "to maintain shareholder confidence" appeared most frequently, followed by "shareholders expect a cash return" and "continuity of dividend payment necessary for share to have a high rating". It would appear that management believe most strongly that dividends are relevant to the market's valuation of their company's shares. Furthermore, in our opinion the responses reflect the managements' "clientele" view of investors; that investors hold shares in a specific company because it meets their individual needs.

The rankings of question 5 were just as conclusive. On a percentage of first rankings the scores were – "past and future earnings" 39%, "amount of cash available" 21%, "shareholders' desire for cash income" 19% and "anticipated need for funds" 14%. Not surprisingly, in view of the replies to question 1, the "opportunities for investment" was at the bottom of the scale with 2,5% (on the same point scale, the rankings were the same with respective scores – 24%, 21%, 19% and 19%).

It is clear from the results of these responses that our hypotheses 4 and 5 must be accepted.

## 4 Desired relationship between dividends and earnings

Question 6 was used to evaluate not only a company's attitude to a pay out ratio but also represented a veiled hope on our part to see whether respondents would relate dividend cover to the problems of inflation. In this respect, we refer to the work by Archer (1981) where he discusses the significance of dividend cover during periods of inflation. Within the context of his methodology, Archer states:

*"Dividend cover has an important role to play. When a company is affected to a large extent by inflation the danger of an adjusted dividend cover of less than one, if the historical cover is not high enough, is very real" (p. 29).*

57 of the 63 respondents commented on question 6. Of these 15 referred directly and several indirectly (about 26%) to the problem of inflation and the need for an adequate dividend cover. Perhaps more interestingly, 36 respondents (66%) quantified their target dividend cover. These ranged from 1,4 to 1, to 5,3 to 1, with a mean of 2,5 and a mode of 2. Unfortunately very few respondents (only 7) referred to the cover in 'real' terms. It would appear that maintenance of 'capital' is not an issue! These responses would indicate that respondents are conscious of the need for a positive policy of dividend cover and this too is interesting in view of the fact that very few companies publish a stated policy of dividend cover.

## SUMMARY AND CONCLUSIONS

There is little doubt that the results of the survey suggest that South African managements display the same attitudes to dividend policy as do the USA counterparts described by Cadle (1980). They, thus, follow an active and positive dividend policy and are chiefly influenced by recorded earnings and the prospect of future

earnings. Furthermore, the implementation of their dividend policy is dominated by the two factors of continuity of payment and stability of the dividend.

A substantial majority of executives believe in the efficiency of the stock market and do not believe this to be inconsistent with their dividend policy described above. They appear to believe in the information content of an active dividend policy but are not prepared to substitute 'indirect' information with direct information. The efficiency of markets (and for that matter economic efficiency) is dependent upon information. In financial terms, including annual financial statements, information refers to the full disclosure of **relevant** information. Much of the accounting literature, for example Arnold and Hope (1975), is replete with the benefits to be gained by investors from the disclosure of forecast information. The criticisms of disclosure of forecasts is also well documented but disclosure of intent could be equally useful and relevant information to investors. Intent is related to policy decisions whereas forecasts are related to expectations. If a company reduces or passes its dividends in order to avail itself of sound opportunities and disclosed all relevant information to investors we believe such a dividend decision would not adversely affect the market's valuation of a company and would be consistent with the objective of maximising shareholders' wealth. If a company foregoes investment opportunities because of certain (incorrect?) beliefs in shareholder understanding, then in the long term shareholders' welfare is not being maximised. We believe managements, or more particularly the accountants responsible, should ensure that investor understanding is improved by full and fair disclosure of all relevant information.

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# Questionnaire to selected sample of financial executives

## Subject: Dividend policy and practice

### JSE Section

**Question 1**

This question refers to the general policy to which your company subscribes. Do you believe in a policy such that irrespective of the number of desirable and acceptable investment opportunities which could be financed from retained earnings (and funds) your company considers the payment of a dividend as of overriding importance? In other words you regard **the dividend decision as an active variable**? Alternatively do you believe in a policy that the declaration and payment of a dividend should only be considered when all desirable and acceptable investment opportunities have first been financed from available retained earnings (and funds)? That is to say you regard **the dividend as a passive residual**?

Is the dividend policy pursued by your company best described as:

(Please mark with an "X" in the appropriate square)

An active variable? 57 90%

or

A passive residual? 6 10%

**Question 2**

This question is in three parts. Please answer subsequent parts only if your previous answer is "Yes"

The first part of the question refers to what is known as "efficient capital markets", which implies that the prices of securities in such markets fully reflect all publicly available information about such securities.

(Please place an "X" in the appropriate square)

*Part I*

Do you believe that capital markets, such as stock exchanges, can be efficient in the above sense?

Yes	53	84%
No	10	16%

*Part II*

If your answer to Part I is "Yes" then do you believe that The Johannesburg Stock Exchange is efficient?

Yes	47	90%
No	5	10%

*Part III*

If your answer to Part II is "Yes" then do you believe investors should be indifferent as between capital gains and dividend income (especially as in South Africa capital gains are not taxed)?

Yes	5	11%
No	42	89%

*Part IV*

If your answer to Part III is "Yes" do you then believe that your company should pursue a dividend policy that is a **passive residual**?

Yes	3	60%
No	2	40%

If your answer to Part IV is "Yes" but your company does not or if your answer to Part III is "No" could you please elaborate briefly?

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**Question 3**

Please rank the relative importance of the following factors which influence your company's dividend practice (1 = most important).

	First running	Point scale
Continuity of payment	60,3%	31,1%
Stability of rate of div.	19,1%	24,0%
Stability of amount of div.	6,4%	23,0%
Importance of size	4,7%	14,0%
Other (please specify)	9,5%	8,0%

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**Question 4**

In respect of the item given the top ranking, could you please give your reasons for this ranking.

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**Question 5**

Could you please indicate the relative importance attached to the following factors in influencing your dividend practice. (Please put an X in the appropriate square.)

	Most important			Not important		Point scale
	1	2	3	4	5	
The amount of cash available		21,3%				21%
The anticipated need for funds				13,8%		19%
Company's past and prospective earnings	38,7%					24%
Shareholder's desire for a cash income			18,7%			19%
Opportunities for investment					2,5%	14%
Other (Please specify)					5,0%	3%

**Question 6**

If there is a desired relationship between the amount of dividends paid and the earnings of your company, please briefly describe the desired relationship.

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