

The Interdependence among Dividend Policy, Investment Decision, Financial Performance and Survival of the Firms in Kenya

Edmond Mukhongo Mubanani*

Technical University of Mombasa

<https://orcid.org/0009-0009-1579-4927>

*Corresponding Author

Purity Njeri Fadhil

<https://orcid.org/0009-0007-1821-0750>

Technical University of Mombasa

Charles Guandaru Kamau

<https://orcid.org/0000-0002-8085-0421>

Technical University of Mombasa

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Abstract:

The main objective of this study was to analyze patterns and tendencies in dividend policy. By extensively reviewing existing literature, the research aimed to establish the connections between dividend policy and other important financial aspects. The study's findings clearly indicate that investors who are astute prefer companies that provide higher dividends rather than keeping their earnings. This preference is due to the liquidity benefits that such firms typically provide, which align with the liquidity requirements of investors in various financial markets worldwide. It is important to note that the distribution of dividends significantly affects the speed of adjusting the capital structure. The conflict between the distribution of dividends and strategic financing initiatives impedes the progress of these adjustments. A majority of institutional entities allocate dividends strategically to increase their financial resources by investing in high-yielding ventures identified by corporate management. However, in emerging economies, the utility and effectiveness of dividends as a signaling mechanism and cost-minimizing tool are relatively reduced compared to more mature and well-established capital markets. Additionally, it is worth highlighting that dividend policy has a statistically significant and positive correlation with variables such as firm size, profitability levels, and interest coverage ratios. This emphasizes the complex relationships that exist between dividend policy and these key financial metrics.

Keywords: Dividend Policy, Investment Decision, Financial performance, Dividend pay out

1. Introduction

The relationship between corporate governance and firm performance has been a topic of considerable interest in the finance literature. Researchers have explored the impact of various corporate governance mechanisms, such as board size, board independence, and ownership structure, on the financial and non-financial performance of firms (Gúney et al., 2020). However, the effectiveness of these governance practices may vary across different institutional contexts, particularly in emerging markets like Kenya. This paper aims to investigate the interdependence among dividend policy, investment decisions, financial performance, and the survival of firms in the Kenyan market.

The percentage of profits that are paid out as dividends to the company's shareholders is known as the dividend payout ratio. The payout policy, sometimes referred to as the dividend policy, is the process of selecting the percentage of profits to be disbursed among the shareholders. Consequently, the terms "dividend policy" and "payout policy" are also sometimes used synonymously.

The company's dividend policy is the plan of action followed to determine the dividend amount and distribution date (Trinha, Karab, & Elnahass, 2022). Dividends serve as a lucrative source of income for investors. A dividend payout is a percentage of a company's earnings that is distributed to a class of shareholders in accordance with the board of directors' decision and is referred to as a dividend. One of the four main functions of financial management is the determination of how much of the company's net profits should be paid out as dividends and how much should be kept in reserve (Trinha, Karab, & Elnahass, 2022). The dividend payment may be made in the form of cash dividends, bonus shares, or share repurchases, among others. The choice of dividend policy is crucial for businesses since it directly affects both their investment and financing choices. For both present and potential investors, the payout ratio is crucial for helping them make the best investment choice (Pinto, Rastogi, Kadam, & Sharma, 2019). Ndlovu and Haabazoka (2024) posit that Foreign Direct Investment (FDI) is viewed as advantageous not solely due to its infusion of essential capital, but also for its role in facilitating job creation, granting entry to cutting-edge technologies, and fostering additional positive effects that enhance organizational efficacy.

Companies raise their reputation through dividend decisions, which affect the share price. Both businesses and investors benefit from the cyclical link between company

profitability, dividend payments, and share prices. A corporation can occasionally be the face of the business with the help of a sound dividend policy. One of an organization's key policies is its dividend policy.

2. Methodology

This study utilizes a literature review methodology, which involves thoroughly examining and analyzing past studies conducted by numerous researchers in the field. These studies explore complex concepts such as dividend theory, investment decision-making processes, and the influence of these factors on organizational financial performance. The results of these studies are carefully scrutinized and interpreted to arrive at an informed and well-supported conclusion. The reviewed literature is organized and presented meticulously under specific headings to effectively categorize and organize the information.

3. Literature Review

3.1 Dividend Policy and Investment Decision

The relationship between dividend policy and investment decisions is a complex and widely debated topic in the field of corporate finance. Dividend policy refers to the guidelines set by a company's board of directors for distributing profits to shareholders, while investment decisions involve the allocation of a firm's resources towards new projects or assets. Profitability is a key factor that influences a company's dividend policy (Azhariyah et al., 2021). Firms with higher profitability, as measured by return on assets, tend to distribute a larger portion of their earnings as dividends to investors (Azhariyah et al., 2021). Free cash flow (FCF) influences dividends and investment. Firms raise investment and cut payouts when their FCF is higher. Overinvestment is curbed by the use of debt. This finding is in line with agency theory's ability to account for managers' actions in relation to their investment plan (Poretti & Blal, 2020).

Dividend payouts negatively affect investment decisions, whereas debt financing positively impacts them. The financing and investing of debt have a detrimental impact on a company's profitability, whereas choosing to pay dividends has a beneficial effect. The corporate decision-making procedures of enterprises are better understood (Bhatt & Jain, 2022). The path-analytic approach was employed in this work to successfully evaluate the causal structure of corporate financing, investment, dividend payment decisions, and business performance simultaneously. Dividend policy is negatively, but not significantly, impacted by collateralizable assets. This demonstrates that the high levels of

collateralizable assets have little bearing on the dividend policy of manufacturing corporations. Growth in net assets, the second factor, has a negative and considerable impact on dividend policy. This demonstrates that manufacturing businesses' dividend policies will be reduced if net asset growth accelerates (Wahjudi, 2020). The dividend policy does have an impact on the performance of industrial and service companies through the impact of dividend yield and dividend pay-out ratio (independent variables) on performance (a dependent variable); however, the dividend policy has a significant impact on the PE ratio. Shares of the business are in line with Kanakriyah (2020). One explanation for this is that investors favor companies with higher dividends than retained earnings because they tend to have greater liquidity, which is what investors in many financial markets require.

The corporate value of companies that adopt a greater dividend distribution policy is significantly impacted by dividend policy. The ratio of cash dividends, which has a positive impact on the value of businesses and statistical significance at 1%, is used to measure dividend policy (Dang, Vu, Ngo, & Hoang, 2021).

3.2 Dividend policy and Firm's Financial performance and survival

Higher levels of cash dividend payouts increase a firm's likelihood of surviving because paying dividends lowers agency issues, lowers the cost of debt, and allows for greater public monitoring. Large payouts and the likelihood of survival have an inverted U-shaped relationship. At higher payment levels, firms are in a less risky position with regard to default, but at very high dividend levels, when the levels of payouts surpass a threshold, such payouts diminish the probability of survival (Nguyen, To, Nguyen, & Do, 2021). While carrying out daily activities, it is essential for an organization to maintain a balance between liquidity and profitability. Insolvency is a possibility if such a balance is not maintained (Sogomi et al, 2024). There must be a balance between dividend payout and profit retention rate so as to maintain optimum liquidity.

Where firms hold more cash and pay fewer dividends, there is a stronger positive impact on firm survival than for firms that decide otherwise (Kamaruddin, Subramaniam, Ghani, & Rahim, 2022). This kind of decision is also dependent on industry insights and policy implications.

If a company pays fewer cash dividends, its capital structure will change more quickly, and its dividend distribution policy will be at odds with its financing requirements. If a company pays more cash dividends, the capital structure adjusts more slowly, and market timing financing tactics are incompatible with the high dividend policy (Islam, Asghar, & Bilal, 2019). In other words, the behavior of dividend distribution has a big

impact on how quickly capital structure adjustment happens, and the tension between dividend distribution and financing strategy slows it down. The dividend distribution policy is concerned with evaluating performance through return on assets and return on equity, and it states that the majority of institutions pay dividends in order to gain more money by investing in corporate management's search for high-yielding investments. Additionally, external financing is advantageous because it provides the necessary funds so that the company can maintain a rate of growth that is characterized by stability (Kanakriyah, 2020).

3.3 Dividend policy and pay out time

In the traditional dividend problem, dividend decisions can be made at any time. The best dividend techniques within such a framework frequently fall into the barrier or threshold categories, which over time may result in very erratic dividend payments. In reality, however, businesses regularly distribute dividends (Hoang, Dang, & Tran, 2020).

The optimal dividend problem in a discrete-time risk model with interest is covered in this article. Assume that, because of the impacts of the environment, the premium received per unit of time is a positive real-valued random variable, and the sequence of premiums is a Markov chain. Whether a claim occurs or not in an arbitrary unit of time depends on the premium that was paid at that time (Nurwulandari, 2020).

The periodic dividend problem can be analyzed in the dual risk model with a non-exponential discount function, leading to a time-inconsistent control problem. We generalize the theory of the classical optimal periodic dividend by extending the Hamilton system of equations from the fixed terminal to the time of ruin and proving the verification theorem. We obtain the closed-form equations of the equilibrium strategy and the accompanying equilibrium value function in a compound Poisson dual model under two particular non-exponential discount functions. The impact of specific parameters is finally demonstrated through some numerical examples (Reppen, Rochet, & Soner, 2019). Most businesses now have systems in place to help them keep accurate records, enabling timely information to be gathered and evaluated for decision-making (Kamau & Ilamoya, 2023). Dividend decisions can be made with the aid of computer systems programmed for that purpose. Companies in emerging markets have more erratic dividend payouts. Dividends are substantially less sensitive to prior dividends. These findings corroborate the alternative view of dividend policy, which holds that dividends in these developing nations are less viable as a signaling and cost-reduction tool than for their US counterparts operating in more developed arms-length capital markets (Aivazian, Booth, & Cleary,

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3.4 Determinants of Dividend Policy

Liquidity has a negative and significant impact on dividend policy. This suggests that industrial companies' dividend policies will be reduced as liquidity increases. Furthermore, it has been discovered that leverage has a negative and significant impact on dividend policy. This implies that the manufacturing company's dividend policy will be reduced as a result of the increased leverage (Wahjudi, 2020). Dividend policy is significantly positively correlated with size, profitability, and interest coverage ratios. Additionally, debt and business risk show a markedly negative relationship with dividends. The free cash flow hypothesis is supported by the profitability data. Businesses favor a consistent dividend strategy. Because of this, businesses with greater potential for growth but lower cash flows nonetheless pay dividends. Additionally, we discover proof that dividend policies in India's various industrial sectors differ considerably. Financial managers and policymakers can utilize the study's findings to inform their judgments on dividends. They can also help investors select portfolios based on sectoral dividend payment patterns (Pinto, Rastogi, Kadam, & Sharma, 2019). While there were much more dividend cutbacks and omissions during the epidemic, most companies were nevertheless able to either retain or raise dividends. As suggested by dividend signaling theory, corporations might use this to pursue more stable payout policies and communicate their financial prospects throughout the crisis (Ali, 2022). It is clear that business profitability, earnings expectations, size, and leverage seem to be significant predictors of dividend policy decisions during the pandemic.

In the context of emerging markets, bank size, profitability, capital sufficiency, credit risk, and bank age are the primary bank-specific determinants influencing dividend payment decisions (Subramaniam & Wasiuzzaman, 2019).

3.4 Discussion of the linkages

After conducting a comprehensive analysis of the literature presented in the preceding sections, a relationship chart was formulated and is visually represented in

Figure 1. This chart has been carefully designed to illustrate the connections and interdependencies between dividend policy, investment decision-making processes, and the resulting financial performance outcomes.

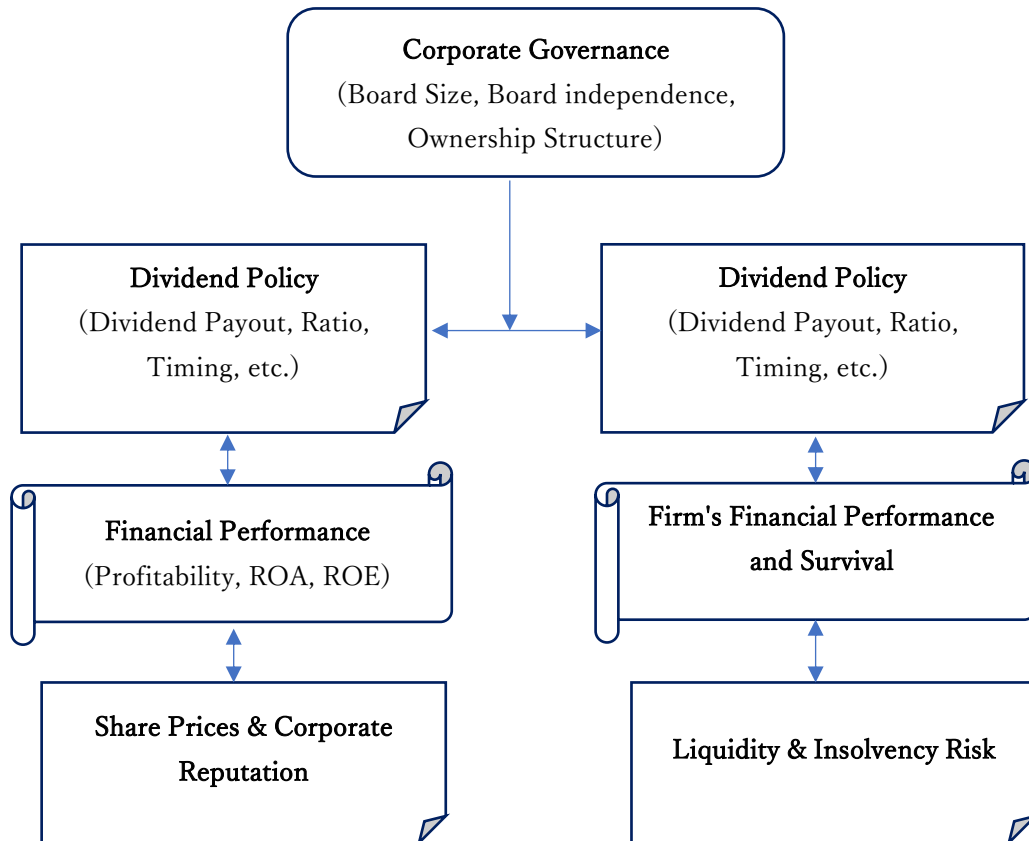


Figure 1: Interaction between dividend policy, investment and financial performance

Figure 1 illustrates the significant role of corporate governance in influencing both dividend policy and investment choices within a firm. Governance mechanisms such as board size, board independence, and ownership structure play a crucial role in guiding these decisions. Effective corporate governance ensures that the strategies of the firm are in line with shareholder interests, thus improving overall financial performance. Through the establishment of clear guidelines and accountability, corporate governance helps maintain a balance between distributing profits to shareholders and retaining earnings for reinvestment, which is vital for sustainable growth and profitability.

Dividend policy pertains to the division of profits that a company opts to distribute to its shareholders, directly impacting the level of retained earnings available for reinvestment. A higher dividend payout reduces funds for investment in new projects or assets, while a lower payout increases free cash flow for allocation towards growth opportunities. Investment decisions, which involve the strategic allocation of resources to new ventures or assets, are significantly influenced by the dividend policy. The

management of the interplay between dividend payouts and retained earnings is crucial for optimizing the financial performance and growth potential of the firm.

Both dividend policy and investment decisions play a critical role in determining the financial performance of a firm. Key financial metrics such as profitability, return on assets (ROA), and return on equity (ROE) are directly impacted by how profits are distributed between dividends and reinvestment. A well-structured dividend policy can boost investor confidence, leading to higher share prices and an enhanced corporate image. Conversely, strategic investment decisions that enhance profitability and asset returns contribute to improved financial performance, creating a positive cycle that benefits both the firm and its shareholders.

The long-term viability and financial well-being of a firm depend on achieving a balance between dividend payouts and profit retention. High dividend payouts can mitigate agency problems and reduce debt costs by indicating financial strength and stability to the market. Nonetheless, excessive payouts can deplete retained earnings, jeopardizing the firm's liquidity and its ability to finance future growth. On the contrary, judicious investment decisions that boost profitability and support sustainable growth enhance the financial stability and longevity of the firm. Thus, maintaining an optimal equilibrium between profit distribution and reinvestment in the business is imperative for the firm's survival and prosperity.

Maintaining an equilibrium between liquidity and profitability is crucial for the operational efficiency and financial stability of a firm. A sound dividend policy guarantees that sufficient funds are retained within the company to meet short-term obligations and operational requirements, thus averting insolvency. Inadequate liquidity can lead to financial distress, while excessive liquidity may signal underutilized resources. By effectively managing the trade-off between immediate shareholder returns and the need for ample working capital, firms can sustain their operations smoothly and mitigate the risk of insolvency.

4. Conclusion

The dividend policy of a company can have significant implications for its investment decisions. Profitability, leverage, liquidity, size, and company growth are all factors that can influence a firm's dividend payout ratio and, in turn, the availability of funds for investment (Azhariyah et al., 2021). It has been demonstrated by the findings that dividend policy is in line with agency theory's ability to account for managers' actions in relation to their investment plan. Dividend payouts are more unpredictable for businesses

in emerging markets. The sensitivity of dividends to previous dividends is significantly reduced. This result supports the alternative dividend policy theory, according to which payouts in these developing countries are less useful as a cost-reduction and signaling tool than for their counterparts operating in more developed arms-length capital markets. Despite the fact that there were significantly more dividend reductions and omissions throughout the epidemic, the majority of corporations were nonetheless able to maintain or increase dividends. As proposed by dividend signaling theory, corporations might use this to promote more reliable payout practices and communicate their financial prospects throughout the crisis.

It is evident that judgments about dividend policy during the pandemic appear to be significantly influenced by corporate profitability, earnings projections, size, and leverage. The high levels of collateralizable assets have little bearing on the dividend policy of manufacturing corporations. Growth in net assets, similarly, has a negative and considerable impact on dividend policy. This shows that manufacturing businesses' dividend policies will be reduced if net asset growth accelerates. Furthermore, the findings demonstrate that liquidity has a detrimental and considerable impact on dividend policy. The theoretical implication of this study in Kenya is that it can be regarded as advanced research or research material by investors. It can be extended and expanded upon in a related study or in a different study that still has relevance, especially on other factors such as internal or external ones that affect dividend policy. However, the above findings should be relied upon to provide guidance on dividend policy in most developing nations.

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