

Implication of Catering Theory of Dividend: Evidence from Financial Firms Listed on the Nigerian Stock Exchange

Rihanat Idowu Abdulkadir^{1,2*} Nur Adiana Hiau Abdullah¹ Woei-Chyuan Wong¹

1 School of Economics, Finance and Banking; College of Business, Universiti Utara Malaysia, 06010 UUM Sintok, Kedah Malaysia.

2. Department of Accounting and Finance, University of Ilorin, P.M.B. 1515, Ilorin, Kwara State, Nigeria.

* E-mail of the corresponding author: riolaq29@yahoo.com

Abstract

The increasing number of non-payers of dividend on the Nigerian Stock Exchange stimulates the interest to re-examine the determinants of payouts decisions in the market. This necessitates seeking alternative explanation for the dividend behavior of firms beyond the traditional determinants that have been established overtime. This paper examines the implication of the catering theory of dividend on the Nigerian Stock Exchange. Based on a sample of 386 firm-year observations drawn from 49 financial firms listed on the exchange, the study investigates the role of dividend premium (proxy for catering theory) and other firm level characteristics on dividend payout of the sampled firms. Panel data analysis was conducted using both fixed effect and random effect estimates. Based on the random effect estimates which is preferred by the Hausman test conducted, findings of the study shows that dividend premium have significant positive effect on dividend payout. Thus, indicating support for the catering theory of dividend. However, result indicates further that the theory is not supported during crisis. Findings also revealed that firm level characteristics which include size, profitability, cash flow, and past dividend are significant in explaining dividend payout of the sampled firms.

Keywords: Dividend, Catering, Dividend premium, Payout

1. Introduction

Different theories have been used over time to explain dividend payout policies of firms. These theories relax the perfect market assumptions of dividend irrelevance theory as propounded by Miller and Modigliani (1961). The catering theory of dividend is a recent explanation for payout behaviour of firms. The theory which was propounded by Baker and Wurgler (2004a) have received some attention in recent times in offering explanation to changes in the dividend behavior of firms in the developed markets. However, empirical evidence in support of this theory is mixed. More so, empirical studies in emerging markets have not paid much attention to the theory in explaining payout policies. The catering theory which offers behavioral explanation for the dividend behavior of firms indicates that dividend supply is the manager's response to investors demand for dividend paying stocks (Baker & Wurgler, 2004a).

This study seeks to examine whether this theory can explain payout policies in the Nigerian market. Unlike in the developed markets where the theory have majorly been tested, dividend legislation on the Nigerian Stock Exchange prohibits borrowing to finance dividend payments. Thus, the regulation on dividends in the market creates an avenue to examine the phenomenon in a unique market setting as firms listed on the Nigerian stock market are prohibited from borrowing to finance dividend payments (Sec 379 (5) & Sec 381 (1) of CAMA, 1990). Therefore when the firm faces cash flow constraints, it may be difficult to respond to investor's demand for dividend paying stocks since they cannot augment cash flow with external funds to finance dividend payments. Neves and Torre (2006) documents that companies with higher levels of cash flow cater more strongly to their investors. More so, the Nigerian stock market is yet to recover from a serious crisis which started in year 2008 and which was aggravated by the global financial meltdown. This crash has put many companies in a difficult financial situation hence making dividend payments difficult. Responding to investor's demand for dividend paying stock in this situation may be difficult as catering incentives have been found to drop along with payout ability during market crashes (He, Li, & Liu, 2012).

The Nigerian market currently hosts 200 companies in 12 diverse sectors. However, studies on dividend policies have paid very little or no attention to the financial sector. Exclusion of the financial sector in most empirical studies on dividend policies due to their unique regulatory system stimulates the interest to study the sector. The financial service sector account for the largest contribution to the total market capitalization on the Nigerian Stock Exchange. The sector accounts for 34% of the total market capitalization as at end of 2012 (NSE Factbook,

2012). More so, the leading financial information provider in the market, Proshare News (2012) stated that the largest portion of the dividend payment on the Nigerian Stock Exchange comes from the financial sector. Based on the foregoing, the objective of this study is to test the implication of the catering theory in Nigeria by examining whether the theory can explain payout policies in the Nigerian financial service sector. The study also investigates the role of catering (if any) on payout policies during the financial crisis. We employ a sample of 49 financial firms listed on the Nigerian Stock Exchange over 10 years (2003-2012).

The paper is structured as follows: section two provides a brief review of previous related literature. Section three presents data and methodology employed. Section four provides results from the regression estimates and discussion in line with prior findings while section five concludes the paper.

2. Literature Review

Different firm level variables have been used to explain payout policies in the dividend literature. Lintner (1956) indicates that earnings and past dividend are the most important determinants of dividend changes. Other firm characteristics which include size, profitability, investment opportunities, leverage and cash flow have also been reported in the dividend literature as explanatory factors for payout policies. However, mixed evidence have been reported overtime with respect to these traditional determinants of dividend. More recently, Baker and Wurgler (2004a) propounded the catering theory of dividends and they argued that investors have time varying demand for dividend paying stocks. The authors contend further that this demand is what drives dividend payment by firms. The theory explains that managers cater for the investor's demand by paying dividends when investors desire such payment and not paying when investors do not desire dividend payment. As a result of this demand, investors may have preferences for dividend or capital gains depending on the value they place on dividend payers. Baker and Wurgler (2004a) referred to the value placed on dividend payers as dividend premium" and contends that managers are more likely to pay when the dividend premium is high and less likely to pay when the dividend premium is low. In another empirical study, Baker and Wurgler (2004b) noted that catering theory is the major explanation for decline in dividend payment in the US market.

More empirical explanations have been offered on the catering theory. However, there is mixed evidence in this regard. In a multi-country study, Denis and Osobov (2008) reported little evidence in support of the catering theory outside the US market. Their findings indicates that the years with the most positive dividend premium recorded more dividend omissions for the other markets studies. Some other studies (Hoberg & Prabhala, 2009; Kuo Phillip, & Zhang, 2013) also conducted in the US and UK markets respectively have shown that catering cannot explain dividend policies of firms when the risk factor is taken into account. Other studies (Baker, Saadi, Dutta, & Gandhi, 2007; Tsuji, 2010) have shown in survey research that managers do not take into account investor's demand when making decisions on dividend initiations, thus the studies argue that catering cannot explain a firm's payout behavior. Other empirical studies (Eije & Megginsson, 2007, Turner, Ye, & Zhan, 2011) reported that the dividend premium can only explain little of the variation in the dividend initiation rate overtime. The authors also contend that the impact of dividend premium on dividend maintenance is insignificant.

Contrarily, other studies provide support for the catering theory. A survey report by Haleem, Rehman and Javid (2011) in Karachi stock market shows that 65% of respondents are of the opinion that the preferences of investors are taken into account when companies formulate payout policies. In another study conducted in the US market, Li and Lie (2006) extended the significance of the theory to changes in dividend levels (dividend increases and dividend decreases). The authors argued that the theory as presented by Baker and Wurgler (2004a) can only offer explanation on dividend initiation and omission. Li and Lie (2006) also reported a link between dividend premium and announcement returns. Their findings revealed that investor's react by placing a higher market valuation on companies that consider dividend premium in their payout decisions.

Certain factors have been attributed to enhancing catering incentives. In support of the theory, Ferris, Jayaraman and Sabherwal (2009) document that firms in common law countries respond to investor's demand for dividends while those in civil law countries do not consider investor's demand in their payout decisions. This was ascribed to more rights and protection enjoyed by investors in common law countries. Thus, legal protection is regarded as a necessary factor for catering to hold. Anour (2012) also reported that profitability and debt level can propel catering incentives. The author found that firms with more profitability and lower debt level have higher tendency to respond to investor's demand for dividend. In the same vein, He et al. (2012) noted that market condition is another factor that can drive catering incentives. The authors argued that managers have more ability to cater for investor's demand for dividend in a booming market but less ability to respond to such demand during market crashes. Similarly, Neves and Torre (2006) found that firms with higher cash flows in the

Eurozone cater more to investor's demand for dividends. Most of the evidence on catering theory have focused on developed markets and the implication of the theory remain uncertain in the emerging market setting.

3. Data and Methodology

The study employs an unbalanced panel data set of 386 firm-year observations. This sample was drawn from a sample of 49 financial firms listed on the Nigerian Stock Exchange between year 2003 to 2012. Relevant firm level data were extracted from the financial statements of the firms.

3.1 Regression Model

In order to achieve the objective of this study, the study models dividend premium (proxy for catering theory) as a function of dividend payout. Other traditional determinants of dividend payout are also included in the model. In addition, the interaction of dividend premium and dummy variable representing the crisis period have been included to ascertain whether or not catering theory can explain dividend payout during the crisis period. Thus, the regression model estimated in the study is as specified below.

$$dps_{it} = \beta_1 + \beta_2 prem_{2it} + \beta_3 size_{3it} + \beta_4 roa_{4it} + \beta_5 inv_{5it} + \beta_6 lev_{6it} + \beta_7 cf_{7it} + \beta_8 pydps_{8it} + \beta_9 prem * crisis_{9it} + \mu_{it}$$

where: *dps* is dividend per share; *prem* is the dividend premium and proxy for catering theory, in line with the approach of Baker and Wurgler (2004a,b), it is defined as the log difference between the average market to book ratio of dividend payers and non payers; *size* is the size of the firm and it is defined as the natural log of total assets; *ROA* is the return on assets and it represents the firm's profitability; *inv* represents the growth opportunities of the firm and it is defined as the market to book ratio; *lev* represents the firm's debt level and it is defined as total debts to total assets; *cf* represents the net operating cash flow of the firm; *pydps* is the previous year dividend per share; and *prem*crisis* is the interaction term of dividend premium and the dummy variable for the crisis period. The dummy variable for crisis period takes the value of 1 for years 2008 and 2009 while it takes the value of 0 for the remaining years.

Panel data analysis was employed by obtaining both random effect estimates and fixed effect estimates. The study then employed the use of Hausman test in determining which of the two estimates is preferred.

4 Empirical Results

4.1 Descriptive statistics of variables

The descriptive statistics of the variables in the regression model is given in table 1 below:

Table 1. Variable definition and descriptive statistics

Variables	Obs	Mean	Std.Dev	Min	Max
Dividend per share (dps)	386	0.601	3.868	0	60
Dividend premium (prem)	386	0.506	0.279	0.18	1.08
Size	386	15.786	2.493	14.794	25.630
Profitability (roa)	386	0.102	0.821	-1.790	4.27
Growth Opportunity (inv)	386	1.920	1.462	-4.379	5.938
Leverage (lev)	386	0.574	0.292	-0.621	1.364
Cashflow (cf)	386	21.099	2.573	14.272	27.018
Previous year dividend (pydps)	386	0.550	3.79	0	14.50
Crisis	386	-	-	0	1

Note: Cash flow figures are rescaled to avoid measurement unit error that may arise from very large values.

4.2 Panel Regression Results

The regression results are given in table 2 below. The table presents the random effect estimates which is preferred based on the Hausman test conducted which tests insignificant at ($p > \chi^2 = 0.3126$).

Table 2: Random effect regression for determinants of dividend payout
 Dependent Variable = Dividend per share

Explanatory Variables	Coefficient	Z-statistic	S.error
Dividend premium (Prem)	0.905*	1.78	0.508
Size	0.281***	3.56	0.079
Profitability (roa)	0.680**	2.19	0.311
Growth opportunities (inv)	-0.053	-0.51	0.105
Leverage (lev)	-0.601	-0.76	0.789
Cashflow (cf)	0.39*	1.88	0.207
Previous year dividend (pydps)	0.497***	9.86	0.050
Interaction of dividend premium and crisis (prem*crisis)	0.098	0.16	0.597
No. of observations	386		
R-squared	56%		

*significant at $p < 0.10$, **significant at $p < 0.05$, ***significant at $p < 0.01$.

The regression results are given in table 2 above. The table presents the random effects estimates which is preferred based on Hausman test conducted which tests insignificant at ($p < \chi^2 = 0.3126$). The estimates show how dividend payout is influenced by the explanatory variables. Results indicates that dividend premium is significant with positive coefficient. This implies that the higher the value placed by investors on dividend paying stocks, the higher the dividend payout. This indicates support for the catering theory of dividend. However, the interaction of dividend premium and crisis tests insignificant. This indicates that the predictive power of dividend premium is altered during crisis. This may be attributed to the need to preserve cash during crisis which is usually characterized by uncertainty and depletion of funds. This may hinder the sampled financial firms from responding to investor's demand for dividends in such period.

Amongst the traditional determinants controlled for, findings indicates support for size, profitability, cash flow, and past dividend. These variables have been found to be significant with positive coefficient. Thus, they exert positive influence on the dividend payout policies of the financial firms. Findings indicates negative coefficients for growth opportunities and leverage. However, these variables cannot explain the payout policies of the sampled firms as they were found to be insignificant.

5. Conclusion

The study examines the implication of catering theory of dividend in the Nigerian market. The study concentrates on financial sector due to its exclusion from most prior studies on dividend payout policies. Besides, the sector account for bulk of the payout recorded in the market as noted earlier. Findings indicate that dividend premium exert positive influence on dividend payout of sampled firms. Thus, the study concludes that financial firms listed on the Nigerian Stock Exchange consider investors demand for dividends and respond to this demand when making dividend payout decisions. However, the study concludes further that catering to investor's demand for dividends by the sampled firms is limited to normal economic conditions and does not extend to crisis period. Based on the findings, the study also concludes that size and past dividend are the most important factors that explain dividend payout of financial firms in the Nigerian market. Comparison of the implication of the theory between the financial sector and the non financial sector will be an interesting area to

explore in future research. In addition, subsequent studies in the market can also investigate whether the market place a premium on companies that cater to their investor's demand for dividends.

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