

**THE EFFECT OF FINANCIAL LEVERAGE AND REVENUE  
GROWTH ON DIVIDEND POLICY OF FIRMS LISTED AT  
NAIROBI SECURITIES EXCHANGE**

**BY**

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## DECLARATION

This research project is my original work and has not been presented to any other institution for examination.

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This research proposal has been submitted with my approval as the University Supervisor.

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## **DEDICATION**

Special dedication goes to my wife, Gladys Masakhwe Kivale and my children: - Sunford Imbalo, Churchil Mutumbi and Precious Washiswa for their tremendous inspiration during my studies. They have taught me that the largest task can be accomplished if it is done one step at a time and the longest journey starts with one step.

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## **LIST OF ABBREVIATIONS**

CG	Corporate Governance
CMA	Capital Market Authorities
Co	Company
Ltd	Limited
MM	Modigliani and Miller
MoU	Memorandum of Understanding
NASI	NSE All Share Index
NPV	Net Present Value
NSE	Nairobi Securities Exchange
SPSS	Statistical Package for Social Sciences

## **ABSTRACT**

Dividend is paid out of profits thus it is used as a yard stick to show future prospects of a firm, attract investors and to monitor underinvestment by managers. The objective of the study was to establish the effect of financial leverage and revenue growth on dividend policy of firms listed at Nairobi Securities Exchange between 2008 to 2012.

The study considered forty firms, out of a population of sixty firms, that had been listed consistently from 2008 to 2012. Secondary data was collected from group annual and financial reports of individual companies for five years thus complete business cycle. Data of interest was extracted, coded and analyzed using SPSS Version 17.0. Multivariate regression model considered dividend payout as dependent variable while independent variables were financial leverage, revenue growth, return on equity, size of the firm, current earnings, corporate tax and liquidity.

From the findings, the study revealed that there exists negative association between financial leverage, revenue growth and dividend payout. Firms pay dividend as a sign of current and future prospects. They adopt the agency theory of dividend policy. Dividend payment is used to solve the agency problem of underinvestment, consumption of perks by managers and diversion of excess cash to unprofitable projects. The study supports previous research done in developing capital markets.

The study recommends that firms should pay dividend to attract investors. Also, from dividend payout, firms are able to control consumption of perks and underinvestment by managers. Macro economic factors and forces of the market should be considered when declaring dividend in order to align firms' goals in terms of investment, growth and dividend.

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background to the Study

Financing decisions involve how a company utilizes debt and equity to maximize shareholders' value with minimal risks, improve its competitiveness and expansion of capital structure. A firm establishes appropriate amount of funds needed, project appraisals and analysis, raises the required funds through bonds, equity and working capital management. Through appropriate financing mix, the firm's value increases thus increase in liability and equity side of the statement of financial position. Debt financed projects increases firm's obligations while there is less risks faced when projects are equity financed. From financing decision, the firm is able to invest in profitable projects that generate return which in turn is paid in terms of dividends. Dhillon (1994) claimed that shareholders are able to give out funds for future return in terms of dividends thus increase in firm value in the future. From this argument, shareholders gain twice in terms of rise in value of shares and dividend received. Dividend payment is a sign of good performance of the company though it becomes a challenge to a firm to decide how much to pay and when to plough back profits to the business.

Institutional investors are crucial when it comes to firm's ownership and financing decisions since they have resources and knowledge. They invest heavily in organizations and allocate adequate funds for agency in order to curb the problem of underinvestment by managers and even firing managers due to declined performance. Hart and Grossman (1980) found in their study that institutional investors allocate funds towards monitoring thus control the over and under investment problems. Optimal investment is achieved if a firm institutes prudent financing and dividend decisions since increase in share prices indicates growth in firm and maximization of firm value. Also, Liang and Fenn (2001) argued that individual ownership

wear two hats in terms of ownership and management. They put more effort in the firm to ensure it grows and maintain high proportion of ownership in terms of shares. Dividend is used as a tool to control managers' action of under investing thus negative relationship between dividend payout and ownership. In support, Verma (1994) examined that institutional investors prefer dividends distributed in terms of cash to curb the agency problems.

Rapid growing firms have high appetite for cash. Although sales revenue increases, cashflow levels tend to be low due to investment level and cashflow problem decreases as firm matures. Due to this, it forces firm to source for funding and to sustain growth, firms increase their product lines in order to increase profitability level. According to Susela (2011) firms that record high growth rate tend to pay less dividends and there exist negative relationship between dividend policy and investment availability. Growth rate of firms is boosted by availability of various investment opportunities. These firms will hold less cash and have low level of net working capital since funds are directed towards investments thus boosting growth. Increase in shareholders' value is achieved in two aspects. Firstly, by generating cashflow and dividing the distribution in pie chart among stakeholders. It ensures that securities are provided to stakeholders to meet their desire thus increase in shareholders' wealth. Secondly, by strengthening investment and operating decisions thus increasing confidence among stakeholders.

Dividend policy remains elusive and interesting since it affects growth, financing decisions and how it is distributed (when and how much). When dividend is declared and paid, there is reduction in cashflow in terms of internally generated profits / funds thus it forces a firm to source for external financing which is debt. Dividend policy affects various stakeholders. For managers, if a firm distributes dividends, then this means that they will be left with fewer

funds for investment and growth. For lenders, fewer funds will be left to be claimed in case of bankruptcy and for shareholders, they will gain in terms of capital gain and increase in share prices.

### **1.1.1 Financial Leverage**

It determines the extent to which a firm has utilized equity, retained earnings and debt to finance its operations. Firms establish optimal mix between equity and debt since high level of debt tends to be costly in terms of repayment and interest thus increase in the level of liquidation. Donaldson (1961) concluded that firms prefer retained earnings to equity to debt. Financial gearing (leverage) is used to describe the way in which owners of the firm can use the assets of the firm to gear up the assets and earnings of the firm. Employing debt allows the owner to control greater volume of assets than they could if they invested their own money only. The higher the debt equity ratio, the higher the firm equity and therefore the firm level of financial risk. Financial risk occurs due to the higher proportion of financial obligations in the firm's cost structure. The degree to which the firm is financially geared can be measured by the degree of financial gearing given by:

$$\text{Degree of Financial Gearing (DFG)} = \frac{(\% \Delta \text{ in EPS})}{(\% \Delta \text{ in EBIT})}$$

The degree of financial gearing indicates how sensitive a firm's EPS is to changes in earnings before changes in interest and taxes (EBIT). Other popular measures are Debt to equity ratio, Interest covered ratio and Debt ratio used as industry standard

### **1.1.2 Revenue Growth**

It entails expansion and increase in terms of revenue and resources of a firm. Growth of a firm is driven by investing in profitable projects thus expansion and increase in product lines.

Susela (2011) established that growing firms tend to have liquidity problems since more cash is diverted to profitable projects. Growth is a systematic approach employed by the firms to attain effective management performance through planning and budgeting. Through planning and budgeting, a firm is able to take advantage of profitable investments which eventually improves its credit rating, public image, strong brand portfolio and sustained cash flow. Boston Consulting Group growth model has been employed by firms for competitive advantage by holding portfolio investments thus increase in market share. Growth level is measured by percentage change in sales derived as follows:

$$\text{Growth} = \frac{\text{Net Margin} * \text{Retention} * \text{Leverage}}{\text{Asset to Sale} - (\text{Net Margin} * \text{Retention} * \text{Leverage})}$$

For a multi product company, sustainable growth is derived as follows:-

$$\text{Growth} = \frac{\text{Retained Earnings}}{\text{Net Assets}} (1 + \text{Debt/ Equity})$$

### **1.1.3 Dividend Policy**

Dividend is the return that shareholders receive out of their investments and to attract investors, firms should have sound dividend policies. Dividend is paid out of profits thus it is used as a yard stick to show future prospects of a firm, attract investors and to monitor under investment by managers. Verma (1994) established that firms pay dividends to curb the agency problems. Through dividend payout, the agency problem between shareholders and managers is sorted out. With excess working capital, managers tend to misappropriate funds, invest in unprofitable projects, pay themselves huge perks and perquisites. To solve this problem, the firm comes up with a sound dividend policy framework that ensures that earnings are distributed as dividend hence reduction of excess working capital.

There are four types of dividends. Firstly, constant amount of dividend per share. Under this policy a company will pay a fixed amount per annum per share regardless of the fluctuations in its profits. Dividends are increased only after an increase in earnings appears clearly sustainable and relatively permanent. Secondly, constant payout ratio, under this policy, the firm will pay a fixed dividend rate (e.g. 10% of earnings). The dividend per share would therefore fluctuate as the earnings per share changes. Thirdly, constant dividend per share plus extras. This is a compromise between the two policies discussed above. It gives the firm flexibility to increase dividend during years of high earnings. The extra dividend is given to the shareholders in such a way that they don't perceive it as a commitment on the part of the company to continue this extra dividend in the future. And lastly, residual dividend policy, under this policy dividend is paid out of earnings left over after investment decisions have been financed. Dividend will only be paid if there are no profitable investment opportunities available. This policy is consistent with shareholders wealth maximization objective.

#### **1.1.4 Effect of Financial Leverage and Revenue Growth on Dividend Policy**

Dividend decisions are complex and impact on financing decisions and revenue growth of a firm. Different dividend policies are employed for different capital structure in order to attain efficiency and performance thus effect on wealth maximization. It involves how firms attract shareholders and increase their share values. Dividend is usually paid out of profits or through issue of bonus shares to shareholders based on their investment levels. Black and Scholes (1974) on their paper on impact of dividend policy on share prices in New York concluded that there is no relationship between dividend yield and expected return thus support of the irrelevance theory of dividend.

Corporate governance is one of the upcoming and critical aspect in terms of development and implementation of corporate strategies and policies since it ensures that managers maintain

professional code of ethics. Shareholders are many and they don't have time thus employ managers to run firms on their behalf. Through corporate governance, managers are restricted to mismanagement of funds and misstatement of accounts for personal benefits. Jensen (1986) concluded that firms which have high liquidity levels and adequate working capital tend to have high agency costs since this is a solution to agency problems. Managers opt to invest in unprofitable projects at the expense of shareholders. Thus, it is advisable to distribute cash in form of dividends instead of investment in unprofitable projects. Guizani (2009), a Tunisian based research, concluded that there is positive relationship between dividend payment pattern and firm's ownership.

Forrest, Ambler and Robinson (2004) added that growth strategies are critical since firms operate in weak environment with strong economic forces from key players like regulators, competitors and government. Management and policy makers should understand the overall effect of growth to the economy and firm, demand and supply sides, effect of growth and strong linkage between projects undertaken that is how are projects evaluated, appraised and implemented. Large firms are able to raise funds through issue of shares to the public thus incur lower costs compared to their counterparts. In this context, they pay high dividend rate and maintain adequate liquidity level. Baker (2007) published that most large firms in Canada constantly pay dividend. They have adequate opportunity to raise external finances, face less bankruptcy risks since they maintain high liquidity levels and have diverse growth opportunities and greater ownership.

Financing decision deals with sourcing of funds and how these funds are utilized through investment in profitable projects in order to increase returns thus distribution of dividend. Investment, financing and dividend decisions are among the decisions that determine success or failure of business. Investment decisions concentrate on capital budgeting which deals



with how scarce resources are allocated and measures the level of return from these investments. Although equity financing is less risky, it leads to dilution of ownership while debt is cheap but also leads to risk of bankruptcy in case the firm doesn't honor its obligations when they fall due. A study by Utami and Eno (2011) on Indonesia listed firms revealed that there is insignificant negative association between free cashflow and dividend payout while positive association between cashflow and leverage. Also, Hashemijoo, Ardekani and Younesi (2012) findings showed that negative significant relationship exists between share price volatility and dividend payout.

Investment and dividend policy are inter-linked and cannot be separated thus dividend is relevant. Return on investment and cost of capital determines the optimal dividend policy. If return on investment is greater than cost of equity, then firms should retain all the earnings for investment. From this perspective, dividend can be looked at different view points. First, as a yard stick to satisfaction of managers and shareholders and secondly, on the controlling rights of a firm. The study intends to answer the question, Does dividend policy, financial leverage and growth matter to a firm? The proposal will attempt to find out the effect of financial leverage, growth and dividend policy of firms listed at NSE between 2008 to 2012.

### **1.1.5 Nairobi Securities Exchange**

NSE is used as a trading platform for quoted shares and securities and also provides an oversight function to listed companies. It was constituted in 1954 and has grown over the years by making various milestones. Currently there 60 listed firms to Nairobi Security exchange as at 30<sup>th</sup> June 2013. The firms have been classified into ten sectors i.e. Agricultural, Manufacturing, Investment, Construction and Allied, Energy and Petroleum, Banking, Automobiles and Accessories, Telecommunication, Commercial and Services and finally Insurance. In 2006, NSE entered into MoU with Uganda Securities Exchange to

ensure cross listing of securities. To deal with market inefficiency, NSE upgraded its website to ensure that information accessed is accurate, timely and faster. The NSE All Share Index (NASI) was implemented as an alternative index in 2008 to monitor overall market performance. Due to growth and diversification opportunities in East Africa, FTSE NSE Kenya 15 and 25 indices were launched in 2011 that enabled investors to know the trading history of securities of interest and provide adequate information to make timely decisions. With these milestones achieved so far, NSE becomes a market of interest to be studied since it presents the Kenya market economy.

## **1.2 Research Problem**

Financial leverage increases the liquidation level while growth increases resources and income of the firm. Dividend payment reduces the profits recorded since it is paid out of earnings. In order to boost the firm's growth, a firm needs to pay dividend and this comes at a cost since the level of financial leverage increases. Firms employ optimal mix between equity and debt in order to sustain their operations. To increase sales revenue and resources, then a firm need funds which in turn increases the level of financial leverage. Higgins (1972) established that fast growing firms experience liquidity problems since cash is diverted to profitable projects. The lenders of funds require return in terms of dividend thus the link between financial leverage, growth and dividend policy.

A review of various research work on financial leverage, growth and dividend policy reveal findings which are not consistent. Diamond (1967) and Higgins (1972) commended that there is negative relationship between dividend preference and growth of a firm. A firm needs additional funds to sustain its growth rate and expansion which net working capital alone cannot be used to do so this is evidenced from published performance reports of Kenya Airways Authority, one of the consistent listed firms which face challenges of financial

leverage, growth and dividend policies. Research by Kibet (2004) established that there is clear dividend policy among large firms compared to small ones thus negative association between value of the firm and dividend policy. Olweny (2011) demonstrated that dividend discount model proved to be unreliable in the valuation of securities among Kenyan firms due to market imperfection or inefficiency at NSE, and inappropriate discounting factor. In contrast, positive association exists. Njoroge (2001) sort to find out dividend practices and the factors that should be considered while declaring dividend. He found out that dividend relevance theory is practiced in Kenya. Companies pay dividend out of retained earnings thus positive association between dividend payout and shareholders' wealth. In support, Keith (1971) stated that dividend is considered as a long term strategy since it determines to what extent firms can pay out of their earnings and how much they can plough back to operations for growth purposes. He further stated that there is no single dividend theory that explains organization behavior and companies take long to decrease the dividend levels. Opuodho (2010) documented that capital structure is critical among commercial banks of Kenya since it determines the dividend policy to be adopted by a firm and investment decision.

In summary, dividend policy and financing decisions are potential areas in research that need further research. Despite voluminous studies, there has not been an optimal dividend, financing policies and growth strategies employed by firms. Conclusions from various theoretical frameworks have concluded that value of a firm is affected by increase or decrease in dividend payout and value of a firm is not affected by dividend policy adopted. From theoretical and empirical studies, there have been diverse outcomes on the association between dividend policy, financing leverage decisions and growth. Studies have been done in developed countries and this need to be implicated in developing/emerging markets like Kenya.

The research intend to answer the research question, does the association exists between financial leverage, revenue growth and dividend policies adopted by firm listed at Nairobi Securities Exchange?

### **1.3 Objective of the Study**

To establish the effect of financial leverage and revenue growth on dividend policy of firms listed at Nairobi Securities Exchange.

### **1.4 Value of the Study**

Shareholders; the study will enable them to have an insight more knowledge on how to balance their investment portfolio in order to increase returns in terms of capital gain and increase in share value.

Management; the study will provide management with insight information pertaining to financing decisions, growth and dividend. They will be able to institute sound policies on financing mix in order to increase shareholders' value and minimize the cost of capital thus aid them in making prudent sound decisions.

Government and Regulators; the study will enable government and CMA to come up with sound regulatory framework to aid firms in their operations and institute tax, dividend and financing policies for the firms.

Consultants; they will use the findings to aid them in delivery of advisory services to their clients pertaining to financing, growth strategies and dividend pattern of the firms since the research is rich in policy implications.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This Chapter entails dividend theories, determinants of dividend policies, financing theories, previous studies done on financing decisions, revenue growth strategies and dividend policies adopted by firms in Kenya and summary of the overall view. Summary section entails a recap of previous literature done on aspects of financing, growth and dividend.

#### **2.2 Dividend Theories**

Dividend still remains a puzzle since there is no clear basis on how corporations distribute dividend to shareholders. As a strategic decision in finance, a company employs adequate policy that answers whether dividend should be paid out of profits and to what proportion since it has an effect on wealth maximization and share prices. Various theories on dividend policies include:-

##### **2.2.1 The Agency Theory**

A firm consists of various stakeholders with vast individual interest who want to achieve personal interest rather than maximizing shareholders' wealth. Jensen and Meckling (1976) established that in order to curb agency problem between managers and shareholders, then dividend should be paid out. This will solve the underinvestment problems and opportunistic consumption since managers are left with less funds and are forced to source for additional capital for investment in viable projects. As per agency theory, dividend is paid out to curb the problem of underinvestment. Managers seek additional financing thus increase in financial leverage level and promotion of growth of a firm. Agency theory affects the financial leverage and growth variables since if practiced, the level of financial leverage and growth increases.

### **2.2.2 Dividend Irrelevance Theory**

MM (1961) proved that dividend policy has no effect on share prices or cost of capital but firms increase their value through investment only. The theory holds in a perfect market where information is available, no transaction costs; no taxes, no floatation costs and securities are divisible. In such market, investors are able to choose securities and forecast their future value with certainty. According to dividend irrelevance theory, firms need not to pay dividend but can increase their growth through investment. This is only possible under perfect market. The theory relates to the study since firm do not always declare dividend but capitalize through right issue. The theory affects growth and size variables since if implemented; a firm is able to increase its growth and size level.

### **2.2.3 The Signaling Theory**

Dividend is used as a signaling mechanism to portray firm's present and future performance thus managers release information to aid investors in making sound decisions. The theory further holds that information is not readily available to related parties since managers hold more information about firm's performance than shareholders. Ross (1995) conducted a study on the relationship between change in dividend policies and reaction of investors and established that for those firms that had increased dividends had a corresponding increase in share prices while those which reduced had a decline in share prices. The signaling theory is relevant as it encourages firms to pay dividend. Through this, financial leverage increases since firms are able to access debt to increase their growth by investing in profitable projects. The theory has implications on growth, liquidity, size and return on equity. When firms declare dividend, they are able to boost their growth, liquidity, size and profitability levels since dividend is viewed as a sign of prosperity.

#### **2.2.4 The Bird in the Hand Theory**

Gordon and Linter (1962) established that external shareholders prefer dividend at higher rates and they opt for current dividend than future uncertain capital gains. They believe that future is uncertain hence present is better. Gordon and Linter (1962) conflicted with MM theory and established that dividend is relevant under uncertainty environment. In such markets, investors are rational and risk averse thus prefer current dividends to future capital gains which are uncertain. The Bird in the hands theory is relevant to the study because most investors advance finances to firms that pay current dividend as compared to future capital gains. This increases the current financial leverage and growth of a firm as compared to the future. The theory implies that current financial leverage and growth of a firm increases as compared to the future.

#### **2.2.5 Clientele Effect of Dividend Theory**

Pettit (1977) investigated the reaction of investors due to change in dividend policy. Retirees prefer to invest in high paying dividend firms while young investors prefer low paying dividend firms and would reinvest dividend for the future. From this perspective, firms use dividend as a yard stick to attract investors. The theory is relevant as firms opt to pay low dividend to young investors in order to sustain future growth and the level of financial leverage. The theory implies that for young investors, financial leverage and return on equity variables decrease as compared to when a firm declares dividend to old investors.

### **2.3 Capital Structure Theories**

In corporate finance, financing theories define the mix and extent to which debt and equity is used. There are three financing theories namely: -

### **2.3.1 Traditional Trade Off Theory**

As per this theory, a firm sets a target mix between debt and equity where marginal benefits and costs offset each other. It will move towards this target thus a firm that has high taxable income tends to hold high debt – equity proportion. Brealey (1984) stated that the theory was not able to explain why profitable firms generally rely on low leverage level. The theory is relevant to the study in that a firm gauges the mix of debt and equity to maximize returns. To increase the dividend payout level, a firm employs low debt – equity proportion thus low level of leverage.

### **2.3.2 Pecking Order Theory**

According to this theory, internally generated funds are the most preferred then debt and finally equity. Donaldson (1961) established that preference of internally generated funds, retained earnings, is due to avoidance of scrutiny when firms need financing. Profitable firms utilize debt. Pecking order theory is relevant to the study in that it enables managers to seek additional financing to finance growth thus increase in financial leverage and revenue growth. Internally generated funds are used to pay dividend thus solves the problem of underinvestment, consumption of perks by managers and diversion of excess cash to unprofitable projects.

### **2.3.2 Modified Pecking Order Theory**

Myers (1984) suggested that safe debt is preferred for risky projects. Presence of information asymmetry is the main cause of debt preference thus underinvestment by firms. Risky stocks lead to underinvestment due to perceived thought by investors thus undervaluation of firms. Managers prefer retained earnings, then safe debt, risky debt and lastly costly equity. Under modified pecking order theory, the study established that managers seek additional funding



based on riskiness of a project. For low risk projects, a firm employs safe debt and vice versa. If these sources are exhausted, then it forces managers to seek equity which is costly and leads to dilution of ownership.

## **2.4 Determinants of Dividend Policy**

Dividend policy remains a puzzle. In order to find out an optimal level, the following determinants have been established to affect dividend policy employed by firms:-

### **2.4.1 Leverage**

It determines to what extent debt financing has been employed by a firm and high leverage level leads to low dividend payout thus inverse relationship between the two. Afza and Mirza (2011) published that the main cause of such relationship is presence of high transaction costs and interest that the firm has to bear leading to less profitability level. This supports the agency theory of dividend policy.

### **2.4.2 Institutional Ownership**

Institutional ownership act as monitoring agents and reduces the reliance on external financing. In agency theory, conflict of interest arises between managers, shareholders, government, minority and debenture holders thus presence of institutional ownership solve this through monitoring activities of management. From this, positive association exists between institutional ownership and dividend payout. La Porta and Vishny (2000) documented that managers divert firms' resources for their own benefit by consuming high perquisites, underinvestment and investing in unprofitable projects. To solve this, then shareholders incur monitoring cost through establishment of institutional ownership.

### **2.4.3 Profitability**

The higher the profitability level, the more the firm's ability to pay dividend thus direct relation between the two. As per signaling theory, firms pay dividend to convey about its outstanding current and future performance. Wang', Gao and Guo (2002) showed that UK listed firms paid higher dividend than Chinese listed firms. UK listed firms had a clear dividend framework and firms increased their payment level annually while Chinese listed firms didn't have clear framework and they relied on current earnings to settle dividend payment.

### **2.4.4 Business Risk**

It determines the extent to which a firm is able to achieve its desired profitability level. High business risk affects firm's profitability since it hinders ability of a firm to record desired profit level thus lower dividend payout. With high business risks, there exists uncertainty thus inability to predict the future. In their study, Mollah, Keasey and Short (2002) didn't support this argument and concluded that Dhakan listed firms paid higher dividend although the market beta was high. They further documented that in emerging markets, dividend payout is not the best tool to convey information about firm's performance.

### **2.4.5 Liquidity and Cashflow**

It measures the ability of a firm to settle its obligations as they fall due. High liquidity level enables a firm to settle cash dividend when due thus positive association. This supports the signaling theory of dividend policy. Jensen and Meckling (1976) defined free cash flow as excess funds derived put of all projects with positive NPV. High free cash flow lead to conflict between managers and shareholders thus hinders firm's performance. Shareholders expect managers to maximize their value while managers utilize excess cash flows by

investing in unprofitable projects and consumption of higher salaries and benefits.

#### **2.4.6 Revenue Growth.**

Chang and Rhee (2003) showed that firms that face growth opportunities tend to retain their earnings to finance growth and expansion thus lower dividend payout. From their study, they revealed that firms pay lower dividend and divert retained earnings to growth opportunities and reduces reliance on external financing which is expensive. Moreover, firms with fewer growth opportunities pay high dividend to curb the problem of overinvesting of funds by managers in unprofitable projects. From this perspective, dividend is used to divert cash from the firm and reduce agency cost.

#### **2.4.7 Firm Size**

Large firms are mature and able to pay dividend compared to small firms since they have easier access to financial market. Sawicki (2005) established that performance in large firms can be monitored through dividend payment. Information asymmetry in large firms is high due to dispersion of ownership thus increase in shareholders inability to monitor managers' activities. Dividend payment cubs this problem since higher dividend payout triggers for debt financing which eventually leads to monitoring due to existence of trade payables and debenture holders.

### **2.5 Empirical Review**

Various scholars and economists have raised issues pertaining to dividend, growth and financing decisions and have developed various empirical and theoretical frameworks. On financing decisions, a firm should consider risks, flexibility, income, timing and control. On risks, it determines to what extent a firm utilizes debt to finance its operations. Too much debt usage leads to high level of bankruptcy. Flexibility entails firm's ability to change the

mode of financing from equity to debt and vice versa. Timing dictates what, when and how much to invest in a certain project in order to receive future returns. On control, use of debt to finance operations means that ownership for debenture holders increases. Ntoiti (2004) concluded that there is positive relationship between dividend policy employed and public, private and state ownership while negative relationship between dividend policies, managerial and institutional ownership among the oil marketing firms in Kenya.

MM (1958) focused on growth and capital structure and found out that a positive association exists between the two. When firms are faced with growth opportunities, then the firm is unable to finance its growth through internally generated funds due to inadequacy. Due to this, they source for debt to solve the growth opportunities. At the initial stage of the project, debt will be issued and as project matures and profits realized, then the firm will repay debt and issue shares to raise more funds. Study by Awan and Bhatti (2010) on growth opportunities related to corporate leverage decisions found out that a positive association between corporate leverage and growth opportunities. Institutional and individual ownership find growth as key to success but risky. In order to reduce the risk, they transfer it to external financiers who are able to lend funds to the firm to finance growth. If investment opportunities succeed, then the firm is better off not issuing additional shares at higher prices. They further established that leverage and growth opportunities are affected by the industry in which a firm operates.

Wansley and Saxena (1996) added that negative relationship exists between dividend payout and risks faced by a firm. Dividend distribution depends on risks appetite of a firm and firms that have high risk level pays dividend at a lower rate. They concentrate honoring their financial obligations thus record low earnings which is attributable to shareholders. Through this, they employ various strategies of debt management by matching liabilities versus assets

and injecting equity to boost their capital structure thus minimizing bankruptcy and agency costs. In support, Hashemi and Zadeh (2012) found out that the association between leverage and dividend policy is negative. With leverage, the firm divides its profits between shareholders and debenture holders.

Bradley, Capozza and Seguin (1998) documented that high systematic risks triggers firms to record low dividend yields and cash flow volatility leads to higher agency costs. Their study support the information based theory of dividend policy which states that managers have perfect information about dividend reduction and its impact on firm value. When managers foresee cash flow volatility, they reduce payout to mitigate on the impact of dividend reduction in future. Lara and Mesqita (2003) proved that dividend policies become a challenge when a firm operates in unstable environment like Brazilian market. In short – run, there exist positive relationship while in long – run, there exists negative association between profitability and leverage. This is triggered by high interest rates in long run thus debt is expensive than equity. Jensen, Zorn and Solberg (1992) argued that inverse relationship exists between dividend payout and leverage. The higher the dividend payout, the higher the risk of liquidation thus lower dividend distribution level among the US listed firms.

Pandey (2001) observed that with growing economy, a firm enjoys economies of scales through growth and this motivates it to finance growth through external funding. Growth in sales holding all cost constant or within marginal range leads to improvement in retained earnings. As retained earnings grow, the firm is motivated to issue debt thus support of trade – off theory. This supports the positive relationship between financing and growth. From pecking order theory, firms prefer to use debt than equity thus used as a preference for growth. Such firms must maintain high liquidity level in order to reduce agency cost. Moreover, Alonso and Sanz (2005) studied financial decisions and growth opportunities of

Spanish companies and found out that capital structure is relevant in terms of resources allocation. There exists negative association between leverage and value of a firm when it faces growth opportunities. When firms don't register profits, then the relationship turns out to be positive thus dividends will be outstanding in order to increase firm value.

In their seminal paper Dittmar, Smith and Servaes (2002) on corporate liquidity, observed that firms maintain high liquidity levels when they have access to capital market and especially markets which have little investor protection framework. Moreover, Bae, Chang' and Kang' (2010) documented that firms operate in markets that have strong shareholders' protection pay high dividend when future is uncertain. Differences in variation of dividend pattern practiced in various countries are due to cultural differences. Where there is high uncertainty level, then dividend payout is driven by corporate governance.

Lingling (2004) revealed that large Japanese firms which are profitable face less risks thus have high dividend payout level than small firms. Also, Powell and Baker (1999) established that value of a firm and shareholders' wealth is affected by dividend payout. Disclosure of information is important and continuous declaration of dividend is a sign that the firm is performing well thus shareholders hold their shares for them to increase in share prices. Casey and Puleo (2007) explained that there exist direct relationship between dividend yield and ownership while inverse relationship with growth. Shareholders of insurance company prefer higher dividend payout which is financed through leverage. Likewise, Ghassan (2012) documented that a negative relationship exists between dividend payout and cashflow (liquidity) while positive association with profitability and leverage among Amman listed firms.

Abor and Amidu (2006) argued that there is positive relationship between dividend payout

and profitability level of a firm. Profit levels registered by firms are considered as a signal of prosperity and growth for a firm thus when a firm record profits, then firms should be able to pay dividend without any difficulty. Also, Billet (2007) noted that debt covenants protect debenture holders. Firms adhere to the covenants since they want to create a good working relationship with debenture holders. With debt covenants, then there exists positive association between leverage and growth and vice versa. Moreover, Gordon (1962) noticed that dividend payment affect value of shares in a perfect market since there is information which is readily available and future is uncertain. Better present time which is certain than future which is uncertain thus dividend payment is relevant.

In the Kenyan context, Njuguna (2006) reported that firms consider four variables in determining dividend policy which include cashflow, profitability level, investment and financing opportunities available to sustain its operations. There is insignificant relationship between size of the firm, nature of industry, number of years that the firm has been in operations and dividend payout. Olando, Mbewa and Jagongo (2012) claimed that growth inabilities of SACCOs in Kenya leads to inabilities to withstand losses thus transfer of losses to share capital and members' savings. They concluded that growth depends on financing mix, financial stewardship and funds allocation strategy (investment). Firms promote quality financial management through having clear policies on investment, financing decisions, liquidity, risk management and corporate governance.

Valipour and Rostami (2009) proved that there exists significant negative association between dividend policy and asymmetric information. As part of corporate governance, managers are required to disclose information since they have wealth of information than shareholders and they release information to the market through profit dividing. Their study supported the signaling theory of dividend. Further, Moradi, Salehi and Honarmand (2010)

revealed that inverse association exists between debt, beta, price earnings rate and dividend among the Iran firms. Internal financing is preferred than external borrowing since it is cheaper and safe when it comes to liquidity issues. Dividend payout is an indicator of corporate investment since it is a reward to shareholders for their committed savings but on the other hand higher dividend denies firms adequate funds for investment. From the research, dividend is critical and its decisions have various impact.

According to Afza and Mirza (2011) a positive association exists between growth of firm and dividend payout while negative association between dividend payout and leverage. Dividend payout among the Pakistan firms fell from 46% in 2005 to 40% in 2007. Most firms are held by the government and they prefer to plough back earnings in order to finance growth thus this forces a firm to use its internally generated funds to finance its operations. Small firms have limited access to external funding thus rely on internal earnings to finance their investment projects thus reduction of dividend payout during the growth stage. Also, Deshmulch, Goel and Howe (2012) claimed that overconfident managers perceive that debt financing is costly thus pay low dividend level and substitute available cash for investment purposes. Such firms experience low level of growth and maintain less working capital. From this, it is clear that there is direct association between dividend payout and cash flow.

Alam and Hossain (2012) supported dividend irrelevance theory that dividend don't affect firm value since it is home made. Based on UK firms, market capitalization, profitability and leverage positively affect dividend while growth and liquidity negatively affect dividend payout. While in Bangladeshi firms, leverage, profitability, market capitalization and liquidity negatively affect dividend while growth positively affect dividend. Dividend depends on industry and nature of market. They argued that liquidity, profitability, market capitalization, leverage on dividend payout is higher in Bangladeshi firms in comparison to



UK based firms.

Ouma and Murekefu (2012) showed that a significant positive relationship between dividend policy and firms' performance thus dividend is relevant since it affect share prices. When it comes to design of dividend policy, a firm considers taxes, ownership structure, and industry, growth stage of financial market, legal framework and investment opportunities. Njoroge (2001) explained that both return on assets and equity are positively related with dividend policy employed among the Kenyan listed firms. Karanja (1987) emphasized that liquidity position and cash, profitability and company's resources are among the most critical determinants of dividend policy. Moreover, locally controlled companies have less liberal dividend policies than foreign controlled companies.

Chebii, Kipchumba and Wasike (2011) concluded that significant positive relationship exists between dividend payout and capital structure. Firms operating under finance and investment sector maintained high leverage levels compared to other firms in other sectors. Debt is cheaper due to presence of tax deductible on interest and firms can easily access funds to finance their operations. Wairimu (2002) reported that a positive association exists between dividend policy and investment decisions. These decisions compete for firm's resources thus firms invest resources in order to obtain return which is distributed as dividend. Kibet (2004) explained that dividend is relevant among Kenyan firms and there exists weak negative relationship between value of the firm and dividend policy. There is clear dividend policy among the large firms compared to small firms which thus impact on their value.

## **2.6 Summary of Literature Review**

In summary, corporate governance entails leadership and accountability to stakeholders by ensuring that there is proper disclosure of information, risk assessment, ensuring that checks

and balances are in place. There is confidence by stakeholders about the company performance thus increase in share prices and reduced cost of capital. Risks faced on financing should be looked in totality. Maturity of liabilities should be matched to assets returns in order to avoid mismatch of the two. If this is not achieved, then this can lead to liquidation like the case of Uchumi Supermarkets Limited where short term financing was used to finance long term projects e.g. acquisitions and expansions. Growth should be monitored since rapid growth overstretches firm's liquidity level thus inability to meet its obligations as they fall due.

Dividend policy remains a puzzle since there are three schools of thought who draw inconclusive results and conflicting. The rightists argue that firms pay dividend to increase shareholders wealth, the leftists argue that firm pay low dividend because dividend is highly taxed than capital gains and lastly the middle of roaders argue that firms should vary dividend payout since it doesn't affect firm value. All these decisions affect financial leverage and growth of a firm. The research aims to establish the effect of financial leverage and growth on dividend policy adopted by firms in a developing market, Kenya, where there exists market imperfections.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

In this Chapter, discussion focuses mainly on research methodology pertaining to research design, population of the study and sample size, research model, data collection and analysis in order to draw conclusions in Chapters four and five.

#### **3.2 Research Design**

The research adopted descriptive design; descriptive design study is the systematic approach where information is collected in the current state to describe what exist or the phenomenon. Descriptive study is an innovative tool, it represent an opportunity to fuse both qualitative and quantitative data. This offers a unique means to collect data in the research case study of Nairobi Securities Exchange. The source of information was print media firms, published accounts for all firms listed at the Nairobi Securities Exchange.

#### **3.3 Population of the Study**

The study considered all sixty listed firms at NSE as at 31<sup>st</sup> December 2012 (See Appendix I). There are sixty listed firms in Kenya classified into ten sectors.

#### **3.4 Sample Design**

A sample of forty firms that have been listed consistently from 2008 to 2012 was selected (See Appendix II). Purposive sampling method was used to select a sample of forty firms. It involved judgmental selection of units of study from the population. During this period, Uchumi Supermarkets Ltd and Hutchings Biemer Ltd were suspended and Uchumi

Supermarkets Ltd relisted in 2011 thus not considered. Also, all firms under insurance and banking sectors were excluded since they have standardized asset and debt structure that comply with regulatory oversight bodies.

### 3.5 Data Collection

Secondary data was collected from group annual and financial reports of individual companies between 2008 to 2012. Five years was considered since Rafique (2012) noted that complete business cycle is between five to seven years. Audited annual and financial reports were considered since they show financial performance, position and changes in financial position of companies. They were obtained from NSE and CMA.

### 3.6 Data Analysis

Data collected was presented in form of tables, pie charts and graphs. Variables were calculated and subjected to SPSS version 17.0 and advanced MS Excel to obtain the relationship and analyzed further to obtain the objective of the study. Descriptive statistics were utilized to further analyze the data and included percentage, mean, median, maximum, minimum and median. The variable definitions are included in table 3.1 below.

#### 3.6.1 Analytical Model

The model aimed at establishing the relationship between dividend policy, financial leverage and revenue growth. It aimed at explaining the association between variables and thus solving the research question. The study used the following multi – variable regression model:-

Analytical Relationship between dividend payout, financial leverage and growth of firms:

Rafique (2012) model

$$DPR = b_0 + b_1FL + b_2G + b_3R + b_4S + b_5CE + b_6T + b_7L + E_t \dots \dots \dots (3.1)$$

Let:-

DPR = Dividend Payout Ratio

FL = Financial Leverage

G = Revenue Growth

R = Return on Equity

S = Size

CE = Current Earnings

T = Corporate Tax

L = Liquidity

$b_i$  = Regression Coefficient for Independent Variables     $E_t$  = Error Term

### 3.6.2 Test of Significance

Analysis of Variance (ANOVA) was used to test and estimate the hypotheses about the population, variances and means. It involved use of P and F values to explain the random variables. To test the strength of the model, F- test was used and t – test to investigate if actually there exists any relationship.

**Table 3.1 Variable Definition**

<b>Independent Variable</b>	<b>Equation</b>
Dividend Payout Ratio	$\frac{\text{Dividend Paid}}{\text{Net Income Available to Shareholders}} \dots \dots \dots (3.2)$
<b>Dependent Variable</b>	<b>Equation</b>
Financial Leverage	$\frac{\text{Long Term Liabilities}}{\text{Total Assets}} \dots \dots \dots (3.3)$
Revenue Growth	Percentage Change of Sales.....(3.4)
Return on Equity Ratio	$\frac{\text{Net Profit}}{\text{Shareholders' Equity}} \dots \dots \dots (3.5)$
Size of the Firm	Natural Log of Total Assets.....(3.6)
Corporate Tax	$\frac{\text{Corporate Tax}}{\text{Profit before Tax}} \dots \dots \dots (3.7)$
Current Earnings	$\frac{\text{Earnings before Interest and Tax}}{\text{Total Assets}} \dots \dots \dots (3.8)$
Liquidity	$\frac{\text{Current Assets}}{\text{Current Liabilities}} \dots \dots \dots (3.9)$

## **CHAPTER FOUR**

### **DATA ANALYSIS, FINDINGS AND DISCUSSION**

#### **4.1 Introduction**

This Chapter provides detailed analysis of data collected, research findings of the study and the results from analyzed data. Annual audited financial statements were obtained from NSE, CMA and respective companies. The research sought to establish the effect of financial leverage and revenue growth on dividend policy of firms listed at NSE thus data of interest was extracted , coded and analyzed using SPSS Version 17.0. The Chapter contains three sections namely findings of various determinants of dividend policy, the effect of financial leverage and revenue growth on dividend policy of firms listed at NSE and lastly interpretation of findings of the study.

#### **4.2 Findings**

The section discusses the various determinants of dividend policy. The data was presented in bar graphs, tables and pie charts while the findings were presented in frequency distributions, percentages, mean, maximum, minimum, median and standard deviation. (Appendices III and IV)

##### **4.2.1 Dividend Pay Out Level**

Dividend is paid out of profits thus it is used as a yard stick to show future prospects of a firm, attract investors and monitor under - investment by managers. Managers tend to misappropriate funds, invest in unprofitable projects, and pay themselves huge perks and perquisites. From the data collected, it was established that Eaagads Ltd paid the highest level of dividend at 77%, while Kenya Airways paid the lowest level at negative 49%. On average, dividend pay out level stood at 22% between 2008 and 2012. (Appendices III and IV).

**Table 4.1 Dividend Pay Out Level (2008 – 2012)**

Descriptive Statistics	Dividend Pay Out Level
Mean Level	0.22
Maximum Level	0.77
Minimum Level	(0.49)
Median Level	0.18
Standard Deviation Level	0.23

Source: Research Findings

From table 4.1, standard deviation stood at 23% while the median at 18%. Kenya Airways had negative dividend pay out of negative 49% due to huge losses recorded in 2009.

#### **4.2.2 Financial Leverage Level**

It entails to what extent a firm has utilized equity, retained earnings and debt to finance its operations. High level of financial leverage increases the level of firm's liquation. On average, the market financial leverage stood at 46%. From appendix III, Kenya Orchards Ltd recorded the highest level at 100% while City Trust Ltd recorded the lowest level at 2%. This means that Kenya Orchards Ltd was fully funded with debt while for City Trust Ltd, only 2% of its capital structure was debt and 98% equity financed.

#### **4.2.3 Revenue Growth Level**

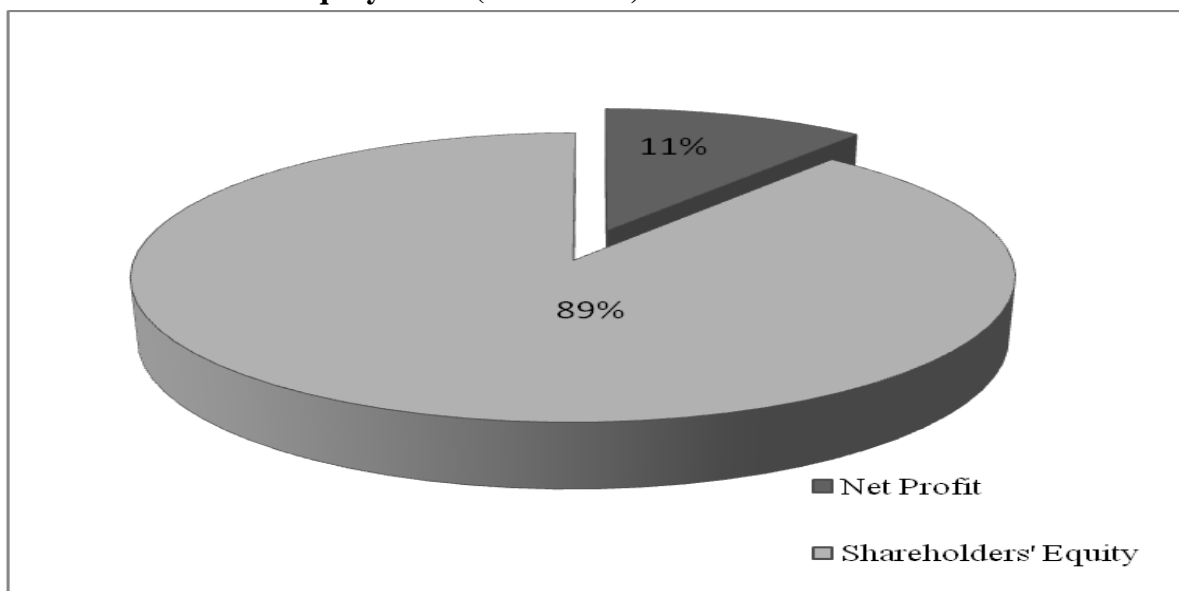
High growing firms face liquidity problems since cash is diverted to investment projects thus reduction in agency costs. Firms pay lower dividend and divert retained earnings to growth opportunities and reduces reliance on external financing which is expensive. From appendix IV, the mean market revenue growth was 15% and median was 16%. From the analysis, Kapchorua Tea Company Ltd recorded the maximum revenue growth of 61% while the minimum revenue growth level was from Marshalls East Africa Ltd at negative 26%. This implies that Kapchorua Tea Company Ltd was able to expand its revenue generating

activities by 61% while Marshalls East Africa Ltd revenue growth dropped by 26% annually.

#### 4.2.4 Return on Equity Level

High return on equity motivates investors to boost their stake in a company. It is used as a signal of outstanding current and future performance thus firms have ability to pay dividend when due. From appendix III, the highest return on equity level of 43% was registered by Limuru Tea Ltd followed by East African Breweries Ltd at 31% and Nation Media Group Ltd at 29% while Marshalls East Africa Ltd recorded the lowest return on equity of negative 13%.

**Chart 4.1 Return on Equity Level (2008- 2012)**



Source: Research Findings

From Chart 4.1 and appendix IV, the market mean return on equity was 11% indicating that investors earn 11% for every shilling they invest thus used a sign of firm's outstanding performance.



#### 4.2.5 Size Level

On the firm's size, the highest level of 8.14 was recorded by Kengen Ltd followed by Safaricom Ltd and Kenya Power and Lighting Company Ltd at 8 and 7.95 respectively while the lowest level of 1.35 was registered by Olympia Capital Ltd.

**Table 4.2 Size Level Distribution Frequency (2008 – 2012)**

Size Bracket	Frequency	Percentage (%)	Cumulative Frequency
0.00 – 2.99	3	7.50	7.50
3.00 – 4.99	1	2.50	10.00
5.00 – 6.99	21	52.50	62.50
7.00 – 8.99	15	37.50	100.00

Source: Research Findings

From table 4.2, the market mean size of firms was 6.39 and standard deviation stood at 1.54. (Appendix IV). Out of forty firms studied, 52.5% recorded size level between 5 to 6.99.

#### 4.2.6 Corporate Tax Level

From appendix III, the maximum corporate tax level of 44% was recorded by Crown Paints Kenya Ltd while the minimum of 0.01 was recorded by Marshalls East Africa Ltd. On average, the mean corporate tax level stood at 33%.

#### 4.2.7 Liquidity Level

Liquidity level measures the ability of a firm to pay its short term obligations as they fall due. Express Kenya Ltd recorded the minimum level at 0.33 while the maximum level was recorded by Eaagads Ltd at 10.50 followed by Limuru Tea Company Ltd (Appendix III). From appendix IV, the mean market liquidity level was 2.39, median at 1.54 and standard deviation at 2.36.

### 4.3 The Effect of Financial Leverage and Revenue Growth on Dividend Policy of Firms Listed at the NSE

To establish the effect of financial leverage and revenue growth on dividend policy of firms listed at the NSE, computed data on various variables was applied to multivariate regression model as per Chapter Three and regressed on SPSS Version 17 and results generated.

The estimated multivariate regression model was:

$$\text{DPR} = 0.03L - 0.07FL + 1.16ROE + 0.01T - 0.04G + 0.01S + 0.003CE$$

t-Statistic [1.69] [-0.31] [2.70] [0.14] [-0.19] [0.74] [1.07]

Std. Error [0.02] [0.24] [0.43] [0.09] [0.19] [0.02] [0.003]

P Value [0.10] [0.79] [0.01] [0.89] [0.85] [0.46] [0.29]

From the regression output, it was found out that liquidity, return on equity, corporate tax, size and current earnings were positively related to dividend pay out while financial leverage and revenue growth were negatively related to dividend pay out. Out of the seven explanatory variables, only return on equity was found to be having significant impact on dividend pay out. T – Statistic was derived by dividing respective co-efficients by standard error values. It was found out that liquidity, return on equity, current earnings and size had a positive impact on dividend payout meaning at 5% confidence interval, any 1% change on return on equity, liquidity, current earnings and size would lead to 5% increase in dividend pay out level. P-Value was used to explain the random variables in the model. It was found out that all explanatory variables had positive association with dependant variables of dividend payout level.

From table 4.3, Multiple R was 82%,  $R^2$  was 0.67, Adjusted  $R^2$  was 0.58 and Durbin Watson Statistics was 1.81. On explanatory power of the multivariate regression model, R squared

was used. It was at 67% implying that out of the independent variables considered, 67% of all determinants of dividend payout were considered. Multiple R at 82% shows that there is a strong association between dividend pay out level and independent variables considered. Durbin Watson statistics at 1.81 indicates that the multivariate regression model is good since it is between 1 and 3.

From table 4.3, P Value was 0.000002 and F Value was 9.59. At 95% confidence interval, P-Value was less than  $\alpha$  (0.05) thus reject the null hypothesis and conclude that there is relationship between financial leverage, revenue growth and dividend pay out. In general, there is negative relationship between financial leverage, revenue growth and dividend pay out of firms listed at NSE between 2008 and 2012.

**Table 4.3 The Regression Analysis Results for the Effect of Financial Leverage and Revenue Growth on Dividend Policy of Firms Listed at the Nairobi Securities Exchange**

Regression Statistics					
Multiple R	0.82				
R Square	0.67				
Adjusted R Square	0.58				
Standard Error	0.19				
Observations	40				

Analysis of Variance					
	Degree of Freedom	Sum of Squares	Mean Square	F Value	Significance F
Regression	7	2.63	0.38	9.59	0.000002
Residual	33	1.29	0.04		
Total	40	3.92			

	Coefficients	Standard Error	t Stat	P-value	Upper 95%	Lower 95%
Liquidity Ratio	0.03	0.02	1.69	0.10	0.05	(0.01)
Financial Leverage	(0.07)	0.24	(0.31)	0.76	0.41	(0.56)
Return on Equity	1.16	0.43	2.70	0.01	2.03	0.29
Corporate Tax	0.01	0.09	0.14	0.89	0.19	(0.17)
Revenue Growth	(0.04)	0.19	(0.19)	0.85	0.36	(0.43)
Size of the Firm	0.01	0.02	0.74	0.46	0.05	(0.03)
Current Earnings	0.003	0.003	1.07	0.29	0.003	(0.01)

Source: Output obtained after applying SPSS

#### **4.4 Interpretation of Findings**

The objective of the research was to establish the effect of financial leverage and revenue growth on dividend policy of firms listed at NSE between 2008 and 2012. There exists positive association between liquidity, return on equity, corporate tax, size of the firm, current earnings and dividend payout of companies quoted at the NSE. Dividend is used as a signaling mechanism to portray firm's present and future performance thus direct association between return on equity, current earnings and dividend payout. Liquidity level indicates ability of the firm to settle its obligations as they fall due thus firms maintain high liquidity level to settle dividend as they fall due. Large firms have ability to pay dividend compared to small firms since they have easier access to financial market. It portrays that most of the listed firms at NSE are large in size, have ability to pay dividend and have easier access to financial market to borrow.

Negative relationship exists between financial leverage, revenue growth and dividend payout. High financial leverage level implies that a firm faces high bankruptcy level incase of default to meet its obligations. Most firms listed at the NSE employ debt thus high level of financial leverage and maintain low dividend payout level thus the inverse relationship. Listed firms at NSE employ agency theory of dividend policy. High financial leverage level lead to high transaction costs and interest that the firm has to bear leading to low profitability level. On revenue growth, firms maintain low dividend payout level since they face growth opportunities and thus retain their earnings to finance growth and expansion. Firms with fewer growth opportunities pay high dividend to curb the problem of over investing of funds by managers in unprofitable projects. From this perspective, dividend is used to divert cash from the firm and reduce agency costs.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

#### **5.1 Introduction**

The Chapter gives summary of the findings from Chapter Four, conclusion of the study and recommendations for further research. It is a recap of prior chapters done earlier. It draws conclusions on the effect of financial leverage and revenue growth on dividend policy of firms listed at Nairobi Securities Exchange from 2008 to 2012.

#### **5.2 Summary**

From data analysis and findings in Chapter four, there exists negative relationship between financial leverage, revenue growth and dividend pay out while positive association between liquidity, return on equity, corporate tax, size, current earnings and dividend payout. The objective of the study was to establish the effect of financial leverage and revenue growth on dividend policy of firms listed at NSE. It found out that firms adopt agency and signaling theory of dividend policy. They maintain high liquidity level to settle debt when due thus high financial leverage and low dividend payout levels. On revenue growth, firms face growth opportunities thus maintain earnings and search debt to finance expansions and growth. Due to this, low dividend payout level is maintained.

Firms listed at NSE are large in size thus have easier access to the capital markets. They pay dividend as a sign of current and future prospects in terms of performance. From this perspective, there exists positive relationship between return on equity, current earnings, size, corporate tax and dividend pay out levels. Dividend payout determines and increases share prices, information asymmetry in large firms is high due to dispersion of ownership thus increase in shareholders' inability to monitor managers' activities. From this point of view, dividend is paid to trigger for debt financing.

### **5.3 Conclusions**

From the findings, the study revealed that there exists negative association between financial leverage, revenue growth and dividend pay out. Financial leverage is used to describe the way in which owners of the firm use assets and earnings of the firm. The higher the financial leverage, the higher the firm equity and therefore the level of financial risk. High financial leverage lead to high transaction costs and interests that eventually reduces the profitability level of a firm.

Fast growing firms face liquidity problems since more cash is diverted to profitable projects. From investment perspective, firms generate return that boosts their revenue position and cashflow. From this perspective, firms listed at NSE practice agency theory of dividend policy. Dividend payment solves the agency problem of underinvestment, consumption of perks by managers and diversion of excess cash to unprofitable projects. Managers are put into task to seek additional financing to finance growth thus increase in financial leverage and revenue growth.

Positive association exists between liquidity, return on equity, corporate tax, size, current earnings and dividend pay out. From this perspective, firms quoted at NSE practice signaling theory of dividend policy. Dividend is used a sign of current and future prospect performance of the firm. When firms declare dividend, they are able to boost their growth, liquidity, size and profitability levels since dividend is viewed as a sign of prosperity. From the findings, the research supports studies done by Verma (1994) on agency theory, Susela (2011) on growth perspective and Jensen (1986) on liquidity issues.

#### **5.4 Recommendations for Policy**

From the study, dividend is relevant since it is used as a sign of prospect performance by firms. The study recommends that firms should boost their dividend payout level to attract potential investors. Through this, investors will increase their shareholding level in the company.

From agency point of view, the study recommends that dividend should be paid to reduce agency costs and consumption of perks by managers since managers will seek additional finance for growth. From this perspective, firms maintain high financial leverage thus low profitability level.

Finally, the study recommends that other macro economic factors and external market environment need to be considered when declaring dividends since they have significant impact on dividend payment patterns. These factors affect firm's performance and investors expect returns out of their investment. From this, firms will be able to prioritize investment, growth and dividend issues.

#### **5.5 Limitations of the Study**

From the study, there were various research difficulties experienced. Firstly, the study considered data from financial statements only. It is clear that there are some qualitative factors that affect dividend policy which the study didn't take into account. These factors include age of investors, investment opportunities, preferred stock restrictions, shareholders expectations, approach of the board of directors and legal restrictions. From the analysis, only 67% of factors that affect dividend policy were considered. 33% of the factors are qualitative thus this limited the scope of the study.



Secondly, other factors like inflation, economic and political factors were not considered but they affect operating environment significantly. Firms don't have control of external factors thus they carry out market analysis to establish their strengths, weaknesses, opportunities and weaknesses. These macro economic factors were not considered but significantly affect overall performance of a firm.

Thirdly, out of the financial statements considered, there was material restatement of figures thus lack of consistency by firms. The financial statements have been released to the stakeholders but still there are some occasions of restatement implying material misstatement and errors. Based on this, firms adjust released and adopted figures thus lack of accuracy on reporting by firms.

## **5.6 Recommendations for Further Research**

From the limitations, further researches are proposed. Firstly, the study considered the sixty listed firms at NSE. In Kenya, there are many unlisted firms that operate under different sectors. A further study is advocated for the unlisted firms in Kenya to establish if the same relationship is exhibited.

Secondly, with the advancement of behavioral finance, it would be more practical and interesting for a further research to be carried out on how investors react towards aspects of dividend policy adopted by firms. Behavioral finance involves cognitive, emotional and social factors on how rationale investors make decisions pertaining to their investment.

Thirdly, other determinants of dividend policy like age, level of education, board constitution, inflation and economic factors need to be incorporated into the model and results drawn.

These factors have significant effect on dividend and thus relationship between dividend payout, financial leverage and revenue growth.

Finally, a similar study needs to be replicated to other countries to find out if the resulted are consistent. The study considered firms in Kenya, developing market. With development of capital markets in East Africa, a similar study is advocated for within East Africa.

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## APPENDICES

### Appendix I: Firms Quoted at the Nairobi Securities Exchange as at 30<sup>th</sup> June 2013

<p><b>Industry : Agricultural</b></p> <ol style="list-style-type: none"> <li>1. Eaagads Ltd</li> <li>2. Kapchorua Tea Company Ltd</li> <li>3. Kakuzi Company Ltd</li> <li>4. Limuru Tea Company Ltd</li> <li>5. Rea Vipingo Plantations Ltd</li> <li>6. Sasini Ltd</li> <li>7. Williamson Tea Kenya Ltd</li> </ol> <p><b>Industry : Commercial And Services</b></p> <ol style="list-style-type: none"> <li>8. Express Ltd</li> <li>9. Kenya Airways Ltd</li> <li>10. Nation Media Group Ltd</li> <li>11. Standard Group Ltd</li> <li>12. TPS Eastern Africa (Serena) Ltd</li> <li>13. Scangroup Ltd</li> <li>14. Uchumi Supermarket Ltd - Relisted (2011)</li> <li>15. Hutchings Biemer Ltd</li> <li>16. Longhorn Kenya Ltd</li> </ol> <p><b>Industry : Telecommunication And Technology</b></p> <ol style="list-style-type: none"> <li>17. Access Kenya Group Ltd</li> <li>18. Safaricom Ltd</li> </ol> <p><b>Industry : Automobiles And Accessories</b></p> <ol style="list-style-type: none"> <li>19. Car and General (K) Ltd</li> <li>20. CMC Holdings Ltd</li> <li>21. Sameer Africa Ltd</li> <li>22. Marshalls (E.A.) Ltd</li> </ol> <p><b>Industry : Banking</b></p> <ol style="list-style-type: none"> <li>23. Barclays Bank Ltd</li> <li>24. CFC Stanbic Holdings Ltd</li> <li>25. Diamond Trust Bank Kenya Ltd</li> <li>26. Housing Finance Company Ltd</li> <li>27. Kenya Commercial Bank Ltd</li> <li>28. National Bank of Kenya Ltd</li> <li>29. NIC Bank Ltd</li> <li>30. Standard Chartered Bank Ltd</li> <li>31. Equity Bank Ltd</li> <li>32. The Co-operative Bank of Kenya Ltd</li> </ol>	<p><b>Industry : Insurance</b></p> <ol style="list-style-type: none"> <li>33. Jubilee Holdings Ltd</li> <li>34. Pan Africa Insurance Holdings Ltd</li> <li>35. Kenya Re-Insurance Corporation Ltd</li> <li>36. CFC Insurance Holdings</li> <li>37. British American Investments Co. Ltd</li> <li>38. CIC Insurance Ltd</li> </ol> <p><b>Industry : Investment</b></p> <ol style="list-style-type: none"> <li>39. City Trust Ltd</li> <li>40. Olympia Capital Holdings Ltd</li> <li>41. Centum Investment Ltd</li> <li>42. Trans-Century Ltd</li> </ol> <p><b>Industry : Manufacturing And Allied</b></p> <ol style="list-style-type: none"> <li>43. B.O.C Kenya Ltd</li> <li>44. British American Tobacco Kenya Ltd</li> <li>45. Carbacid Investments Ltd</li> <li>46. East African Breweries Ltd</li> <li>47. Mumias Sugar Company Ltd</li> <li>48. Unga Group Ltd</li> <li>49. Eveready East Africa Ltd</li> <li>50. Kenya Orchards Ltd</li> <li>51. Baumann Company Ltd</li> </ol> <p><b>Industry : Construction And Allied</b></p> <ol style="list-style-type: none"> <li>52. Athi River Mining Ltd</li> <li>53. Bamburi Cement Company Ltd</li> <li>54. Crown Berger Ltd</li> <li>55. E.A. Cables Ltd</li> <li>56. E.A. Portland Cement Ltd</li> </ol> <p><b>Industry : Energy And Petroleum</b></p> <ol style="list-style-type: none"> <li>57. KenolKobil Ltd</li> <li>58. Total Kenya Ltd</li> <li>59. KenGen Ltd</li> <li>60. Kenya Power &amp; Lighting Company Ltd</li> </ol>
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Source: CMA & NSE (2013)

## **Appendix II: Sample of Companies Listed at the Nairobi Securities Exchange Between 2008 to 2012 Excluding Financial Institutions**

1. Eaagads Ltd
2. Kapchorua Tea Company Ltd
3. Kakuzi Company Ltd
4. Limuru Tea Company Ltd
5. Rea Vipingo Plantations Ltd
6. Sasini Ltd
7. Williamson Tea Kenya Ltd
8. Express Kenya Ltd
9. Kenya Airways Ltd
10. Nation Media Group Ltd
11. Standard Group Ltd
12. TPS Eastern Africa (Serena) Ltd
13. Scangroup Ltd
14. Access Kenya Group Ltd
15. Safaricom Ltd
16. Car and General (K) Ltd
17. Cooper Motors Corporation (CMC) Holdings Ltd
18. Sameer Africa Ltd
19. Marshalls East Africa Ltd
20. City Trust Ltd
21. Olympia Capital Holdings Ltd
22. Centum Investment Ltd
23. Trans-Century Ltd
24. B.O.C Kenya Ltd
25. British American Tobacco Kenya Ltd
26. Carbacid Investments Ltd
27. East African Breweries Ltd
28. Mumias Sugar Company Ltd
29. Unga Group Ltd
30. Eveready East Africa Ltd
31. Kenya Orchards Ltd
32. Athi River Mining Ltd
33. Bamburi Cement Company Ltd
34. Crown Berger Ltd
35. East African Cables Ltd
36. East African Portland Cement Ltd
37. KenolKobil Ltd
38. Total Kenya Ltd
39. KenGen Ltd
40. Kenya Power & Lighting Company Ltd

Source: CMA & NSE (2013)

**Appendix III: Mean Statistics on Determinants of Dividend Policy (2008-2012)**

Name of Companies	Dividend Pay Out	Liquidity	Financial Leverage	Return on Equity	Corporate Tax	Revenue Growth	Size of the Firm
Kenya Airways	(0.49)	1.06	0.71	0.03	0.27	0.13	7.88
Marshalls E.A. Ltd	0.00	0.82	0.66	(0.13)	0.01	(0.26)	6.02
Eveready E.A. Ltd	0.00	1.79	0.60	0.01	0.28	(0.09)	6.01
Express Kenya Ltd	0.00	0.34	0.68	(0.07)	0.33	(0.20)	5.99
Kenya Orchards Ltd	0.01	1.35	1.00	(0.02)	0.36	0.15	4.88
E.A.Portland Ltd	0.03	1.72	0.56	0.05	0.30	0.06	7.08
K.P.L.C.	0.05	10.03	0.63	0.06	0.36	0.08	7.95
Trans – Century Ltd	0.06	1.36	0.53	0.10	0.037	0.23	7.16
Centum Inv. Ltd	0.06	1.45	0.09	0.08	0.13	0.52	6.97
Car and General	0.06	1.24	0.61	0.09	0.29	0.28	6.61
Olympia Capital Ltd	0.09	1.94	0.36	0.06	0.22	(0.05)	1.35
Unga Group Ltd	0.10	2.23	0.37	0.08	0.31	0.16	6.74
Kapchorua Tea Ltd	0.11	1.80	0.39	0.06	0.31	0.61	1.69
Kakuzi Ltd	0.13	3.29	0.31	0.16	0.29	0.03	6.51
Access Kenya Ltd	0.13	0.91	0.49	0.08	0.08	0.21	6.35
Athi River Mining	0.15	1.08	0.69	0.08	0.22	0.25	7.17
Williamson Tea Ltd	0.17	2.29	0.32	0.12	0.29	0.27	6.70
Crown Paints Ltd	0.17	1.45	0.53	0.10	0.44	0.16	6.31
Rea Vipingo Ltd	0.17	2.11	0.37	0.18	0.31	0.17	6.27
Kengen Ltd	0.18	4.83	0.49	0.03	0.01	0.04	8.14
Sameer Africa Ltd	0.18	2.91	0.29	0.06	0.23	0.03	6.50
Kenya Oil Ltd	0.20	1.23	0.69	0.01	0.34	0.49	7.51
Safaricom Ltd	0.22	0.57	0.42	0.19	0.29	0.18	8.00
Sasini Ltd	0.22	2.33	0.29	0.11	0.20	0.17	6.92
Total Kenya Ltd	0.23	1.19	0.67	0.03	0.22	0.32	7.44
TPS (Serena) Ltd	0.24	1.34	0.40	0.06	0.29	0.09	7.003
Scan Group Ltd	0.26	2.04	0.46	0.13	0.28	0.31	6.79
CMC Holding Ltd	0.26	1.44	0.61	0.04	0.32	0.06	7.13
Mumias Co. Ltd	0.28	1.63	0.40	0.09	0.03	0.09	7.29
Limuru Tea Ltd	0.29	9.29	0.28	0.43	0.33	0.19	5.14
Bamburi Cement	0.36	1.97	0.42	0.23	0.30	0.12	7.51
Carbacid Inv. Ltd	0.40	8.34	0.16	0.25	0.28	0.23	6.19
E.A. Breweries Ltd	0.42	1.43	0.48	0.31	0.27	0.17	7.61
City Trust	0.43	7.54	0.02	0.13	0.06	0.23	1.99
Nation Media Ltd	0.47	2.11	0.32	0.29	0.30	0.10	6.90
E.A. Cables Ltd	0.51	1.26	0.53	0.14	0.33	0.08	6.64
Standard Group Ltd	0.56	1.21	0.55	0.12	0.32	0.05	6.50
B.O.C Kenya Ltd	0.60	2.18	0.26	0.12	0.32	(0.03)	6.29
B.A.T. Ltd	0.70	1.12	0.54	0.26	0.31	0.17	7.08
Eaagads Ltd	0.77	10.50	0.23	0.13	0.34	0.27	5.58

Source: Research Findings

**Appendix IV: Statistical Description of Variables (2008-2012)**

Descriptive Statistics	Dividend Pay Out	Liquidity	Financial Leverage	Return on Equity	Corporate Tax	Revenue Growth	Size of the Firm
Mean Level	0.22	2.39	0.46	0.11	0.26	0.15	6.39
Median Level	0.18	1.54	0.47	0.09	0.29	0.16	6.72
Maximum Level	0.77	10.50	1.00	0.43	0.44	0.61	8.14
Minimum Level	(0.49)	0.34	0.02	(0.13)	0.01	(0.26)	1.35
Standard Deviation Level	0.23	2.36	0.19	0.10	0.10	0.17	1.54

Source: Research Findings