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Research Article

The impact of capital structure on dividend policy: Evidence from Pakistan

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ABSTRACT

This study investigates the impact of capital structure over dividend policy. For this purpose data of 40 companies of textile and cement sector listed at Pakistan stock exchange during the period of 2009 to 2014 was examined. Dividend pay-out ratio is taken as dependent variable and is used as a proxy for the dividend policy while debt-to-equity ratio, liquidity and profitability were used as independent variables; debt-to-equity ratio is used as a proxy for capital structure. Multivariate regression analysis shows that debt-to-equity ratio and dividend-pay-out ratio are negatively significant related to each other. Moreover it is found that liquidity and profitability are also significantly related to dividend-pay-out ratio.

Keywords: *Dividend Pay-Out Ratio; Debt-To-Equity Ratio; Liquidity; Profitability.*

1. INTRODUCTION

Capital structure is one of the most critical areas in corporate finance that can affect the overall operations of a firm. Capital structure can be defined as a combination of debt and equity used by a firm to finance its operations. One of the basic reasons of capital structure management is to reduce the cost of capital in order to maximize shareholders wealth. It is very difficult for a company to allocate suitable resources for business operations. A company can finance their operations by using debts or equity. Mostly the companies' finance the business functions by a mix of both i.e. debts and equity. Companies can use both inner and external sources to fund their functions. A company inner source consists of retained earnings and the owners' capital; whereas the external sources of funding the company functions contain credit loans or by offering shares. A positive capital structure is a combination of debts and equity and it tells us about the number of stockholders and debtor's. Dividend policy is a combination of guidelines that a company uses to decide how much of its earnings will be paid to the shareholders. Some evidence suggests that investors are not concerned with a company's dividend policy since they can sell a portion of their portfolio of equities if they want cash.

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Capital structure and divided policy have long been the areas of interest in the finance literature for the researchers. Miller and Modigliani (1958) and Modigliani and Miller (1961) gave their opinion that firm value is not affected by its capital structure and dividend policy. But their expectations were only related in perfect market where in reality, a perfect market does not exist. Capital structure theories showed that what impact debts and equity had on the market value of a company. Modigliani and Miller (1958) said that capital structure has no impact on a firm value.

2. LITERATURE REVIEW

According to M & M model when a firm uses 100% debt it has maximum market value. While in real world firms don't finance by using debts only and the reason behind that is there are other sources of financing that are much cheaper than debts.

(Baxter, 1967) gave two reasons that why firms maintain low level of debt. First reason is that interest rate on debt is directly related to debt/ equity ratio. Because of it the cost of borrowing increases. The second reason is that if a company is not able to pay its debts continuously for few years than it can result in bankruptcy. Brennan suggest that a firm should look for tax savings only if it is not going towards bankruptcy because higher debts reduce the possibility that firm can survive in future. The substitution theory also considered the problem to separate the ownership and management functions. This issue was also considered by the agency theory. This issue was also pointed out by Marshall who is considered as one of the founders of neo classical economics (Gruszecki, 2002). Mohsen's and Downs in their life maximization theory pointed out that manager's focus on those actions that maximize their own life income and not the enterprise profits. When ownership and management are separate from each other it will be good for the shareholders because than managers will have a focus on their own performance for achieving profits for the company. This paper analyses capital structure between the internationalized and domestic electronic industries in Taiwan from 1999 to 2008 as the reference for financing strategies and decision. The evidence shows that the leverage and the pay-out cash dividend ratio in the internationalized electronic firms are lower than those in domestic electronic firms. Due to the uniqueness and the high profit ability of the internationalized electronic firms in the Taiwan, they have more earnings and inside capital so that the leverage is lower. On the contrary, the internationalization level is irrelevant with the pay-out cash Dividend ratio due to the pay-out cash dividend depending on the dividend balance policy regulated by government in Taiwan (Feng-Li Lin 11, 2011).

(Rahim et, al. 2013) used standard partial adjustment model while studding listed firms on Malaysian stock exchange and 434 firms as a sample, the variables took into consideration were Firm's leverage ratio, Growth MV, The findings of this study support the relevance of the Dynamic trade-off theory. However, the dynamic adjustment in certain conditions, specifically for near-target and underleveraged firms, is weak and can be easily dominated by other Considerations. This means that other theories of capital structure might dominate the financing decisions. Similarly (Faruk Husain, 2013) also investigated the Dhaka stock exchange and take 41 non-financial firms as a sample from DSE, the variable considered in the study are growth, ownership structure, earnings volatility, liquidity,

profitability, and firm size. This study results showed that profitability and size have significant positive relations with dividend payments. On the other hand, this study also found that earnings volatility and Managerial ownership are negatively and significantly related with dividend payments

Some of the important elements that were added to Miller & Modigliani (1958) irrelevance model were corporate tax (M&M 1963), personal income tax

2.1. Research Hypothesis

H_1: There is a significant positive relationship between capital structure and dividend policy.
H_2: There is a significant relationship between firm's liquidity and dividend policy.
H_3: There is a positive significant relationship between profitability and dividend policy

3. RESEARCH METHODOLOGY

3.1. Population of the study

The population of this study contains the companies of textile sector and cement sectors of Pakistan registered at the Pakistan Stock Exchange.

3.2. Sample Size

For the selection of sample 40 companies is take as a sample from both sectors that are listed at the Pakistan Stock Exchange for the period 2009 to 2014

3.3. Data Collection Procedure

This data was collected from different sources like analysis reports, annual reports of the selected companies, business recorder website and joint stock companies' analysis reports from SBP.

3.4. Model Specification

$$DP = \beta_0 + \beta_1 (D/E) + \beta_2 (Pf) + \beta_3 (lq) + \beta_4 dummy + \varepsilon$$

Where

DP = Dividend pay-out

D/E = Debt to equity ratio

Pf = Profitability

Lq = Liquidity

Dummy =Industry

ε = the error term

3.5. VARIABLES

3.5.1. Debt to equity ratio

It is considered here as an independent variable. The debt-to-equity ratio (D/E) is a financial ratio indicating the relative proportion of shareholders 'equity and debt used to finance a company's assets it is calculated by dividing its total liabilities by stockholders' equity. It indicates what proportion of equity and debt the company is using to finance its assets. Closely related to leveraging, the ratio is also known as Risk, Gearing or Leverage

$$\text{Formula: D/E ratio} = \frac{\text{Total liabilities}}{\text{Total Stock holders' equity}}$$

3.5.2. Profitability

Profitability is the primary goal of all business ventures. Without profitability the business will not survive in the long run. Profitability is the ability of a business to earn a profit. A profit is what is left of the revenue a business generates after it pays all expenses directly related to the Generation of the revenue, such as producing a product, and other expenses related to the Conduct of the business' activities

$$\text{Formula: Profitability} = \frac{EBT}{Total\ assets}$$

3.5.3. Liquidity

The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets. Liquidity ratio is the ratio of liquid assets to current liabilities. This ratio has two main components that are liquid assets and liquid liabilities. The liquid assets consist of Cash, bills receivable and marketable securities. Similarly, liquid liabilities are also called as current liabilities and it includes bills payable and outstanding expenses etc.

$$\text{Formula: Liquidity ratio} = \frac{\text{Liquid assets}}{\text{Liquid liabilities}}$$

3.6. DIVIDEND PAY-OUT RATIO (DPR)

It is the dependent variable of the study. Dividend pay-out ratio is the amount of dividend paid to shareholders relative to the total net income of the company. The amount of that income that is not paid out as dividends is used for reinvestment and is known as retained earnings.

$$\text{Dividend pay-out ratio (DPR)} = \frac{\text{Dividend}}{\text{Net income}}$$

4. RESULTS AND DISCUSSIONS

Data of 40 companies of textile sector and cement sector of Pakistan was collected from state bank of Pakistan .Financial statements analysis and from the companies' annual

reports. The data collected was presented by showing the results in the form of tables for easy understanding. Different tools and techniques such as descriptive statistics, correlation and regression are used to test the relationships between the variables. In this chapter analysis of the data and testing of the hypothesis of this study are also covered.

Table 1. Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Firm dummy	237	20.47679	11.64393	1	40
Industry dummy	237	1.493671	.5010181	1	2
Tax dummy	237	1.50211	.5010537	1	2
Year	237	2087.852	1175.822	2009	2014
Divr	237	.2380802	.6140839	0	5.53
Sder	237	.3411772	.2407424	.004	1.935
Der	237	1.26173	1.230102	-8.24	4.61
Cr	237	1.288949	1.532806	.029	11.892
Fg	237	6.71189	.6603387	4.92	8.447
Tang	237	6.502882	.7363791	4.334	8.44
Roa	237	.0555485	.1108465	-.27	.507

Table 1 shows the descriptive statistics of the variables of this study. Der represents.

The debt to equity ratio of the firm, tang represents the tangibility of the firm, sder represents the Short term debt to equity and diver represents the dividend pay-out ratio of the firm.cr stand for current ratio, Fg represent firm growth, tang represents tangibility and ROA (Return on Assets).

4.1. Explanation

Table shows the minimum and maximum range, statistical mean and standard deviation. The minimum value of sder is .004 while its maximum value is 1.935 out of 237 observations. Its standard deviation is.2407424 and mean is.3411772.der minimum value is -8.24 while maximum is 4.61. Its mean and standard deviation values are 1.26173 and1.230102. The maximum and minimum values for cr are 11.892 and. 029.The mean and standard deviation values are1.288949 and 1.532806. The fg minimum value is 4.92 and maximum is8.447.The mean and standard deviation values are 6.71189 and.6603387. The maximum and minimum values for are 8.44 and 4.334. The mean and standard deviation values are .0555485 and .7363791.

Table 2. Correlation Analysis (Total Observations =237)

Variables	Divr	Sder	Der	Cr	Fg	Tang	Roa
Divr	1.0000						
Sder	-0.1648	1.0000					
Der	-0.0238	-0.2005	1.0000				
Cr	0.3983	-0.3324	-0.1369	1.0000			
Fg	-0.0100	-0.3045	0.0724	-0.1181	1.0000		
Tang	-0.0575	-0.3289	0.0896	-0.1799	0.9770	1.0000	
Roa	0.0985	-0.4303	-0.0579	0.2448	0.0496	-0.253	1.0000

Table 2 shows Pearson correlation results among the explanatory variables and dependent variable and it shows the positive or negative direction and the linear association between the dependent and explanatory variables.

4.2. Explanation

To find out the relation among the variables, multiple correlation model is used for statistical tool to find out that they are correlated to each other or not. This correlation model finds out either the variables are strongly positively or strongly negatively correlated or they are weakly positively and weakly negatively correlated. This model state that dividend pay-out perfectly correlated to itself. The model also shows that DPR is 16% correlated to sder, which shows a strongly negative relation between DPR and sder. DPR is 23% related to Der of the firm, which shows a strongly negative relation between DPR and Der of the firm. DPR is 39% related with Cr, which shows an optimal positive relation between DPR and Cr. DPR is 1% related to Fg, which shows a strongly negative relationship between DPR and Fg. DPR is 5% strongly negative correlated to tangibility(Tang) of assets. DPR is 9% related to Roa, which shows a strongly positive relationship between DPR and Roa.

The table 1 also shows the correlation between Sder and other variables. Sder is 20% related to Der, which means there is a strongly negative relationship between Sder and Der. Sder is 33% correlated to Cr, which shows a strongly negative relation between Sder and Cr. Sder is 30% strongly negative related to Fg. Sder is 32% strongly negative related to tangibility of assets. Sder is 43% optimal negative related to Roa.

Table 1 shows Der is 13% correlated to Cr, which shows that Der is strongly negative correlated to Cr.Der is 7% correlated to Fg. This shows a strong positive relation between firm sizes. Der is 28% strongly positive correlated with tangibility of assets. . Der is 57% weakly negatively correlated to Roa.

Table 1 shows that Cr is 11% strongly negative correlated to Fg. The Cr is 17% strongly negative correlated to the tangibility of assets. Cr is 24% strongly positive correlated to the Roa.

Table 1 shows that Fg is weak positively correlated to tangibility of assets that is 97%. Fg is optimal positively correlated to growth that is 49%.

Table 1 shows that tangibility of asset is 25% strongly negative related to Roa.

Table 3. Regression Analyses

Source	SS	Df	MS	No. of obs =237
Model	16.0704957	6	2.67841594	
Residual	72.9248664	230	0.317064637	
Total	88.9953621	236	0.377098992	

Prob >F = 0.0000 *R-squared = 0.1806* *Adjusted R-squared = 0.1592*

Root MSE = 0.56308 *F (6 , 230) = 8.45*

From the above data we can see that F test has p value less than 0.05 so model fit is good and 18.06% of variation is being explained in dependent variable by independent variables.

Table 4. Regression Analyses

Divr	Coef.	Std Err.	T	P>t	95% conf.	interval
Sder	-.3108357	.02245804	-10.38	0.0018	-.7533337	.1316622
Der	.35392	.317483	11.00	0.001	-.0590155	.066094
Cr	.1315371	.0295621	4.45	0.0000	.0732899	.1897842
Fg	.7419371	.3121693	2.38	0.018	.1268599	1.357014
Tang	-.6845926	.2933513	-2.33	0.020	-1.262592	-.1065932
Roa	-.5223054	.4251458	-1.23	0.221	-1.359984	.3153729
Cons	-.3288421	.4624237	-0.71	0.478	-1.23997	.582286

4.3. Explanation

Table 4 shows the regression analysis of the research. The table tells and shows how much effect in dependent variable i.e. Dividend pay-out are caused by the independent variables i.e. Debt to equity, profitability and liquidity.

From the above table, it is clear that the relationship between sder and Divr is significant negative in Pakistan. The value of the coefficient of dividend pay-out is -.3108357 which is statistically significant as t-calculated is less than the critical value that is -10.38.The column tabulated as p- value shows that the result of independent variable is significant, this is because the fact that if we take the maximum value from the table, still is less than 5 percent, which shows the significance of the data. The F-value is also lesser than the T-critical value, which is -10.38 percent, so a 100 percent of confidence is used in this thesis. For the significant results-value must always be smaller than 0.05,or percent which is 0.0018. The coefficient for DER gives a positive sign; this way DER and DPR have positive relationship. The coefficient of DER is .35392, the t-calc=11.00 which is lesser than the t-critical-value and the p-value is 0.001 also significant. So the results are statistically noteworthy. So we will agree that, because DER is positive significant related with DPR (DIVR) coefficient of CR gives a positive sign; the means that CR and DPR have positive association. The coefficient of CR is .1315371 the t-calc=4.45 which is larger than the t-critical-value and the P- value is 0.0000 also significant. So the results are statistically momentous. So will admit that, because CR is significantly positive with DPR (DIVR).The coefficient for FG gives a positive sign; this means that FG size and DPR leverage have positive association. The coefficient of FG is .7419371, the t-calc=2.38 which small from the t-critical-value and the p-value is .018 also significant. So the results are statically significant. So will accept that, because FG is significantly positive related with DPR. The coefficient for tangibility of asset gives a negative sign; this means that tangibility of asset and DPR has negative relationship. The coefficient of tangibility of asset is -.6845926, the t-calc=-2.33 which is smaller than the t-critical-value is .020 also significant. So the results are statistically significant. So we will accept that, because tangibility of asset is significantly negative related DPR. The coefficient for ROA gives negative sign; this means that ROA and DPR have negative relationship. The coefficient of ROA is -.5223054 the t-calc -1.23 which is smaller than the t-critical- value and the p-value is 0.221 also insignificantly. So the results are statistically insignificant. So we will accept that, ROA is insignificantly negative related with DPR (DIVR).

Table 5. Regression after inclusion tax dummy firm dummy and industry dummy

Source	SS	Df	MS	No. of obs =237
Model	17.8674911	9	1.98527679	
Residual	71.127871	227	0.313338639	
Total	88.9953621	236	0.377098992	

Prob >F = 0.0000 *R-squared = 0.2008* *Adjusted R-squared = 0.1691* *Root MSE = 0.55977*

From the above data we can see that F test has p value less than 0.05 so model fit is good and 20.08% of variation is being explained in dependent variable by independent variables.

Table 6. Regression analysis of the research

Divr.	000Coef.	Std Err.	T	P>t	95% conf.	Interval
Sder	-.3126599	.2246801	-1.39	0.165	-7553851	.1300654
Der	.83201	.0328119	25.00	0.0008	-.0563348	.0729749
Cr	.1197973	.0309829	3.87	0.0000	.0587465	.1808481
Fg	.72199762	.314972	2.29	0.023	.1013334	1.342619
Tang	-.6316367	.2981986	-2.12	0.035	-1.219228	-.0440453
Roa	-.7750098	.4361341	-1.78	0.077	-1.634399	.0843791
Firm dummy	-.0008913	.0068184	-0.13	0.896	-.0143268	.0125442
Industry dummy	-.1109862	.174026	-0.64	0.524	-.4538991	.2319268
Tax dummy	.153168	.0757493	2.02	0.044	.0039064	.3024296
_cons	-.5615216	.4700479	-1.19	0.233	-1.487737	.3646935

4.4. Explanation

Table 6 shows the regression analysis of the research. The table tells and shows how much effect in dependent variable i.e. Dividend pay-out are caused by the independent variables i.e. Debt to equity, profitability and liquidity.

From the above table, it is clear that the relationship between sder and Divr is significant negative in Pakistan. The value of the coefficient of dividend pay-out is -.3108357 which is statistically significant as t-calculated is less than the critical value that is -1.39.The column tabulated as p- value shows that the result of independent variable is insignificant, this is because the fact that if we take the maximum value from the table, still is more than 5 per cent, which shows the significance of the data. The F-value is also lesser than the T-critical value, which is -1.39 per cent, so a 100 per cent of confidence is used in this thesis. For the significant results-value must always be smaller than 0.050, or per cent which is 0.0018. The coefficient for DER gives a positive sign; this way DER and DPR have positive relationship. The coefficient of DER is.83201, the t-calc=25.00 which is lesser than the t-critical-value and the p-value is 0.008 also significant. So the results are statistically noteworthy. So we will agree that, because DER is positive significant related with DPR (DIVR) coefficient of CR gives a positive sign; the means that CR and DPR have positive association. The coefficient of CR is .1197973 the t-calc=3.87 which is larger than the t-critical-value and the P- value is 0.0000 also significant. So the results are statistically momentous. So will admit that, because CR is significantly positive with DPR (DIVR).The coefficient for FG gives a positive sign; this means that FG size and DPR (DIVR) have positive association. The coefficient of FG is .7219762, the t-calculated=2.29 which small from the t-critical-value and the p-value is .023 also significant. So the results are statically significant. So will accept that, because FG

is significantly positive related with DPR. The coefficient for tangibility of asset gives a negative sign; this means that tangibility of asset and DPR has negative relationship. The coefficient of tangibility of asset is -.6316367, the t-calculated=-2.12 which is smaller than the t-critical-value is .023 also significant. So the results are statistically significant. So we will accept that, because tangibility of asset is significantly negative related DPR. The coefficient for ROA gives negative sign; this means that ROA and DPR have negative relationship. The coefficient of ROA is -.7750098 the t-calculated -1.78 which is smaller than the t-critical- value and the p-value is 0.077 also significantly. So the results are statistically insignificant. So we will accept that, ROA is significantly negative related with DPR (DIVR). The coefficient for firm dummy gives negative sign; this means that firm dummy and DPR have negative relationship. The coefficient of firm dummy is -.0008913 the t-calc -0.896 which is greater than the t-critical- value and the p-value is 0.896 also insignificantly. So the results are statistically insignificant. So we will accept that, firm dummy is insignificantly negative related with DPR (DIVR). The coefficient for industry dummy gives negative sign; this means that industry dummy and DPR have negative relationship. The coefficient of industry dummy is -.1109862the t-calc -.64 which is smaller than the t-critical- value and the p-value is 0.524 also insignificantly. So the results are statistically insignificant. So we will accept that, industry dummy is insignificantly negative related with DPR (DIVR). The coefficient for tax dummy gives positive sign; this means that tax dummy and DPR have positive relationship. The coefficient of tax dummy is .153168 the t-calc -.2.02 which is smaller than the t-critical- value and the p-value is 0.044 also significantly. So the results are statistically significant. So we will accept that, tax dummy is significantly positive related with DPR (DIVR).

Table 7 shows the result of Hausman Test. The Hausman test actually used to select the model i.e. which model is appropriate for data analysis. The hausman test result shows that fixed effect model (FEM) is appropriate rather than random effect model (REM). The p value of Hausman test is 0.8519 which is insignificant and suggests using Random model rather than the Fixed effect model.

Table 7. Fixed vs. Random effect

VARIABLES	(1) Fixed Effects	(2) Random Effects
Sder	-0.5450	-0.346
	(0.0341)**	(0.0245)**
Der	0.5420**	0.1490**
	(0.0554)	(0.0365)
Cr	0.114***	0.119***
	(0.0336)	(0.0301)
Fg	0.616	0.689*
	(0.662)	(0.368)
Tang	-0.134	-0.592*
	(0.640)	(0.349)
Roa	-0.393	-0.714
	(0.538)	(0.453)
Tax dummy	0.131	0.157**
	(0.0822)	(0.0718)
Industry dummy		-0.134
		(0.122)

VARIABLES	(1) Fixed Effects	(2) Random Effects
Constant	-3.231	-0.585
	(2.501)	(0.590)
Observations	236	236
R-squared	0.163	
Number of firm dummy	40	40
Country FE	YES	

Standard errors in parentheses **** p<0.01, ** p<0.05, * p<0.1*

Table 8. Hausman test for fixed and random effects

Independent Variables	Coefficients		(b-B)	S.E.
	Fixed(b)	Random(B)	Difference	
Sder	-.5453374	-.3459119	-.1994254	.2367874
Der	.0542424	.0148876	.0393548	.0416588
Cr	.1136929	.1185753	-.0048824	.0148368
Fg	.6162323	.6894085	-.0731761	.5502611
Tang	-.1340672	-.5924098	.4583426	.5367895
Roa	-.3929808	-.7140663	.3210855	.2891354
Tax dummy	.131339	.157286	-.0259471	.0401102

b= consistent under H0 and Ha; obtained from xtreg

B= inconsistent under Ha, efficient under H0, obtained from xtreg

Test H0: difference in coefficient not systematic

Chi2(7) = (b-B) [(v_b-V_B)^(-1)] (b-B) = 3.34 *Prob>chi2 = 0.*

5. SUMMARY OF FINDINGS, CONCLUSION

This study took data of 40 companies of textile sector and cement sector to find out the relationship between capital structure and dividend policy decisions. Data of firms from 2009 to 2014 was taken for analyses. Descriptive statistics, Pearson correlation test and multivariate regression analysis were applied over the data to examine it. The results show that there exists an insignificant negative relationship between debt to equity ratio and dividend pay-out ratio. Liquidity and profitability had a positive insignificant relationship with dividend pay-out ratio. The study findings had provided empirical evidence to the propositions of Modigliani and Miller that were that capital structure choices had no effect on a firm's pay-out policy. It was found that out of 40 firms only 16 firms were paying dividends. The amount of dividend that is paid by these firms is residual left after reinvestment done for growth. The firms are free to decide that how much dividend they want to pay from their profit because there are no government restrictions over them. The government should bound these firms to pay dividends to their shareholders. Most of these firms are family owned. Majority of the shares of these firms belong to the families and due to that majority they are able to select their own board of directors and management an than it their wish whether to pay dividend to other shareholders or not.

5.1. RECOMMENDATIONS

I presented few recommendations on the basis of my findings of this research.

1. The recommendation of this study are not only useful for the academic world but also for the professionals of textile and cement sectors who are involved in formulating the financial policies.
2. In terms of the academics this study has generated the empirical evidence for M&M propositions that capital structure has no influence on firm value. So these recommendations are applicable in the textile and cement sectors of Pakistan.
3. Most of the companies are owned by families. Majority of the shares belong to families due to which they have their own board of directors and management by the help of which they impose their decisions that whether to pay dividends or not and to what extent they should be paid.
4. There are no government restrictions about the payment of dividends. Government should make certain policies in the best interest of other shareholders so that they get a proper return on their investment.

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