

# INTERNAL AND EXTERNAL FACTORS THAT DETERMINE CORPORATE DIVIDEND PAYOUT: EVIDENCE FROM SELECTED PRIVATE INSURANCE COMPANIES IN ETHIOPIA

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**ABSTRACT:** : The aim of this study is to investigate the internal and external determinants of dividend payout in selected private insurance companies in Ethiopia over the period of 2006 to 2017. The study employed quantitative research approach and explanatory research design. Random effect panel regression model was employed for 8 purposively selected private insurance companies. The empirical results revealed that profitability, firm age, firm size, lagged dividend, liquidity, GDP, tangibility have positive and significant effect on dividend payout of private insurance companies in Ethiopia. Risk, inflation and leverage have negative and significant effect on dividend payout. On the other hand, growth opportunity and premium are found to be insignificant factors to determine the dividend payout of private insurance companies in Ethiopia.

**Key Words:** Dividend payout, determinants, insurance companies, Ethiopia

## 1. INTRODUCTION

The insurance sector plays a valuable role in support of the growth of the country's economy, and providing cover for properties and services exposed for different insurable risks to the public who are exposed for these risks. Moreover, a well-developed insurance market paves way for efficient resource allocation through transfer of risk and mobilization of savings Charumathi (2012). Besides, insurance companies contribute substantially to the national economy by using capital gathered through premiums for investment (Gulsun&Umit, 2010). Therefore, the current business world in the absence of insurance companies is unsustainable, because risky businesses have no a capacity to retain all types of risk in current extremely uncertain environment.

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

## 2. STATEMENT OF THE PROBLEM

Many researchers in various countries have conducted studies in order to describe the relationship between the number of factors and the company's dividend policy (Kumar (2003); Ho (2003); Baker *et al.* (2006); Ahmed & Javid (2009); Hosain (2016); Sangeetha (2018)). Even though, a number research has been conducted on dividend policy; gaps still exist from both theoretical and empirical perspectives. The dividend puzzle results from the existence of dividend policy in a real world that is multivariate and complicated (DeAngelo *et al.*, 2008). Frankfurter and Wood (1997) indicated that dividend policy is influenced by customs, regulations, public opinion, perceptions, general economic conditions, and several other factors. Besides, most of the empirical studies appear to focus on the dividend behaviours of companies in developed economies, but the evidence from developing economies is very limited and the findings of the developed economies may not be directly applied to developing economies like Ethiopia due to differences in regulations, culture environment and nature of investors. To the best of the researcher's access and knowledge regarding the dividend payout in Ethiopia, there are only few studies. Nuredin (2012), Assefa (2017), Demilie (2016),Yohannes and Venkati (2016). Although the contribution of these studies are important and worth mentioning most of these studies focused on firm specific factors. The impact of

macroeconomic factors and other external factors such as GDP growth rate and inflation were not considered. Therefore, this study empirically examined the influence of firm specific factors and macro economic variables on the dividend payout of private insurance companies in Ethiopia.

### 3. RESEARCH OBJECTIVES

#### 3.1. General Objective

The general objective of this study was to investigate the internal and external factors affecting the dividend payout of private insurance companies in Ethiopia.

##### 1.1.1 Specific Objectives

- 1) To examine firm specific factors that affects the dividend payout of private insurance companies in Ethiopia.
- 2) To investigate macroeconomic factor/s that affects the dividend payout of private insurance companies in Ethiopia.

### 4. EMPIRICAL REVIEW ON DETERMINANTS OF DIVIDEND PAYOUT AND RESEARCH HYPOTHESES

This section reviews the internal and external factors that determine corporate dividend payout. In addition, this section further demonstrates the corresponding research hypotheses that are developed, based on the reviewed internal and external determinants of dividend payout.

Profitability is one of the most important determinant factor affecting firm`s dividend payout. Since dividends are usually distributed from annual profits, it is argued that profitable firms tend to pay higher amounts of dividends. According to the signaling theory of dividend policy, profitable firms are willing to pay higher amounts of dividends to convey their good financial performance (Ho, 2003; Aivazian *et al.*, 2003). Benartzi *et al.* (1997) stated that dividend payments are used to signal current profitability, rather than future profitability, they reported a positive correlation between profitability and dividends. Consequently, the signaling theory of dividend policy supports the argument that profitable firms pay larger dividends to signal their good financial performance. Therefore, the hypothesis regarding profitability is as follows:

***Hypothesis 1: There is a significant positive relationship between profitability and dividend payout of private insurance companies in Ethiopia.***

Liquidity is highly useful to creditors and commercial banks that provide short-term credit. Darling (1957) suggested that a firm`s liquidity is crucial in determining its dividend policy within the capital budgeting process. Ho (2003) found that firms with higher cash availability pay higher dividends than others with insufficient cash availability. Amidu and Abor (2006) find a positive relationship between cash flow and dividend payout ratios. (Anil and Kapoor 2008) also indicate that cash flow is an important determinant of dividend payout ratio. This suggests that liquidity has a positive effect dividend payout. Thus the hypothesis is:

***Hypothesis 2: There is a significant positive relationship between liquidity and dividend payout of private insurance companies in Ethiopian.***

Leverage is considered to be an important factor for the dividend policy decisions. Crutchley and Hansen (1989), argued that leverage and dividends are alternative ways to control agency costs associated with free cash flow problems, which can be controlled by either issuing debt or distributing large dividends. Furthermore, empirical studies found that firms with high debt ratios are willing to pay fewer dividends (Al-Malkawi, 2005 ; Faccio *et al.*, 2001; Gugler & Yurtoglu, 2003) since they are committed to fixed payments to service their debt, which restrict the distribution of dividends. This suggests that leverage has a negative effect dividend payout. Thus hypothesis 3 is:

***Hypothesis 3: There is a significant negative relationship between Leverage and dividend Payout of private insurance companies in Ethiopia.***

Large size firms can obtain external finances because of their high asset value and better growth perspectives, therefore dividend payments are not reduced with high investment opportunities (Afza & Mirzan 2010). Redding (1997), Holder *et al.* (1998), Fama & French (2001), Aivazian *et al.* (2003), Mehta (2012), Al-Malkawi (2007), Mahdzan, *et al.* (2016), Jumah *et al.* (2008), and Sawicki (2005) found a positive relationship between dividend payout. Based on this discussion, hypothesis 4 is:

***Hypothesis 4: There is a significant positive relationship between firm size and dividend Payout of private insurance companies in Ethiopia.***

Grullon *et al.* (2002) proposed an alternative explanation to Jensen`s (1986) free cash flow hypothesis, known as the maturity hypothesis, which suggests that higher dividend increases are a sign of change in a firm`s life cycle, particularly in a firm`s transition from growth phase to a more mature phase. Since a firm

gets older in terms of age, its investment opportunities decline. This leads to slower growth rates, and therefore, reduces the fund's requirements of capital expenditure. However, mature firms tend to have steady earnings with high excess to external capital markets and they are able to preserve a good level of funds, which allows them to pay higher dividends. Moreover, a study conducted by Asefa (2018) on determinants of dividend policy of insurance companies in Ethiopia found that firm age has positive and significant relation with dividend payout. Based on this discussion, hypothesis 5 is:

***Hypothesis 5: There is a significant positive relationship between firm age and the dividend Payout of private insurance companies in Ethiopia.***

Growth opportunity is one determinant factor which influences the corporate dividend payout. La Porta et al. (2000) stated that the relationship between dividend policy and investment opportunities may significantly differ in countries. According to Myres and Majluf (2013), companies having high growth opportunities require more money to finance their future investment; as a result they pay fewer dividends and make more investments. Accordingly, Rozeff (1982) hypothesised that the relationship between anticipated investment opportunities and dividend payout ratio is negative since firms prefer to avoid transaction costs related to external financing. Moreover, Milgrom and Roberts (1992) argued that dividend payments were higher in slow growth industries. However, firms with profitable growth opportunities have limited free cash flows and distribute lower dividends when they are experiencing higher growth opportunities. This suggests that growth opportunity has a negative effect on dividend payout. Thus hypothesis 6 is:

***Hypothesis 6: There is a significant negative relationship between growth opportunity and dividend payout of private insurance companies in Ethiopia.***

Premium is a part of insurance companies earning collected from the insured persons and companies during a given financial year. An insurance company which generates high amount of gross premium pays high amount of dividend to its share holders. Mashiur, Dipak and Naznin (2013) found that gross premium has significant positive relation with dividend payout. This suggests that Premium has a positive effect on dividend payout. Thus hypothesis 7 is:

***Hypothesis 7: There is a significant positive relationship between premium and dividend payout of private insurance companies in Ethiopia.***

The higher the risk is, the more likely the firm will be bankrupt and hence the less the chance for firms to pay dividends (Al-Najjar, 2009). According to Holder et al. (1998), transaction costs of new issues in the form of under-writing fees are typically much larger for riskier firms. Further, Farinha (2003), Al-Najjar (2009) and Mehta (2012) reported a negative relation between business risk and dividend policy, which supports the notion that firms that have higher uncertainty about their earnings tend to distribute none or lower dividends. In this study underwriting risk is considered. Underwriting risk a risk that the premiums collected will not be sufficient to cover the cost of coverage. Organizations that engage in risky activities are likely to have more volatile cash flows than entities whose management is more averse to risk-taking (Fama and Jensen, 1983). This suggests that risk has a negative effect on dividend payout. Thus hypothesis 8 is:

***Hypothesis 8: There is a significant negative relationship between risk and dividend payout of private insurance companies in Ethiopia.***

Tangibility of assets is considered as collateral and guarantee for creditors when the company needs external financing. Al Yahyaee (2006) carried out a study entitled as capital structure and dividend policy in a personal tax free environment in the case of Oman indicated that dividend policy can be affected by tangibility. Besides a study conducted by Asefa (2018) on determinants of dividend of private insurance companies in Ethiopia found that tangibility has positive and statistically positive relationship with dividend payout. Based on this discussion, hypothesis 9 is:

***Hypothesis 9: There is a significant positive relationship between tangibility and dividend payout of private insurance companies in Ethiopia.***

A study by Asefa (2018) on determinants of dividend policy of insurance companies in Ethiopia found that lagged dividend and current period dividend payout has no relation. Besides, Hosain (2016), Rehman and Takumi (2012) on their study entitled as Determinants of dividend payout ratio: Evidence from Karachi Stock Exchange (KSE) found that lagged dividend payout and current year dividend payout has positive relationship. This suggests that lagged dividend has a positive effect on dividend payout. Thus hypothesis 10 is:

***Hypothesis 10: There is a significant positive relationship between Lagged Dividend payout and current year dividend payout of private insurance companies in Ethiopia.***

GDP is a macroeconomic indicator to measure total economic activity within an economy Lui and Wilson (2007). GDP growth rate is measured by the real annual GDP growth rate, is expected to affect insurance dividend payout positively. Economic growth can enhance the insurance companies' profitability and increase in profitability increases the dividend payout of insurance companies. Thus hypothesis 11 is:

**Hypothesis 11: There is a significant positive relationship between GDP and dividend payout of private insurance companies in Ethiopia.**

According to Ghafoor (2014), when inflation of one country becomes high, most firms usually retain a large portion of their earnings to avoid a drop in their balance of operation and to compensate for the reduction in purchasing power of money. Hence, firms would not be interested to pay much dividend for their shareholders. Furthermore, a study carried out by Duncan and Wairimu (2013) revealed a positive relationship between inflation and dividend payout. Nsikan et al. (2014) found a negative relation between inflation and dividend payout. Thus hypothesis 12 is:

**Hypothesis 12: There is a significant negative relationship between inflation and dividend payout of private insurance companies in Ethiopia.**

## 5. MATERIALS AND METHODS

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

**Table 1: Definition, Measurement and Notation of Variables**

Type of variable	Variable	Measurement	Notation
<b>Dependent Variable</b>	Dividend payout	Annual dividend / Net income after tax	DPO
Independent variables	Profitability	Net income / Total Assets	PRO
	Firm age	Year of Financial Report – establishment Year of a company	FA
	Firm size	Natural logarithm of Total Assets	FS
	Growth opportunity	$\frac{\text{Current year revenue} - \text{previous year revenue}}{\text{Previous year revenue}}$	GO
	Gross Premium	income from underwriting to total assets	GP
	Leverage	Total debt to total assets	LEV
	Liquidity	Current assets to current liabilities	LIQ
	Tangibility	Total fixed assets to total assets	TANG
	Risk	Claim incurred / premium earned	R
	Lagged Dividend	First lag of dividend payout	LAGDPO
	GDP	GDP growth rate	GDP
Inflation	Annual inflation rate	INF	

Random effect panel regression model is used to estimate the coefficients of variables based on the result of Hausman test employed to test whether the random effect or fixed effect model is appropriate. As revealed in the following table, p-value of this test is 0.3514 which is insignificant at 5%.Hence the appropriate model is random effect panel regression model than fixed effect panel model.

**Table 2: Correlated Random Effects - Hausman Test result**

Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	13.246418	12	0.3514

Source: Own computation using Eviews 9 software package

The Random effect regression model used in this study is;

$$DPO_{it} = \beta_0 + \beta_1(FA)_{it} + \beta_2(FS)_{it} + \beta_3(GO)_{it} + \beta_4(GP)_{it} + \beta_5(LEV)_{it} + \beta_6(LIQ)_{it} + \beta_7(TANG)_{it} + \beta_8(R)_{it} + \beta_9(PRO) + \beta_{10}(LAGDPO)_{it} + \beta_{11}(INF) + \beta_{12}(GDP) + \epsilon_{it}$$

Where  $\epsilon_{it}$  indicates the error term for insurance  $i$  at time  $t$ ,  $\beta_1, \beta_2, \dots, \beta_{10}$  are the coefficients of explanatory variables and  $\beta_0$  is the constant. Regression models may encounter problem/s, e.g. wrong coefficient estimates and wrong standard errors etc. so as to achieve more reliable and consistent estimates, regression model demands to possess the classical regression model assumptions, which should be in line with OLS assumptions. Therefore, various regression diagnostic tests were made. Based the diagnosis tests result all the assumption of the classical linear regression model are satisfied with the exception of auto correlation. To remove the auto correlation problem, the first lag is taken. Correlation coefficient above 0.7 could cause a serious multicollinearity problem leading to inefficient estimation and less reliable results Kennedy (2008).

**Table 3: Multicollinearity Test result**

	PRO	FA	FS	GDP	GO	GP	INF	LEV	LIQ	TANG	R	LAGDPO
PRO	1.0000											
FA	0.1752	1.0000										
FS	0.0167	-0.0496	1.0000									
GDP	0.0594	-0.0623	-0.0420	1.0000								
GO	0.2534	-0.0247	-0.1750	0.0003	1.0000							
GP	0.1485	-0.0001	0.0245	0.3321	0.0421	1.0000						
INF	-0.2264	-0.2980	-0.3050	-0.2512	0.0923	-0.1139	1.0000					
LEV	-0.2978	0.1645	-0.1294	-0.0688	0.0767	0.0972	0.2028	1.0000				
LIQ	-0.0513	-0.1965	-0.0710	0.0092	-0.0157	0.0159	-0.0388	-0.3066	1.0000			
TANG	0.1007	-0.1677	0.2452	0.1913	0.0951	0.6730	-0.0750	0.1384	-0.0525	1.0000		
R	-0.0707	0.1739	0.0494	0.0590	0.0748	-0.1008	-0.0272	0.1897	-0.36607	-0.1042	1.0000	
LAGDPO	0.1123	-0.2044	0.1810	0.1709	-0.0615	-0.2116	-0.1551	-0.2541	0.1568	-0.0520	-0.1137	1.0000

Source: Own computation using Eviews 9 software package

As indicated in the above table, the results of the correlation matrix indicated that the highest correlation was 0.6730 (67.30%) which is between tangibility and gross premium.

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

**6. RESULTS AND DISCUSSION**

As indicated in Table 4 below, the reliability and validity of the model was further enhanced by the probability of (F statistic) value 0.000000 which indicated a strong statistical significance 1% level. According to (Brooks, 2014), R2 value measures the magnitude of the influence or ability of predictor variables simultaneously in describing the response variable. Therefore, the goodness of fit R2 is 0.5932 which indicates 59.32% of changes in dividend payout is explained by the variables included in the model

while the remaining change was explained by other factors which are not included in the model. The adjusted R<sup>2</sup> of 0.585 indicated that 58.5% changes in the dividend payout is explained by the independent variables considered in the model. The advantage of using adjusted R<sup>2</sup> over the R<sup>2</sup> is that Adjusted R<sup>2</sup> value measures the magnitude of the influence or ability of predictor variables simultaneously in explaining the response variable by observing the standard error.

**Table 4: Random effect panel regression model result**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.171383	0.025397	-6.748131	0.0000
PRO	0.063451	0.024834	2.554967	0.0107
FA	0.002064	0.000215	9.612846	0.0000
FS	0.017327	0.001132	15.31173	0.0000
GO	-0.001147	0.009128	-0.125687	0.9000
GDP	0.283298	0.038629	7.333732	0.0000
GP	0.003424	0.006057	0.565273	0.5720
INF	-0.030702	0.009473	-3.241164	0.0012
LADDPO	0.158528	0.026273	6.033896	0.0000
LEV	-0.094705	0.014599	-6.486904	0.0000
LIQ	0.015627	0.005025	3.109630	0.0019
TANG	0.054308	0.008958	6.062253	0.0000
R	-0.105155	0.006551	-16.05080	0.0000

  

Effects Specification			
Cross-section fixed (dummy variables)			
R-squared	0.593196	Mean dependent var	0.079840
Adjusted R-squared	0.584669	S.D. dependent var	0.045809
S.E. of regression	0.029522	Akaike info criterion	-4.186233
Sum squared resid	0.997916	Schwarz criterion	-4.078011
Log likelihood	2473.946	Hannan-Quinn criter.	-4.145416
F-statistic	69.56775	Durbin-Watson stat	1.904780
Prob(F-statistic)	0.000000		

Source: Own computation using Eviews 9 software package

As indicated in the above table (table 4) the coefficient estimate of the constant term of the regression ( $\beta_0$ ) is -0.171383 shows that all other value of explanatory variables becomes zero; the value of the explained variable is decreased by -0.171383.

Besides, the above all variables are significant except GO and GP. Inflation, Risk and leverage are negatively and significantly related with dividend payout with the coefficient of -0.030702, -0.105155 and -0.094705 respectively. This indicates that 1 Ethiopian Birr (ETB) increase in inflation, risk and leverage decreases 3.07, 10.51 and 9.4705 cents in dividend payout respectively and p value of 0.0012, 0.0000 and 0.0000 represents its significant at 1% level.

Return on asset as a measure of profitability has positive and significant effect on dividend payout at 1% significance level, with a coefficient and p value of 0.063451 and 0.0107 respectively. This indicates that 1 ETB increase in the profitability of private insurance companies will increase dividend payout by 6.345 cents and vice versa. P value of 0.0107 indicates that the null hypothesis (Hypothesis1) is failed to reject which was stated as profitability has positive significant impact on dividend payout of private insurance companies in Ethiopia. The same result is found by Amidu and Abor (2006), Mohamed, et al. (2008), Al-Malkawi (2007), Mahdzan, et al. (2016), Jumah et al. (2008), Marfo-Yiadom and Agyei (2011).

The above panel random effect estimation regression result also revealed the effect of age of the firm on dividend payout with a coefficient of 0.002064 and p value of 0.0000 which is significant at 1% level of significance. The positive coefficient of firm age indicates that there is a direct association between firm age and dividend payout. Other thing remains constant as firms' age increased by one year the dividend payout of private insurance companies also increased by 0.2064 cents. The p value of 0.0000 supports (Hypothesis

5) that predicts firm age and dividend payout have a positive significant association. This result is also consistent with the findings of Al-Malkawi (2007), Asefa (2018).

Log of total asset as a measure of firm size has positive and significant effect on dividend payout at 1% with a coefficient and p value of 0.017327 and 0.0000 respectively. This indicates that a 1% increase in insurance company's size will increase dividend payout by 1.7327 cents and vice versa. Firm size has standard error of 0.001368 which indicates that the errors of coefficient estimates. The p value of 0.0000 supports (Hypothesis 4) that predicts firm size and dividend payout have a positive significant association. The same result is found by Mehta (2012), Al-Malkawi (2007), Mahdzan, et al (2016), Jumah et al. (2008), Redding (1997), Holder et al. (1998), Fama & French (2001), Aivazian et al. (2003) and Sawicki (2005).

The macroeconomic variable which is the real GDP growth rate was expected to have significant and positive relationship with the dividend payout of private insurance companies in Ethiopia. As expected (Hypothesis 11) the regression result in table 4 above shows that GDP growth has a direct significant and positive relation to the dividend payout of insurance companies. The coefficient and p value GDP was 0.283298 and 0.0000 respectively. This indicates that a 1% increase in GDP will increase dividend payout by 28.3298 cents and vice versa.

Moreover, the above panel random effect estimation regression result table (table 4) revealed that LAGDPO has positive and significant effect on dividend payout with a coefficient and p value of 0.158528 and 0.0000 respectively. This indicates that the first lag of dividend payout (preceding year dividend payout) has positive and significant effect on the current year dividend payout (DPO). P value of 0.0000 indicates that the null hypothesis (Hypothesis 10) is failed to reject which was stated as lagged dividend payout has positive significant impact on current year dividend payout of private insurance companies in Ethiopia. The same result is found by Hosain (2016), Rehman and Takumi (2012).

Liquidity position of private insurance companies has positive and significant effect (at 1%) on dividend payout with a coefficient and p value of 0.015627 and 0.0019. As a result, an increase in 1 ETB in the liquidity position of private insurance companies increases dividend payout by 1.5627 cent. The p value of 0.0019 supports (Hypothesis 2) that predicts liquidity and dividend payout have a positive significant association. The same result is found by Mohamed, et al. (2008), Jumah et al. (2008), Asefa (2018), Amidu and Abor (2006) and Nuredin (2013).

As shown in table 4 above, panel random effect regression estimation result of asset tangibility revealed the effect of tangibility was positive and significant at 1% which is in line with the expected relationship (Hypothesis 9). This means that tangibility is one of the determinant factor for the dividend payout of private insurance companies in Ethiopia such that as the proportion of fixed assets increases the dividend payout of insurance companies also increase. The finding is consistent with Marfo-Yiadom and Agyei (2011), Asefa (2018).

## 7. CONCLUSIONS

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

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