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# Dividend policy in South Africa

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## 1. INTRODUCTION

Over 50 years ago John Lintner (1956) published a study of corporate dividend policy in which he found that firms typically set long-term target dividend payout ratios and that dividend changes tend to lag earnings changes in order to give management time to assess the permanence of any earnings rises. Five years later Miller and Modigliani (1961) demonstrated that in perfect, frictionless markets investors should be indifferent to receiving their returns in the form of dividends or price appreciation. During the intervening four decades much effort was put into developing a theory of dividend policy and into an associated body of empirical work.

In 2005 Brav, Graham, Harvey and Michaely published a comprehensive survey of US corporate dividend policy. Their objective was to establish whether Lintner's findings remained relevant at the start of the 21<sup>st</sup> century and to shed light on the consistency between modern theories and the practice of corporate dividend policy.

In this paper we review the work done on dividend policy in South Africa over the past 25 years and compare and contrast the results obtained in applying Brav *et al.* (2005)'s questionnaire to a sample of South African listed companies.

## 2. THEORY

Miller and Modigliani (1961) argued that in the presence of perfect, frictionless markets the value of the equity in a firm is independent of its dividend policy. So if there are no taxes, or if capital gains and dividends are taxed at the same rate, investors should be indifferent to the source of their returns. Also assumed were no transactions costs, the investments and the cash flows of the firm were not affected by its dividend decisions, and that managers of firms holding excess cash did not use the cash to pursue negative NPV projects.

Dividends have, however, long been a feature of capital markets, and a number of theories have been developed to explain their persistence. These theories have their roots in the lifting of the perfect market assumptions.

### 2.1 Signalling theory

Signalling theory is based on two ideas: managers of a company have access to more information than investors, and even if the same information were

available to all, it would not necessarily be perceived in the same way (Vernimmen, Quiry, Dallochio, Le Fur and Salvi, 2005:770). When firms announce changes in dividend policy, they are conveying information to the market. Investors receiving this information must decide how credible it is, given the fact the managers will try to present the company in as positive a way as possible.

Signalling theory suggests that firms with good future prospects should take actions that are not easily duplicated by firms with poor prospects. Paying cash dividends is one way to achieve this, since the firm is making a long-term commitment to future dividend payments. Managers in struggling firms will be reluctant to divest themselves of cash in order to send a false signal of prosperity. Investors therefore are likely to interpret positively an increase in dividends from management.

Since dividends are paid some months into the new financial year, the signal they contain would relate both to previous as well as to the current year's earnings. In the face of a fall in current earnings, the maintenance of the past level of dividends will signal management's expectation that the slowdown in earnings is only temporary and that earnings growth is expected to resume in the future. Thus a cut in dividends is interpreted as bad news, suggesting that management believes the long-term future of the firm is poor. However when a firm which has historically paid no dividends announces the payment of a dividend risks sending a signal to the market that it is running short of value adding projects.

### 2.2 Agency theory

The separation of ownership and management in a company gives rise to potential agency conflicts (Jensen and Meckling, 1976). Owners incur monitoring costs to ensure that managers are behaving in a value-maximising fashion. Dividends may be viewed as one way of imposing discipline on managers, for their payment deprives the firm of some of the cash it would otherwise have available for re-investment. Firms wishing to grow will thus have to approach the suppliers of capital to raise the funds for new projects. This enables investors to monitor the use to which this capital is being put in order to ensure that managers are making value adding investments and not simply growing the firm. If managers use the debt market to raise the necessary funds, they will be subjecting themselves to the discipline of making regular interest payments and an eventual repayment of capital. If cash is raised through rights issues, investors have the power to withhold further capital. Dividend payments are thus seen in a positive light given the additional constraints

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they impose on management's ability to engage in self-interested behaviour.

### 2.3 Taxes

Grullon and Michaely (2002) suggest that the recent growth in the proportion of investor payouts in the form of share repurchases is explained by the fact that in many economies capital gains are taxed at a lower rate than dividend income. If investors are rational, they should prefer lower taxes to higher taxes on the cash flows they receive from their investments, and this should lead to a preference for capital gains over dividends.

The extent to which dividends are taxed in SA has varied considerably over the past 15 years. Up until March 1990, dividends were taxed in the hands of all but the lowest income earners in the economy. For most investors, one third of dividends were exempt from tax, and the remainder taxed at the investors' marginal tax rate. Tax was not paid by companies in respect of any dividend income received. Thus if dividends were passed up a chain of subsidiary / holding companies, only the final declaration of dividends to the individual shareholders was taxed.

The March 1990 budget saw the elimination of tax on dividends. At that time South Africa effectively had no capital gains tax, so all returns from equity investments were then tax-free (except in the case of an individual who is deemed by the South African Revenue Services to be a dealer in shares).

A capital gains tax was introduced on 1 October 2001. The effective rate of this tax was 10 percent.

On 1 April 1993 Secondary Tax on Companies (STC) was introduced at a rate of 15 percent, and company tax was reduced from 48 percent to 40 percent. STC was payable on the cash dividends declared by a company. Once dividends had been subjected to STC they were exempt from any further tax in the hands of the shareholders. The STC rate was increased to 25 percent and the company tax rate reduced to 35 percent on 22 June 1994, and on 14 March 1996 the STC rate was dropped to 12,5 percent, leaving the company tax rate unchanged. The budgets of 1999, 2005 and 2008 saw the company tax rate drop progressively to 30, 29 and then 28 percent.

In the March 2007 budget, the Minister of Finance proposed the phasing out of STC in two stages. In October 2007 the rate was to be reduced to 10 per cent and in 2008 it would be converted into a dividend tax, paid by the individual shareholder, but collected from companies who would withhold the tax at the time of the payment of a dividend.

This brief discussion of the SA extent of taxes on dividends suggests that the various taxes in force at a

particular time almost always favoured capital gains over dividends, except for the short period between March 1990 and October 2001 when the country had neither a tax on dividends nor a capital gains tax. The payment of dividends should therefore be negatively viewed given this regime. Since share repurchases have historically attracted lower taxes, this may help to explain the growth in share repurchases, which only became legal in SA on 30 June 1999 after the signing into law of the Companies Amendment Act No 37 of 1999.

### 3. SOUTH AFRICAN STUDIES

Dividend policy in South Africa has been extensively studied over that past quarter century. In the section we present a brief review of the work done to date.

Only two studies surveyed company management to establish their views on issues surrounding the declaration of dividends. The twenty four year old survey of 145 JSE listed companies by Sènèque and Gourley (1983) established that management at that time pursued dividend policy as an active variable, and strongly supported the view that continuity of payments and stable payout ratios were of great importance. When setting dividend policy, respondents were chiefly influenced by 'recorded earnings and the prospect of future earnings'.

More recently Marx (2001) found support for the earlier results by surveying financial directors of JSE listed companies. Almost all of the respondents believed that reasons for dividend policy changes should be communicated to investors. Just over 70% agreed that a company should avoid making changes in its dividend rates that might have to be reversed in the near future and that a company should strive to maintain an uninterrupted record of dividend payments. Two-thirds believed that companies should have target dividend pay-outs and periodically adjust the payout towards the target, and that managers should be responsive to their shareholders' preferences regarding dividends.

Less than half agreed that the market uses dividend announcements as information for assessing share value; that new capital investment requirements have little effect on modifying the pattern of dividend behaviour; that a change in the existing dividend pay-out was more important than the actual amount of the dividend; and that financing decisions should be independent of a company's dividend decision.

Studies based on data collected during times of relatively high inflation found that many companies paid dividends in excess of their real earnings (Du Plessis, Archer and Affleck-Graves, 1986; Gevers and Hamman, 1988), suggesting that at least maintenance of the current nominal dividend is an important factor in setting dividend policy.

Two studies focussed on insiders: Uliana (1988) found that owner controlled companies had significantly lower payout ratios than conglomerate or foreign controlled companies, suggesting that the nature of the shareholding structure affects firms' dividend policy. Bhana (1991b) found that in the six-month period prior to resumptions/omissions of dividends, insiders earned consistently large positive (avoided large negative) abnormal returns. These results suggest that agency issues may well play a role in the dividend arena.

Most extensively studied was the potential signalling effect of dividend announcements. Ooms, Archer and Smit (1987), studying the speed with which market prices react to dividend announcements, found that traders on dividend information were unable to earn abnormal returns. They suggested that the market was not reacting to the dividend announcements per se, but rather to the (simultaneous) release of earnings information.

Knight and Affleck-Graves (1987) examined the impact of 230 dividend announcements on share prices for 41 JSE listed companies over the period February 1973 to November 1980. They found that the announcements contained little or no information about a firm's future earnings. They (tentatively) concluded that dividend changes did not provide a signalling role.

Botha, Bosch and van Zyl (1987) found that dividend policy was not significant in explaining the changes in shareholder wealth from year to year in a sample of 33 JSE industrial firms over the period 1968-1982.

Bhana (1991a) suggested that the results of Knight and Affleck-Graves (1987:84) may have been due to methodological short-comings and the use of weekly as opposed to daily data. Studying companies that had a major shift (omission/resumption, or changes of at least 40%) in dividend policy after two or more years of a stable pattern over the period 1970-1988, and using daily data for 102 days surrounding the event, he found a price adjustment consistent with the direction of the subsequent dividend change, suggesting a possible insider trading effect. He concluded that there was strong support for the hypothesis that investors revise their expectations in response to the announcement of significant dividend changes, which therefore provide a signal over and above the information contained in earnings announcements.

Bhana (1997) studied the behaviour of share prices on the announcement of scrip dividends over the period 1986-1995. He found a significant increase in share price on announcement. The size of the share dividend size was important – distributions of less than 3% conveyed no information to investors. Scrip dividends, he suggested, may be a relatively inexpensive, yet effective, signalling device. Bhana (1998) also found that over the period 1975-1994 the announcement of

special dividends (especially if they were infrequent) were also considered positive signals by the market.

Unlike the studies of Ooms et al. (1987), Knight and Affleck-Graves (1987) and Bhana (1991a), who looked at the information content of significant changes in dividends, Nortje (1997) defined the information content of a dividend in terms of a change in a company's dividend payout ratio. He found that the information contained in a significant change in a company's dividend policy could not be used by investors to predict a company's earnings per share for the next year, and that this information was not reflected in the price change after the announcement.

Auret and De Villiers (2000), using a multiple linear regression technique, found that earnings per share (EPS) had greater explanatory power than dividends per share (DPS) in the explanation of share prices.

Nell, Hamman and Smit (2001) investigated whether changes in dividends contain information about future and/or present changes in earnings. They studied 278 JSE listed companies and found no evidence that future increases in earnings are predicted by dividend changes, but rather that these changes are the response to current and past earnings changes. They found that management is reluctant to increase or decrease dividends since a decrease sends a negative signal, and that an increase will only occur if they are confident that the current level of earnings will be maintained in the future.

Clark (2007) confirmed the results of Nell *et al.* (2001) with respect to dividends. He found that small share repurchases are generally associated with large abnormal earnings growth, but that large repurchases offer no such signal.

Finally Bhana (2007) investigated the market reaction to open market share repurchases by companies listed on the JSE during the period October 2000 to March 2003. A statistically significant return of 4,38% was observed at the time of the repurchase announcement. Using a buy-and-hold strategy, the three-year abnormal return following the announcement was 14,35%. His results also indicated that, on average, the market underestimates the value of the information signalled through the repurchase announcement. This allows investors an opportunity to earn abnormal returns by investing in these companies at the time of the announcement.

In summary Ooms, Archer and Smit (1987), Knight and Affleck-Graves (1987) Botha *et al.* (1987), Nortje (1997), Auret and De Villiers (2000), Nell *et al.* (2001) and Clark (2007) found no substantive information signal about the size of future earnings within dividend announcements. On the other hand, Bhana (1991a and 1997) found that dividends were an effective signalling device. Consistent

support for the signalling theory has not yet been found in the South African literature.

#### 4. OBJECTIVES

No comprehensive survey of company managements' views on dividend policy has been carried out in SA since the amendments to the Companies Act in 1999 allowed for share repurchases as an alternative to dividends as a form of payout to shareholders.

The objectives of the study were firstly to determine the key factors that drive dividend and share repurchase policies of SA firms, secondly to establish whether Lintner's (1956) insights are valid in the modern SA and finally to test the views of SA management as to the relevance of modern dividend theories. The comprehensive research instrument developed by Brav *et al.* (2005) forms the basis of the study and will thus allow us to compare the views of US and SA management.

#### 5. METHODOLOGY

Brav *et al.* (2005)'s questionnaire is a carefully designed instrument based on existing theoretical and empirical work. It was first tested in the academic community and the advice of marketing research experts on the survey design was sought in order to obtain the best possible response rate whilst minimising bias. It was retested using executive MBA and financial management. The final questionnaire contained 11 questions, most with subsections. It printed out in 4 pages.

Permission was obtained to use this questionnaire in South Africa was obtained from John Graham at the Fuqua School of Business, Duke University. The questionnaire was designed to be completed online. Minor adjustments were made to the questionnaire to take into account the presence of Secondary Tax on Companies in South Africa and some terminological differences<sup>1</sup>.

The survey was piloted on three non-executive directors of listed companies, the financial manager of a globally listed JSE company, a University of Cape Town academic and a Chartered Accountant in a Big Four Professional Firm. They were asked for comments on content, completion time and their ability to gain access to the questionnaire on-line was assessed. They took between 12 – 15 minutes to complete the questionnaire.

After appropriate changes, the survey was sent by e-mail to 312 directors of the JSE listed companies on Wednesday 16 August 2006. This was followed up by a second email to non-respondents two weeks later. By the cut-off date of 30 September 2006, 80 responses (26%) were received. Of these 24 were unusable due to

the limited number of questions answered, leaving a total of 46 responses (15%) used in the analysis. Brav *et al.* (2005), whose final sample consisted of 256 public and 128 private companies, reported a response rate of 16%.

#### 6. RESULTS

The responses were representative of the industry classifications on the JSE with the exception of Mining & Construction which was under-represented, and Retail and Wholesale which was over-represented. The sample generally matches the size (as measured by turnover) distribution of companies listed on the JSE. However it is relatively under-represented in terms of small companies (turnover from R20 to less than R200 million) and over-represented in the large company categories (turnover R5 billion and above).

37% of the respondents paid dividends only, 46% paid both dividends and undertook share repurchases, and the balance (17%) did neither. No companies repurchased shares only.

In the majority of questions in the survey respondents were asked to state their level of agreement with specific statements using a five point scale -2 through +2, To align the reporting of our results with those of Brav *et al.* (2005) we usually report the percentage of positive responses (i.e. that either agreed (+1) or strongly agreed (+2) with specific statements or factors affecting their payout policies) unless otherwise specified.

##### 6.1 How important are payout decisions relative to investment and financing decisions?

The key implication of the Miller and Modigliani (1961) paper for this study is that payout decisions should rank below operating decisions in importance.

In response to the question as to whether payout was as important today to firm valuation as it was some 15 to 20 years ago, the percentage of positive responses from dividend payers and from repurchasers was 61% and 10% respectively. This suggests that dividend payout was as important as it was in the past, but that the importance of repurchases was different. In both cases the responses in the US study produced averages of zero, implying no change in importance for both dividends and repurchases (see Tables 1 and 2, rows 4 and 5 respectively).

On the question of whether dividend decisions are made after investment plans are determined (Table 1, row 3), 66% of the SA respondents agreed or strongly agreed, compared to only 34% of the US respondents. Both sets of respondents indicated that repurchase decisions are only made after the determination of their investment plans (Table 2, row 1). This suggests that in SA, the

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<sup>1</sup>Copies of the questionnaire can be obtained from the authors.

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dividend decision is subordinate to the investment decision, but is not necessarily the case in the US.

Both sets of management agreed that they would rather raise new funds to undertake a profitable project than reduce dividends (Table 1, row 5), but would not do so in order to effect a share repurchase (Table 2, row 10). SA respondents felt that the cost of cutting dividends was somewhat less than the cost of raising external funds (average rating -0,2), in contradistinction to the US views (average rating +0,2) (Table 3, row 7).

Do investment opportunities affect payout decisions? The overwhelming majority (over 80%) of SA respondents believe this is an important or very important factor affecting both their dividend and repurchase decisions (Tables 4 and 5, row 2), a much higher percentage than reported in the US study in the case of dividends, but similar for repurchases. A similar pattern was observed for the importance of merger and acquisition activity as a factor in payout decisions (Table 4, row 5 and Table 5, row 3).

**Table 1: Do these statements agree with your company's views regarding dividends? (Dividend payers only, N = 38)**

		% that agree or strongly agree				Average rating			
		SA	Ranking	US	Ranking	Difference	SA	US	Difference
1	Dividend decisions convey information about our company to investors	84%	1	80%	2	4%	0,7	1,0	-0,3
2	There are negative consequences to reducing dividends	74%	2	87%	1	-14%	1,0	1,3	-0,3
3	We make dividend decisions after our investment plans are determined	66%	3	34%	6	32%	0,4	-0,2	0,6
4	Dividends are as important now to the valuation of shares in our industry as they were 15 to 20 years ago	61%	4	41%	4	20%	0,8	0,0	0,8
5	Rather than reducing dividends, we would raise new funds to undertake a profitable project	58%	5	65%	3	-7%	0,4	0,7	-0,3
6	Paying dividends makes a firm's shares less risky (vs. retaining earnings)	55%	6	37%	5	19%	0,6	0,0	0,6
7	We use our dividend policy to make us look like a better investment than our competitors	26%	7	25%	7	2%	-0,3	-0,4	0,1
8	We use our dividend policy as one tool to attain a desired credit rating	21%	8	25%	8	-4%	-0,3	-0,4	0,1
9	We use dividends, to show we can afford to borrow costly external funds or pass up investments, to make us look better than our competitors	3%	9	4%	9	-2%	-1,2	-1,2	0,0

**Table 2: Do these statements agree with your company's views regarding repurchases? (Repurchasers only, N = 29)**

		% that agree or strongly agree				Average rating			
		SA	Ranking	US	Ranking	Difference	SA	US	Difference
1	We make repurchase decisions after our investment plans are determined	83%	1	79%	2	4%	1,2	1,0	0,2
2	Repurchase decisions convey information about our company to investors	79%	2	85%	1	-5%	0,9	1,1	-0,2
3	Paying Repurchasing makes a firm's shares less risky (vs. retaining earnings)	21%	3	24%	5	-4%	-0,3	-0,3	0,0
4	There are negative consequences to reducing repurchases	10%	4	23%	6	-12%	-0,6	-0,4	-0,2
5	Repurchases are as important now to the valuation of shares in our industry as they were 15 to 20 years ago	10%	5	36%	3	-26%	-0,4	0,0	-0,4
6	We use our repurchase policy to make us look like a better investment than our competitors	10%	6	18%	8	-7%	-0,8	-0,5	-0,3
7	We use repurchases, to show we can afford to borrow costly external funds or pass up investments, to make us look better than our competitors	7%	7	3%	9	4%	-1,0	-1,2	0,2
8	Rather than reducing repurchases, we would raise new funds to undertake a profitable project	3%	8=	19%	7	-15%	-1,0	-0,8	0,2
9	We use our repurchase policy as one tool to attain a desired credit rating	3%	8=	24%	4	-21%	-0,9	-0,5	-0,4

### 6.2 Are dividends are repurchases substitutes or compliments?

Whether a firm pays out a dividend or undertakes a repurchase, from the perspective of the investors, cash is received and the level of equity in the firm is reduced. However management may think differently about these two strategies for returning capital to shareholders. The survey tested whether management see the two forms of payment as being substitutes or compliments.

When asked what the most likely alternative use of the cash that could be used to pay a dividend, mergers and acquisitions was the most common response (32%) followed by repurchases at 26%. These responses contrast sharply with those of the US study, where over a third of the responses were a reduction of debt. The comparative responses are shown in Figure 1.

The most likely alternative to a share repurchase elicited a similar set of responses (see Figure 2). 41% of the SA respondents strongly favoured mergers and acquisitions as the alternative use of the funds. A like percentage in the US study chose debt reduction. These responses show no evidence of dividends and repurchases being regarded as substitutes in SA.

In order to further probe the issue of substitution, we asked management what their first payout would be if they were hypothetically paying out for the first time. Their responses, broken down by their current payment form, are shown in Figure 3. Unlike the US where two thirds favoured the use of share repurchases, SA nonpayers favour dividends, followed by a combination of the two payment forms. Over half of the current dividend payers remained wedded to dividends as did their US counterparts. However respondents from firms that currently only undertook share repurchases were almost equally split across paying dividends and a combination of the two methods. The US study reported 79% would repurchase only.

This suggests that SA managers see dividends as an preferable way of returning cash to their shareholders unlike US managers who prefer (more flexible) share repurchases.

### 6.3 Comparing the SA views to those found by Lintner 52 years ago

Lintner (1956) found three patterns in the way firms set their dividends. He reported that they typically set long-run target dividend payout ratios and they only change dividends to match long-term, sustainable changes in earnings, increasing the dividend only if they believe the new higher level can be maintained. Thus dividend changes tend to lag earnings changes. Finally that dividend changes, rather than the absolute level of dividends, are the prime concern of managers. These suggested that dividend decisions were made very

conservatively and that there was a reluctance on the part of managers to reduce dividends.

#### 6.3.1 Are dividend decisions made conservatively?

The depth of feeling about cutting dividends was evocatively captured in a report in the Financial Mail on March 12, 1982: "Just what is De Beers playing at? With one dividend cut to save less than R90m cash it has destroyed the market rating it had been building for the past 50 years." cried an unnamed stockbroker. Our survey sought to examine the degree of conservatism of management when considering dividend policy.

Among the dividend payers, 68% of management respond that they try to avoid reducing dividends per share (Table 3, row 3) (94% of their US counterparts responded in a similar fashion). Similar percentage (Table 4, row 4) stressed the importance of maintaining consistency with the firm's historic dividend policy. This conservatism is also reflected in the fact that the two factors affecting dividend policy that achieved the highest score were the level of dividends paid in recent years (84%) and the change or growth in dividends per share (71%) (Table 3, rows 1 and 2).

The importance of maintaining a smooth dividend stream is somewhat less important to SA management (66% – Table 3, row 4) than to their US counterparts (90%). The fifth ranking factor, which also points to a degree of conservatism is the reluctance to make dividend changes that may have to be reversed in the future (Table 5, row 5).

In general it seems that the conservatism first noted by Lintner is a feature of the SA corporate finance landscape, especially given that over 70% of dividend paying respondents agree or strongly agree that a key decision variable is the change in dividends per share. That said, SA respondents do feel less strongly about changes in dividend policy than those in the US.

#### 6.3.2 Is the payout ratio still targeted?

Lintner found that firms specifically target a payout ratio as an integral part of their dividend policy. This was not the case in the US study. There only 27% of respondents targeted a payout ratio as compared to 39% who set a target dividend per share.

In contrast we find that over half the South African firms target the payout ratio. The full set of responses can be found in Figure 4.

**Table 3: Do these statements describe factors that affect your company's dividend decisions? (Dividend payers only, N = 38)**

	% that agree or strongly agree					Average rating		
	SA	Ranking	US	Ranking	Difference	SA	US	Difference
1 We consider the level of dividends per share that we have paid in recent years	84%	1	87%	3	-3%	0,9	1,2	-0,3
2 We consider the change or growth in dividends per share	71%	2	67%	5	4%	0,7	0,8	-0,1
3 We try to avoid reducing dividends per share	68%	3	94%	1	-26%	0,8	1,6	-0,8
4 We try to maintain a smooth dividend stream from year-to-year	66%	4	90%	2	-24%	0,6	1,3	-0,7
5 We are reluctant to make dividend changes that might have to be reversed in the future	55%	5	79%	4	-24%	0,3	1,0	-0,7
6 We pay dividends to attract investors subject to "prudent man" investment restrictions	37%	6	42%	7	-7%	-0,1	0,2	-0,3
7 The cost of raising external capital is less than the cost of cutting dividends	21%	7	44%	6	2%	-0,2	0,2	-0,4
8 We pay dividends to show that our firm is strong enough to raise costly external capital if needed	1%	8	19%	8	-9%	-0,8	-0,6	-0,2
9 We pay dividends to show that our firm is strong enough to pass up some profitable investments	8%	9	9%	9	-1%	-1,0	-1,0	0,0

**Table 4: How important are the following factors to your company's dividend decisions? (Dividend payers only, N = 38)**

	% that agree or strongly agree					Average rating		
	SA	Ranking	US	Ranking	Difference	SA	US	Difference
1 A sustainable change in earnings	87%	1=	67%	3	20%	1,3	0,8	0,5
2 The availability of good investment opportunities for our firm to pursue	87%	1=	47%	6	39%	1,1	0,2	0,9
3 Stability of future earnings	84%	3	71%	2	14%	1,2	0,9	0,3
4 Maintaining consistency with our historic dividend policy	76%	4	85%	1	-8%	0,9	1,2	-0,3
5 Merger and acquisition strategy	74%	5	40%	8	34%	0,9	0,1	0,8
6 Having extra cash/liquid assets, relative to our desired cash holdings	53%	6=	30%	12	-1%	0,7	-0,2	0,9
7 The influence of our institutional shareholders	53%	6=	53%	5	45%	0,3	0,4	-0,1
8 A temporary change in earnings	47%	8=	8%	17	39%	0,2	-1,1	1,3
9 Market price of our shares	47%	8=	35%	10	12%	0,3	0,0	0,3
10 Reducing cash, thereby disciplining our firm to make efficient decisions	39%	10=	13%	15	27%	0,3	-0,9	1,2
11 Attracting institutional investors to purchase our shares	39%	10=	53%	4	27%	0,1	0,3	-0,2
12 Liability for STC when paying dividend	29%	12=	N/A	N/A	N/A	-0,1	N/A	N/A
13 Attracting institutional investors because they monitor management decisions	29%	12=	33%	11	-4%	-0,1	-0,1	0,0
14 Attracting retail investors to purchase our shares	26%	14	46%	7	-19%	-0,2	0,2	-0,4
15 The dividend policies of competitors or other companies in our industry	21%	15=	39%	9	-17%	-0,5	-0,2	-0,3
16 Flotation costs to issuing additional equity	21%	15=	10%	16	12%	-0,4	-0,9	0,5
17 The possibility that paying dividends indicates to investors that we are running low on profitable investments	5%	17	18%	14	-13%	-0,8	-0,5	-0,3

Current dividend policy seems to be the base from which firms begin their dividend decision. This accords with Lintner's findings. In South Africa payout ratio is reported to be a key target, also in line with the Lintner paper, but different from the results of the US study. Finally, the conservatism in the setting of dividend policy reported by Lintner seems very much alive and well in SA.

### 6.3.3 What about repurchases?

Lintner (1956) ignored repurchases in his study, suggesting that they were at most an unimportant part of corporate financing decisions. However the number of repurchase programmes announced in SA grew from four in 1999 when it was first allowed, to 57 during 2006

(Clarke, 2007). Repurchases have become an established part of the way SA firms return capital to their shareholders. The survey probed whether firms have a target repurchase policy, or whether the repurchase decision is merely a residual one, being driven by the amount of unneeded cash.

Of the SA firms that repurchased shares during the previous three years, 62% had no target in mind. By contrast, 45% of US respondents said they targeted a specific level of repurchases and only 25% did not target at all. These responses are presented in Figure 5. The catch-all category of other represented responses such as the amount of excess cash, shares needed for employee stock options plans and the firm's debt ratio. On the basis of these responses it appears that SA

firms' repurchase policies are much more flexible than their dividend policies.

The views of respondents on the market's perception of a reduction in a firms repurchases can be found in Table 2, row 4 and Table 5, row 12. Only 10% agreed or strongly agreed that there are negative consequences to reducing repurchases and only 14% felt it was important to maintain consistency with their historic repurchase policy. These responses are in strong contrast to the negative views expressed on cutting dividends (Table 1, row 2).

### 6.3.4 How do earnings affect the payout ratio among dividend paying firms?

One of the key insights from Lintner's (1956) work increases in dividends would only occur as a result of permanent increases in cash flows, whereas repurchases could be paid either from temporary cash surpluses or from temporary increases in cash flows.

The survey results shown in Table 4 confirm these suggestions. 84% of our respondents (and 71% of those in the US) say that stability of future earnings is an important or very important factor in their dividend decisions. An even higher percentage (87%) acknowledge the importance of a sustainable change in earnings.

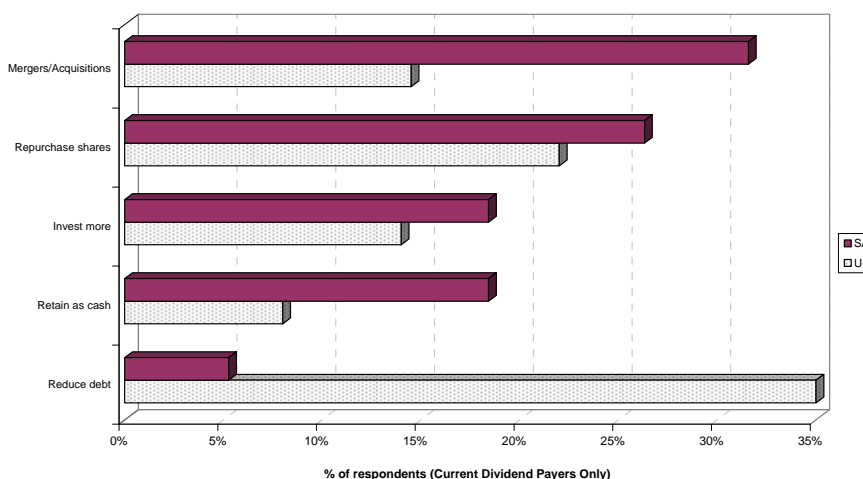


Figure 1: The most likely alternative use of funds by current dividend payers

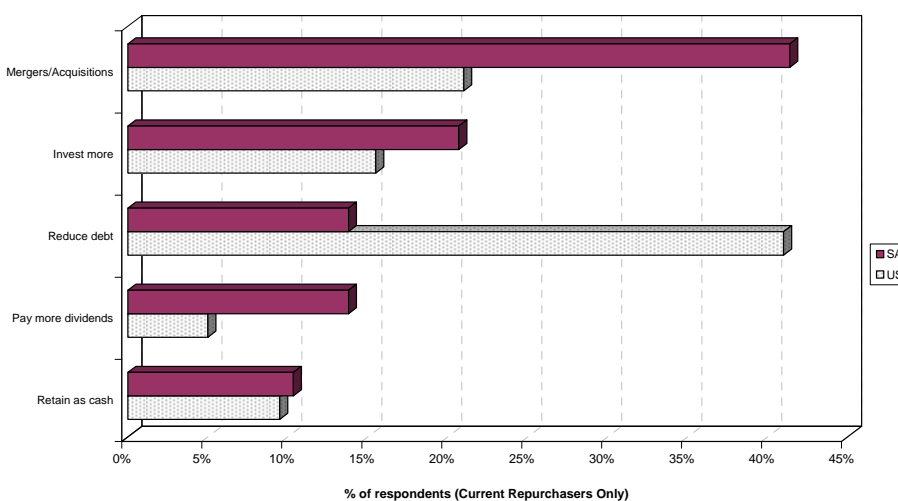


Figure 2: The most likely alternative use of funds by current share repurchasers

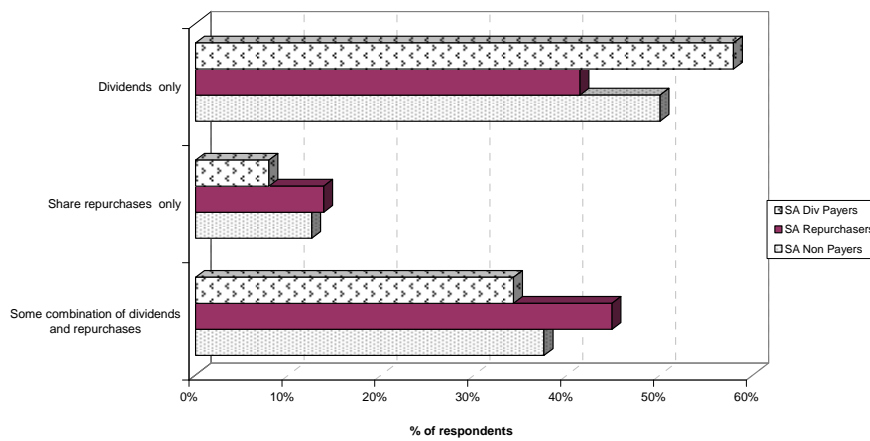


Figure 3: The hypothetical first payout

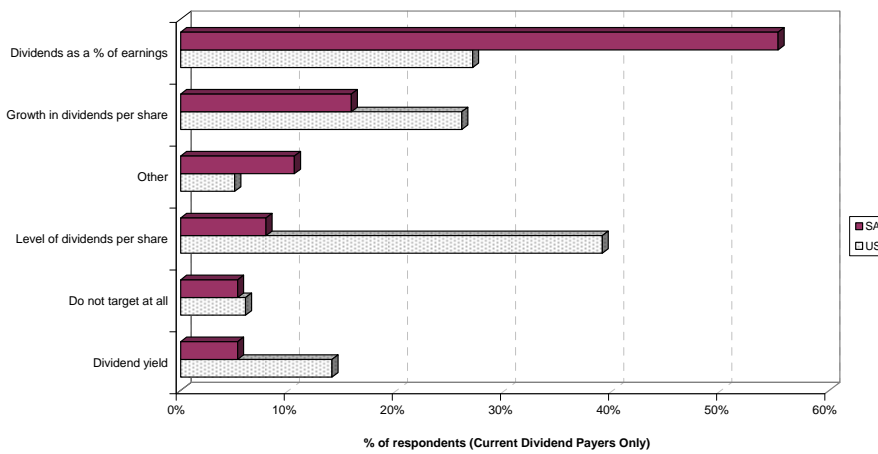


Figure 4: Targets for dividend payers when making dividend decisions

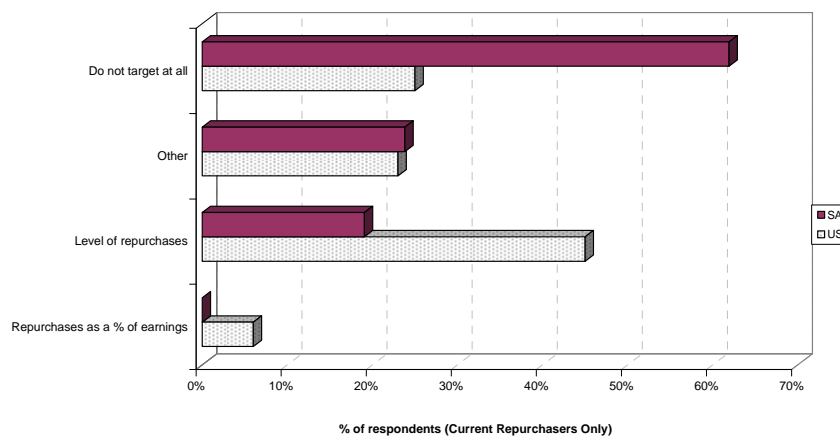


Figure 5: Target for share repurchasers when deciding how many shares to repurchase

The level of agreement when the same questions are posed with respect to repurchases elicited somewhat lower levels of agreement, namely 59% and 41%. These responses are reflected in Table 5.

The impact of a temporary increase in earnings leads to somewhat different responses. Only 47% of dividend payers and a mere 10% of repurchasers think this is an important or very important factor (Tables 4 and 5, rows 8 and 14 respectively). The equivalent US responses were 8% and 35%. There is thus a difference in the responses from the two studies, with US management places more emphasis on using temporary increases in earnings as a source of cash for share repurchase than do their SA counterparts.

Arguably cash is more important than earnings when it comes to payout decisions. 50% of SA respondents (but only 30% of US respondents) agreed or strongly agreed that having extra cash or liquid assets is important to the dividend decision, whereas this factor ranked first at 83% (and 6<sup>th</sup> in the US survey) when considering factors important to the repurchase decision.

Whilst Lintner (1956) ignored repurchases, the growth in repurchase activity in SA, whilst a relatively new phenomenon (Clarke, 2007), has the potential to transform the distribution of cash to shareholders. Brav *et al.*'s (2005) results indicate that US managers view dividends and repurchases differently: repurchases are seen to be a significantly more attractive option. 65% of US non payers would opt for repurchases only if they started a payout programme, and 79% of current repurchasers would opt for a repurchase only payout programme if they were paying out capital for the first time.

SA managers' views are somewhat different. Only 13% of non-payers, 14% of current repurchasers and 8% of current dividend payers would elect to repurchase only if starting a capital payout programme for the first time. SA firms seem much more firmly wedded to the need to pay dividends than do their US counterparts. These results are consistent with those reported by Sèneque and Gourley (1983) and Marx (2001).

We concur with the Brav *et al.* (2005) that the conservative nature of dividend policy remains a key feature of corporate financial life. Firms are reluctant to cut dividends, and increases only occur once management is confident that earnings increases are permanent.

The targeting of payout ratios as a key driver of dividend policy aligns SA managers with the views of those interviewed by Lintner all those years ago – unlike contemporary US managers.

## 6.4. Implications for modern dividend payment theories

As described in the literature review, a number of theoretical explanations have been proposed to account for observed dividend and repurchase policies. In this section we review the results we obtained in the context of these theories.

### 6.4.1 Taxes

Because of the absence of a traditional dividend tax paid by shareholders in SA, only a limited number of questions on the survey addressed the issue of the impact of tax on the dividend decision. The liability for STC when paying a dividend was only ranked joint 12<sup>th</sup> among the factors important in the dividend decision (Table 4, row 12). Respondents strongly disagreed that the capital gains rate paid by shareholders on a share repurchases was a factor in their decision to undertake a repurchase (Table 6, row 9) and only ranked 7<sup>th</sup> (with less than 40% agreeing or strongly agreeing) in importance among the factors in Table 5. Arguably taxes don't rank uppermost in the minds of management when they contemplate dividend policy.<sup>2</sup>

### 6.4.2 Clienteles

The issue of taxes leads naturally on to a consideration of the so-called clientele effect in dividend policy. If institutional investors do not pay taxes on dividends whereas retail investors do, then tax considerations would create two classes of clientele for the firm's shares based on the extent (if any) of dividends paid or repurchases effected. Additionally there may be a desire on the part of one of these groups to receive dividends for reasons other than the impact of taxation.

SA respondents were neutral about the importance of dividends in attracting either institutional or retail investors, ranking the desire to attract them at 10<sup>th</sup> and 14<sup>th</sup> in importance in dividend decisions. When the same question was put with respect to repurchases, the average responses indicated that these factors were not important in the repurchase decision. (See Table 4, rows 11 and 14 and Table 5, rows 10 and 13). These responses are not very different from those found in the US study and tie in with the results of Grinstein and Michaely (2002), who found no relationship between the size of a firm's dividend and the extent to which its stock is held by institutional investors.

Only half of the respondents agree or strongly agree that their institutional shareholders are important in the dividend decision, and only a third respond positively to these shareholder's influence on the repurchase decision. In both instances about half of the US

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<sup>2</sup>This study was carried out in 2006, prior to the proposed dropping of STC and the introduction of a dividend tax to be collected at source.

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respondents were in agreement (Tables 4, row 7 and 5, row 9).

Less than 30% report that they pay dividends and a mere 10% say they undertake repurchases because they wish to attract the attention of institutional investors who monitor their shares (Tables 4 and 5, rows 13 and 16).

Overall these results suggest that the attraction of particular clienteles is not a large factor in firm's payout decisions.

**Table 5: How important are the following factors to your company's repurchase decisions? (Repurchasers only, N = 29)**

		% that agree or strongly agree				Average rating			
		SA	Ranking	US	Ranking	Difference	SA	US	Difference
1	Having extra cash/liquid assets, relative to our desired cash holdings	83%	1=	61%	6	22%	1,1	0,6	0,5
2	The availability of good investment opportunities for our firm to pursue	83%	1=	80%	2	3%	1,1	1,1	0,0
3	Merger and acquisition strategy	79%	3	73%	3	7%	1,0	0,9	0,1
4	Market price of our shares	69%	4	87%	1	-18%	0,7	1,3	-0,6
5	Stability of future earnings	59%	5	66%	4	-7%	0,6	0,7	-0,1
6	A sustainable change in earnings	41%	6	66%	5	-24%	0,2	0,7	-0,5
7	Reducing cash, thereby disciplining our firm to make efficient decisions	38%	7=	20%	16	18%	-0,1	-0,6	0,5
8	Liability for STC when paying dividend	38%	7=	N/A	N/A	N/A	-0,1	N/A	N/A
9	The influence of our institutional shareholders	34%	9	52%	7	-17%	0,1	0,4	-0,3
10	Attracting institutional investors to purchase our shares	31%	10	46%	8	-15%	-0,2	0,2	-0,4
11	Flotation costs to issuing additional equity	21%	11	22%	15	-1%	-0,4	-0,4	0,0
12	Maintaining consistency with our historic repurchase policy	14%	12=	24%	13	-10%	-0,7	-0,3	-0,4
13	Attracting retail investors to purchase our shares	14%	12=	22%	14	-8%	-0,5	-0,5	0,0
14	A temporary change in earnings	10%	14=	35%	9	-24%	-0,6	-0,1	-0,5
15	The possibility that repurchasing indicates to investors that we are running low on profitable investments	10%	14=	30%	11	-20%	-0,4	-0,2	-0,2
16	Attracting institutional investors because they monitor management decisions	10%	14=	35%	10	-24%	-0,4	0	-0,4
17	The repurchase policies of competitors or other companies in our industry	0%	17	16%	17	-16%	-0,9	-0,7	-0,2

**Table 6: How important are the following factors to your company's repurchase decisions? (Repurchasers only, N = 29)**

		% that agree or strongly agree				Average rating			
		SA	Ranking	US	Ranking	Difference	SA	US	Difference
1	Increasing earnings per share	72%	1	75%	2	-3%	0,7	0,9	-0,2
2	Whether our shares are a good investment relative to other available investments	59%	2	77%	1	-18%	0,5	1,0	-0,5
3	Offsetting the dilutionary effect of share option plans or other share programs	55%	3	67%	3	-12%	0,2	0,8	-0,6
4	Changing our debt-to-equity ratio so it is closer to our desired debt ratio	34%	4	30%	6	4%	-0,1	-0,3	0,2
5	The float or overall liquidity of our shares	31%	5	51%	4	-20%	0,0	0,2	-0,2
6	The belief that well-informed investors benefit more from a repurchase program than do less-informed investors	21%	6	21%	7	-1%	-0,1	-0,2	0,1
7	Using repurchases rather than dividends because share options are not dividend protected	14%	7	10%	10	4%	-0,6	-0,6	0,0
8	Selling shareholders cashing out and taking some benefits of the repurchase program with them	7%	8	13%	9	6%	-0,7	-0,7	0,0
9	Investors paying lower Capital Gains Taxes on repurchases	3%	9	42%	5	39%	-0,7	0,1	-0,8
10	Accumulating shares to resist a takeover bid	3%	10	14%	8	-10%	-0,9	-0,8	-0,1

### 6.4.3 Agency theory

Shareholders look to monitor the behaviour of their managers in a number of ways. Jensen (1986) argues that a good way to monitor managers is to minimise the amount of cash they have at their disposal. Interest

payments on debt are one way to control cash, and the payment of dividends is another.

The responses of managers suggest that they do not believe that this potential disciplinary role of dividends and repurchases is a factor affecting payout decisions. In both cases less than 40% of respondents felt that these

were important factors (Tables 4 and 5, rows 10 and 7). There may, of course be some naiveté in expecting managers to acknowledge the need to have their cash resources reduced in order to prevent them from indulging in wasteful (negative NPV) investments.

### 6.4.4 Signalling

As discussed previously management have access to information not available to outside investors. Consequently their actions (including dividend payments and share repurchases) can be seen by outside shareholders as providing new information to the market. Managers can take advantage of this by using their ability to act in costly way (via a cash dividend) to signal information regarding, for example, future earnings prospects. We test for whether managers view the information content of their payout policy decisions as being significant as well as whether they view their payout decisions as an opportunity to send signals to the market.

#### 6.4.4.1 *Do payout policy decisions convey information to the market?*

Both the US and the SA data indicates that management of firms currently paying dividends clearly believe that dividend decisions do convey information to the market. This statement has the highest percentage of positive responses for the SA sample and is second for the US sample (Table 1, row 1). Repurchases decisions are seen to be as important in terms of conveying information (Table 2, row 2) to the market.

The US interview data suggests that while these decisions undoubtedly convey information to the market they are only part of the overall communication process – the “punctuation mark” on the communication process as one of the interviewees is quoted as saying (Brav *et al.*, 2005:512).

Alternatively, payout policies can also be interpreted as conveying negative information i.e. an increase in dividends may be seen to reflect the lack of investment opportunities for the firm. When questioned about this, managers in both the US and SA disagreed – only 5% of SA managers (US - 18%) agree with this statement (Table 4, row 17). While there is relatively greater agreement for the statement that an increase in repurchases can send this negative signal (US: 30%), SA managers still strongly disagree (10% - Table 5, row 14).

#### 6.4.4.2 *Do managers use their payout policy decisions to signal to the market?*

Brav *et al.* (2005) included in their questionnaire statements which expressly tested for agreement with the following three issues: Is payout policy is a way to make firms stand out from their competitors? Is payout

policy a way of sending (costly) signals to the market? The relative importance of some of the specific costs of signalling as identified in the literature.

Only a quarter of both the US and SA firms surveyed agreed that they use their dividend decisions to make themselves stand out from their competitors (Table 1, row 7). There is even less support for the equivalent statement regarding repurchases (Table 2, row 6).

There is also very little support for the statement that firms use dividends (Table 1, row 9) or repurchases (Table 2, row 7) to signal to the market that they can bear costs associated with borrowing extra funds or passing on investments to look better than their competitors.

We asked managers questions regarding the costs of raising additional funds or foregoing profitable projects to meet their desired payout policy. We specifically asked if they used dividends to show that they are able to bear the costs of raising external funds if required. Managers in both SA (10%) and the US (19%) were dismissive of this rationale. We also asked managers if they were happy to pass on profitable investments in order to pay dividends. Again managers strongly rejected this statement. Only 8% of SA managers and 9% of US managers agreed or strongly agreed with this statement (Table 3, row 9).

#### 6.4.4.3 *Repurchases and adverse selection*

As pointed out by Brennan and Thakor (1990), repurchases offer informed investors an advantage over uninformed investors. The informed investors will not participate in the purchase if they believe the share is undervalued, but will if it is overvalued. Uninformed shareholders will thus lose out (relatively speaking) due to adverse selection in a repurchase payout compared to a dividend. They would thus prefer dividends as they do not allow informed investors to cash out taking some of the benefits of the repurchase program with them. This statement is not supported by the data: only 7% of SA managers and 13% of US managers surveyed agreed with this statement (Table 6, row 8).

#### 6.4.4.4 *Impact of the share price*

In the US share repurchase decisions seems to be very strongly affected by managers' perceptions of the relative value of their shares. This statement has the highest rate of agreement (87%) out of all the statements included their survey. SA managers also rate it highly (69%) but this is only fourth in the rankings of the statements in Table 5. By contrast dividend policy is not strongly affected by the companies' share prices: just less than half (47%) of SA managers agree with this statement (US: 35%) (Table 4, row 9). This suggests that repurchase decisions may convey new information to the market (relative to dividends).

In summary, like in the US, the SA survey data does not provide support for the detailed signalling theories. While dividend and repurchase decisions are seen to convey information, managers do not consider the costs identified by theory when making these decisions. In other words they do not actively use them to signal to the market. This is consistent with the results of previous SA studies.

### 6.4.5 Other factors

Dividend policy can affect firms in a number of other ways. These include the impact on the level of earnings per share, share liquidity, credit ratings and their ability to resist potential takeovers. The potential impact of these factors was also examined in this study.

#### 6.4.5.1 EPS and share repurchases

Interviewees in the US survey believed repurchases would have a positive effect on EPS. We found that increasing earnings per share was the most important factor for SA managers (2<sup>nd</sup> for US managers) (Table 6, row 1).

Most managers in both SA and the US agree that their share repurchase decisions are affected by the dilutionary effects of employee share option schemes (Table 6, row 3). Almost no managers in either country, however, indicate that their repurchase decisions are affected by the fact that share options are not dividend protected (Table 6, row 7).

#### 6.4.5.2 Importance of free float and share liquidity

There is a possibility that a firm's share price will fall if the free float or liquidity of the share is reduced significantly after a repurchase. Consequently companies may restrict their repurchases if the level of shares in circulation is close to a critical level or if the level of liquidity in their shares is decreasing. SA managers seem less concerned (31%) about this than their US counterparts (51%) (Table 6, row 5).

There is also little support for the argument that repayments are affected by the costs of issuing shares (to increase the free float and/or liquidity). Only one fifth of both the SA and US managers agree that issuing costs affect their repurchase decisions (Table 5, row 11) and while twice as many SA managers (21%) agree that issuance costs affect their dividend payout decision as compared to their US counterparts (10%), both managers rank this factor as the second least most important factor (Table 5, row 16).

#### 6.4.5.3 Credit ratings and capital structure

There is some evidence that payout decisions are affected by the level of debt of the firm. Paying down debt is the most popular alternative use of funds that would otherwise be used for dividends or share

repurchases for US managers (Figure 1 and 2). SA managers, on the other hand, see this as the least most common alternative use of these funds as an alternative paying dividends (Figure 1), and only the third most popular alternative to share repurchases (Figure 2). SA managers see Mergers and Acquisitions as their most preferred alternative use of dividend or share repurchase funds. Neither set of managers, however, actively target credit ratings when deciding on dividends (Table 1, row 8) or share repurchases (Table 2, row 8). There is more support for the statement that managers use repurchase decisions to move their capital structure towards the desired ratio (Table 6, row 4.).

#### 6.4.5.4 Resist takeover

Both US and SA managers do not agree with the statement that their repurchase decisions are guided by a desire to resist a potential takeover (Table 6, row 10).

Of these other factors the impact on EPS of share repurchases is by far the most important. The other three do not feature in managements' thinking in SA. Retaining funds for mergers and acquisitions is more important than paying down debt, a factor not considered important in the US.

## 7. CONCLUSIONS

We set out to test the extent to which Lintner's (1956) observations were consistent with SA managers' attitudes towards their dividend payouts. We also wished to test whether these attitudes were consistent with more modern theories of payout policies. Finally, by using Brav *et al.* (2005)'s questionnaire, we were able to compare the attitudes of SA and US managers.

Our data suggest that SA managers hold attitudes very similar to those found by Lintner (1956) when looking at dividend payouts. They target a payout ratio and are very conservative when setting dividends in order to avoid having to cut them in the future. US managers, by way of comparison, seem to focus more maintaining the (growth in) the nominal value of dividends rather than payout ratios. However they are similarly conservative in terms of setting dividends and then not cutting them in the future.

With SA firms only being able to repurchase shares since 1999, this study provides new data on the attitudes of SA managers with respect to this alternative to dividends. US managers consider repurchases a significantly more flexible (and thus more attractive) form of repaying capital to investors. Firms are not penalised if they do not meet their repurchase targets. SA managers feel the same way about repurchases, but they have a stronger preference for dividends than their US counterparts – especially if they are paying them out for the first time. Another key area of difference is that SA managers do not seem to have clear share repurchase policy targets as compared to their US counterparts.

SA managers clearly view dividend decisions as being subordinate to their investment decisions – unlike the US where the evidence is mixed. Share repurchases, however, are clearly subordinate to investment decisions for both groups.

Both groups of managers view dividends and share repurchases as compliments, not substitutes. The best alternative use of funds for dividend payments differ between SA and US managers. US managers would prefer to run down debt, but SA managers' preference is to focus on merger and acquisition activities.

Since Lintner's (1956) study there has been a plethora of alternative theoretical explanations for the observed behaviour of firms with respect to dividends. The data provided by this and the US survey provides mixed evidence for these explanations. There is little support for the taxes, clientele or agency approaches.

The evidence for the signalling approach is more nuanced, Manager clearly recognise that dividend decisions in particular convey information to the market but do not actively use this as tool for communicating to the market. Our data shows that managers prefer to repurchase shares when they are perceived to be undervalued. Again this is not seen as a preferred means to send information to the market. They view these policies as being secondary to other communication activities.

There are some limitations to this study which suggest future research opportunities. The relatively poor response rate is worrying as it raises questions regarding the representivity of the findings. In terms of future research methodologies, a semi-structured set of interviews might yield better results.

A comprehensive study of the actual dividend policies of JSE listed firms is needed as this has not yet been done in SA. This would allow for comparison with the results reported in this paper.

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