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The Relationship between Dividends Policy and Firm Value, Profitability, Liquidity and Leverage Evidence from Saudi Stock Exchange

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Abstract

The study sought to discover the effects resulting from the dividend policy on the firm's value, profitability, liquidity and leverage, which were interpreted in the light of the signaling hypothesis. In an emerging market such as the Saudi Stock Exchange, information related to dividends helps current and potential investors to make decisions about investment opportunities available in the market, and dividends are an important tool used by firms to attract investments.

Key words: Dividends Policy, Firm Value, Profitability, Liquidity and Leverage.

1. Introduction

Many financial analysts, investors and other stakeholders are very concerned about the movements of share prices and they attempt to identify the factors behind these movements, due to their implications on the firm's value. Sometimes, the share prices may exceed their minor value. Other times, these prices may reach only a fraction of their nominal value. However, many factors considered as determinant of share prices. These factors include: the financial position of the firm, the monetary situation of the sector in which the firm operates, the expected return on investment, opportunities and the decisions related to the dividend and profit retention policy, the supply and demand forces and other decisions impacting the share prices.

Financial theories focused on the impact of financing and investment decisions on the firm. These theories assumed that mentioned decisions have an important effect on the firm's value. Therefore, studies related to financial theory try to understand the magnitude of this effect on the firm's value. In this context, dividend decision considered one of the most significant financial decision because is created in the light of many other factors, which include the cost of the agency, fees (Jensen, 1986), availability of sufficient fluidity to

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cover the dividends (Bhattacharya, 1979), tax preference (Kalay and Michaely ,2000) and other factors. The multiplicity of considerations affecting the dividend decision led to the emergence of number of assumptions and experimental research projects that try to examine the impact of these considerations on this decision.

The effects of the dividend policy investigated widely, at least since Modigliani and Miller's (M & M) seminal work. Miller and Modigliani (1961) advised that under certain presumptions, dividend decisions would not affect the firm value. They argued that the dividend decisions of the firm would not damage its value, due to other factors such as expected earnings. A similar argument adopted by other researchers, predicted a positive a result of dividend decisions on the firm value. This mainly because investors would prefer cash dividends on the account of the future capital gain (Lintner, 1962; Walter, 1963; Gordon, 1963; Bhattacharyya, 1979). While other research contributions predicted adverse effect of dividend decisions on the firm value. Mainly because arguing that the effect and treatment of taxation might have an effect on dividend payout, a drop in dividends will increase the market value (Poterba and Summers, 1984; Kalay and Michaely, 2000).

Because the empirical studies in this field in the developing countries are very scarce, the present study would add to the existing literature the evidence from Saudi Stock Exchange during the period (2014-2019). The originality and value of this study is that policymakers in the Saudi Stock Exchange need to stimulate and encourage organizations to pay more focus on Variables and factors affected by the dividend policy, especially the firm value, profitability, liquidity and leverage.

2. Literature Review:

Despite the interest of financial and economic studies in examining and studying the dividend policy, we have yet to understanding the factors associated with this policy. Black (1976) sees it as a puzzle; with pieces do not fit together. Reinforces this conclusion Brealey and Myers (2002) consider dividend policy as one of the important problems in finance.

The seminal work of Modigliani and Miller (1961) titled "Dividend Irrelevance Hypothesis" considered as a pioneer theoretical contribution regarding the relationship between dividends and the share prices. Later on, number of theories developed different and contrary interpretations of this relationship. The following paragraphs show concise review of these theories:

- Irrelevance Hypotheses

Miller and Modigliani (1961) assume that under certain presumptions, the earnings of a firm are directly related to its stock prices, while the firm's dividend policy has no bearing on this relationship, the dividend policy used by the firm is not going to affect share prices. Irrelevance hypothesis argues that the firm's value will depend on how best to use the resources available to the firm, not how to deal with profits. For that reason, the dividends policy will not affect the share price. Irrelevance hypothesis based on assuming no personal taxes or taxes on the firm's income, etc.

Many authors criticized this notion because the conditions posited by the irrelevance hypothesis are unrealistic, Gordon (1963) noted that in real-world situations, we encounter imperfect market conditions like taxes, transaction costs, information asymmetry, and agency costs.

A tax system introduced in Saudi Arabia in January 2018, so the irrelevance hypothesis may not provide explanations for the nature of the association between the dividend and the dependent variables of the research.

- Bird-in-the-hand Hypothesis

Bird-in-the-hand Hypothesis criticized Irrelevance Hypothesis. Lintner (1962) believes that buyers prefer current dividends (bird-in-the- hand) against future dividends (bird-on-the-tree). According to this theory, the dividends reduces uncertainties about future flows. Although many researchers have criticized this hypothesis, it was supported by several research such as (Bhattacharya, 1979; Lintner, 1962; Gordon, 1963; Walter, 1963).

-Tax Preference Hypothesis

This theory assumes that an investor prefers to hold profits; Poterba and Summers (1984) indicated share re-purchases are apparently superior to dividends. Because of tax preference since capital gains undergone to a reduced tax rate than those that dividends are subject (As is the case in the United States). Based on Kalay and Michaely (2000) Institutions must hold dividends to generate profits at the cheapest cost of financing if they want to maximize share value.

The rate tax on dividend paid by Saudi firms is 15% and may reach 20%, while the rate on dividend paid by US firms, is 30% and may reach 37%. It can also argued that the low cost of financing may be a cause of inefficiency in the use of resources, in addition to depriving firms of achieving leverage using debt instruments.

- Agency Cost Hypothesis

The principle of splitting up of ownership and management created the agency theory. The most important condition of the agency's agreement is that the administration should perform its functions in order to achieve and maximize the interests of the owners. While in many cases, professional directors are likely to behave in a way that may not be in the best interest of the shareholder. Therefore, it is inevitable for the owners pay some kind of cost to ensure that their interests are strengthened (Jensen, 1986). Costs could better spent on providing material incentives, such as performance bonuses and morale incentives to agents, with a view to aligning the interests of managers (owners) and agents (management). According to the proponents of this theory, the management uses retained earnings to ensure a sustainable and low-cost source to finance growth and expansion, while shareholders may prefer payouts. research conducted by (Al-Malkawi, 2007; Jensen, Solberg & Zern, 1992; Jensen, 1986) were steady with this hypothesis.

Non-dividend payouts leads to depriving companies of achieving financial leverage using debt instruments, and the low cost of financing may be a reason for inefficiency in the use of resources.

- Signaling Hypothesis

According to this theory, firms send signals to current and future investors through dividend payouts. Pettit (1977) indicated dividend payout would give investors a sign that the company expects to increase its future profits. Quite simply, if investors expect dividend a low ratio of profits the talk about price will rise. (Bhattacharya, 1979, Nissim and Ziv, 2001; Asquith and Mullins, 1986; Bali, 2003) offered evidences for the expectation of this speculation.

Signaling Hypothesis may help explain the nature of the relationship between dividends (as an independent variable) and each of the firm's value, profitability, leverage and Liquidity(as dependent variables). Dividends will give investors a signal that the firm expects to increase its future earnings. As a result, the firms value rises, as doe's profitability, the dividends will push firms to achieve leverage using debt instruments, on the other hand, the dividends will negatively affect the firm's liquidity. Therefore, the study adopts the Signaling Hypothesis in explaining the relationship between the distributions and the dependent study variables.

3. Previous Studies:

Recently, many empirical works have been conducted to investigate the effect of dividend on share prices. In fact, these empirical studies came out with different findings. While some research indicates a positive association between cash distributions and share prices, the findings of other studies support a negative relationship in this respect. Consequently, the debate around this issue still goes on. In the following, a review of some of these empirical studies.

Simshauser (2023) analyzed earning, dividend, and market values of Australia's listed electricity utilities during 2007-2021.

The study revealed that listed electricity utilities exhibit dividends consistent with lifecycle theory, while merchants were consistent with information content. Resulting in the registration of listed electricity utilities to record highs in comparison to merchants.

Ali et al (2023) Purpose to perceive the association between dividends policies and stocks return, study selected 40 firms listed on Pakistan Stock Exchange during 2012-2021.The study show insignificant relation with share price and dividend payout ratio.

Louziri and Oubal (2022) examine the elements of dividends on the stock exchange in Casablanca during (2003–2018). The study identified three important factors in dividends, which are firms' size, firm age, and growth opportunities. The study explained the inverse relationship between the size of the company and the age of the company with the dividend policy through the signal theory. The inverse relationship between growth opportunities and distributions can explained by different theories.

Koleosho et al (2022) examine the impact of dividends policies on the volatility of share prices on the Stock Exchange in Nigerian listed companies. Study used a sample of 49 firms during (2010–2020). The study found effect between dividends policy and share prices volatility.

Rahayu and Wardana (2021) were purpose to determine the effect of firms' performance and dividends on Cumulative Abnormal Return for firms' shares in the Jakarta Islamic Index. Utilized a sample of listed firms from Jakarta Islamic Index during 2009-2018. The study found that the firms' performance and dividends had no effect on Cumulative Abnormal Returns for firms' shares.

Margono and Gantino, (2021) aims to examine effect many of variables on stock price; one of these variables was dividend policy. The results showed a significant correlation between dividend policy and stock price among listed firms in Indonesian Stock Exchange during 2008-2010.

Pelcher (2019) sought to test the relationships between share price volatility and dividends. His study found that the association between share prices volatility and dividends yield is positive in listed firms in the Johannesburg Stock Exchange for the period between 2007 and 2016. In addition, the relationship between the volatility of the share prices and the payout ratio was not significant.

In their study, AlAli et al (2019) aimed to investigate the impact of dividends on the market value of insurance companies that are listed on the Kuwait stock exchange from 2009 to 2017. The researchers used share prices as the dependent variable and several independent variables such as dividend payout ratio, dividend yield, book value per share, market price to book value ratio, and earnings per share. Surprisingly, the study presented conflicting results where market price to book value ratio, book value per share, and share prices had a positive influence on the share price, while the dividend payout ratio and dividend yield had a negative impact on the share prices. Based on these findings, the authors interpreted the results in light of the dividend irrelevance theory proposed by Miller and Modigliani (1961).

The study conducted by Nguyen et al (2019) examined the correlation between dividends and share price volatility using a sample of non-finance firms listed on the Ho Chi Minh Stock Exchange from 2011 to 2016. The researchers employed the fixed effect model and reported that higher dividend payouts have a statistically significant negative effect on share price volatility. Additionally, dividend payout and dividend yield were found to have significant negative impacts on share price volatility based on the study's findings.

The objective of Pandya and Marvadi's (2016) research was to investigate the factors that impact share prices in the Indian market. The study analyzed data for 30 companies from 2017-2021. According to the findings, the factors that influence share prices in the Indian stock market are changing advantage, price-to-profit ratio, and profitability to debt. The research also indicated an inverse relationship between advantage and share prices. This implies that if a company increases its use of debt, it would incur higher interest payments, leading to a reduction in dividends.

De Cesari and Huang (2015) investigated the effect of the previous payouts on the current fair market values of the shares. His research on US stock markets indicated a significant association between the previous returns and the current the true market value of the shares. This finding enhances the influence of dividends information and returns on the value of firms. Thus, professionals should take into account this fact, when distribution decisions made.

Sharif and Pillai (2015) attempted to identify how share prices in Bahrain Stock market being determined (during the period 2006-2010). For this purpose, they analyze data of companies listed in market. It is worth mentioning that eight variables used to uncover their effect on the market price. These variables include the book value per share, dividend allocation; dividend yield, profits and corporate size. The findings indicated that these variables are significant determinants of share prices in the Bahrain market.

Almumani (2014) aimed to differentiate the quantitative factors that affect share prices of banking companies listed on the ASE from 2005 to 2011. The study utilized ratios, relationship analysis, and multi-linear regression models to measure the impact of several independent variables on share prices. The results indicated a positive correlation between dividends, earnings per share, book value per share, share price ratio, and share prices.

On the other hand, Alzomaia and Al-Khadhiri (2013) intended to investigate the determinants of dividends for non-financial firms listed in the Saudi stock exchange from 2004 to 2010. The research examined the influence of earnings per share, previous dividends, growth, debt to equity ratio, and capital size on dividends. The study concluded that current earnings per share and past earnings have an effect on dividend payments.

Hussainey, Oscar and Chijoke (2011) tried to explore the relationship between the policy of dividend syndication and changes in the market value of shares in the UK financial market. They employed the multiple regression analysis and concluded that, there is an inverse relation between the distribution of profits and the change in the industry value of shares. The study also concluded that the changes in growth rates and the level of debt are responsible for changes in the market value of the shares.

In contrast to most of the studies conducted in Saudi Arabia, this study examines the effects resulting from the dividends, as it makes dividends an independent factor affecting firm's value, profitability, liquidity and leverage.

4. Methodology

The aim of the study was to examine the influence of dividend policy on share prices of companies listed in the Saudi Stock Exchange by utilizing secondary data. The researchers collected the data from audited financial statements of the firms from 2014 to 2019. The study population included 198 firms that were listed in the Saudi Stock Exchange in 2019, and a sample of 100 non-financial sector firms distributed among 15 sectors, as well as banks and insurance companies were selected for the analysis.

- Variables and Hypotheses:

In this section will focus on the variables tested, in this study, dividends considered as the independent variable, while Profitability, liquidity and leverage dependent variables.

- Dividends

Despite the multiplicity of measures used for distributions, the most widely used of these measures is the dividend yield, in which the dividends per share attributed to the share price. Many studies have relied on this indicator, because it present more information about the firms (Miller and Rock, 1985). Many studies have used this ratio, such as (Bali (2003), Hussainey et al (2011), Alzomai and Al-Khadhir (2013), Yadav (2022).

- Firm's Value:

The association between dividend and business performance tested by many researchers, they arrived to different results, some of them have determined that there is a significant association between dividends and business performance (Ali, et al (2023), - Koleosho et al (2022), - Pelcher (2019), De Cesari and Huang (2015). In contrast, several studies conclude that there is an insignificant association between dividends and firm performance (Prianda et al (2022), - AlAli et al (2019), Sharifet al (2015), and Hunjraet al (2014)).

One of the measures is the firm performance is Share price (SP), a second proxy will then be Earnings per share (EPS) used have used by (Ali, et al (2023), - Koleosho et al (2022), Sharifet al (2015) and Hunjraet al (2014)).

Since the study adopted the Signaling Hypothesis in describing the association between the dividends and the dependent study variables. We suppose a significant association between the dividends and firm's value. Accordingly, the first hypothesis of the study states:

H1- Dividends have a positive influence on firm's value.

- Profitability:

Many studies aimed to test the relationship between dividends and profitability, and reached different and conflicting results. Here we will review the most recent of these studies, to know the measures used to measure profitability, and the expected relationships between dividends and profitability. Many studies have concluded that there is a significant association between dividends and profitability (Aman and Qadri (2022), Bhuneshwar and Nimitha (2022), Alber and Alhabtour (2017), Alzomaia and Al-Khadhiri (2013), Naceur and Goaied (2002). In other hand, several studies conclude that there is an insignificant association between dividends and profitability (Sheikh (2022), Yadav (2022)).

One of the most common measures is the profitability is Return On Assets (ROA), a second common will then be used Return On Equity(ROE). Several studies have used these ratios, such as (Sari et al. (2022), Yadav (2022), Bhuneshwar and Nimitha (2022)).

Since the study adopted the Signaling Hypothesis in describing the association between the dividends and the dependent study variables. We expect a positive relationship between the dividends and Profitability. Accordingly, the second hypothesis of the study states:

H2- Dividend has a significant influence on Profitability.

- Liquidity:

Several studies have test the relationship between dividends and liquidity, and concluded different results. Many studies have conclude that there is a significant association between dividends and liquidity (Stereńczak and Kubiak (2022), Ahmed (2015), Jiang and Shi (2017)). In contrast, several studies concluded that there is an insignificant relationship between dividends and liquidity (Stereńczak and Kubiak (2022), VO (2022), Griffin (2010)).

One of the most common measures is the liquidity is Current Ratio (CR) have used by (Yadav (2022), Adil et al (2011)).

The study adopted the sign hypothesis in explaining the relationship between the dividends and the dependent study variables. We expect a negative relationship between dividends and Liquidity. Accordingly, the third hypothesis of the study states:

H3- Dividends significantly influence the Liquidity.

- Leverage:

The relationship between dividends and leverage tested by many researchers, they arrived to different results, some of them have concluded that there is a significant positive relationship between dividends and leverage (Al-Dabbagh and Moeen (2022), Prianda et al (2022), Sari et al (2022)). In contrast, several studies concluded that there is an insignificant relationship between dividends and leverage (Aman et al (2022), Yadav (2022), Alber and Alhabtour (2017), Houmani and Ghara (2014)).

One of the measures is the leverage is Debt-Equity Ratio (DER) have used by (Yadav (2022) and Adelegan (2003)).

Since the study adopted the Signaling Hypothesis in explaining the relationship between the dividends and the dependent study variables. We expect a positive relationship between the dividends and Leverage. Accordingly, the fourth hypothesis of the study states:

H4- Dividends have a positive effect on Leverage.

Data and Method

The study sample consists of 100 firms listed on the Saudi Stock Exchange, during the period (2014-2019), the following years were excluded to avoid the effects of Covid-19.

The study used correlation to ascertain the existence/absence of a relationship between the dividends (independent variable) and the dependent study variables. Then, used regression to build the following study model:

$$DY = \beta_0 + \beta_1 SP + \beta_2 EPS + \beta_3 ROA + \beta_4 DER + \beta_5 CR + e$$

Where:

DY- Dividend Yield.

SP- Share price.

EPS- Earnings per share.

ROA- Return on Equity Assets

DER- Debt Equity Ratio

CR- Current Ratio

β_0: Constant.

β_1- β_5: Coefficients

e: Error term.

Analysis Results

The data presented in Table (1) displays the correlation coefficients between various variables examined in the study. The results indicate that there was a positive and significant correlation between dividend yield (DY) and stock prices (SP) (0.313, $p < .000$). Similarly, there was a strong and significant positive correlation between dividend yield (DY) and earnings per share (EPS) (0.797, $p < .000$), as well as a moderate and significant positive correlation between dividend yield (DY) and return on assets (ROA) (0.472, $p < .000$), and between dividend yield (DY) and debt equity ratio (DER) (0.468, $p < .000$). On the other hand, the correlation coefficient between dividend yield (DY) and current ratio (CR) was negative and non-significant (-0.122, $p > .115$).

Correlation results show that Dividend (DY) significant affect the Firm Value (SP, EPS), Profitability (ROA) and Leverage (DER), and it shows that the correlation between Dividend (DY) and Liquidity (CR) is a negative non-significant correlation. This confirms the idea that Liquidity is negatively affected by Dividends, which are the findings (VO (2022), Stereńczak and Kubiak (2022), Ahmed (2015) and Griffin (2010)).

Table (1): Correlations

		DY	SP	EPS	ROE	ROA	CR	DER
DY	Pearson Correlation	1	.313**	.797**	.148	.472**	-.122-	.468**
	Sig. (2-tailed)		.000	.000	.055	.000	.115	.000
	N	168	168	168	168	168	168	168
SP	Pearson Correlation	.313**	1	.286**	.136	.030	-.115-	.015
	Sig. (2-tailed)	.000		.000	.079	.699	.137	.847
	N	168	168	168	168	168	168	168
RPS	Pearson Correlation	.797**	.286**	1	.269**	.491**	-.096-	.359**
	Sig. (2-tailed)	.000	.000		.000	.000	.218	.000
	N	168	168	168	168	168	168	168
ROE	Pearson Correlation	.148	.136	.269**	1	.443**	-.096-	.045
	Sig. (2-tailed)	.055	.079	.000		.000	.217	.563
	N	168	168	168	168	168	168	168
ROA	Pearson Correlation	.472**	.030	.491**	.443**	1	-.239-**	.247**
	Sig. (2-tailed)	.000	.699	.000	.000		.002	.001
	N	168	168	168	168	168	168	168
CR	Pearson Correlation	-.122-	-.115-	-.096-	-.096-	-.239-**	1	-.210-**
	Sig. (2-tailed)	.115	.137	.218	.217	.002		.006
	N	168	168	168	168	168	168	168
DER	Pearson Correlation	.468**	.015	.359**	.045	.247**	-.210-**	1
	Sig. (2-tailed)	.000	.847	.000	.563	.001	.006	
	N	168	168	168	168	168	168	168

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

Table (2) show the result of regression analysis. Value of R-squared (0.693), This gives the regression model a value of about (70%) in explaining the variance in the Dividends (DV).This indicated the Share prices, Earnings per shares, Return On Assets and Debt-Equity Ratio has much impact on Dividends.

Table (2): Regression Result

Model	Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
(Constant)	-.667-	.184		-3.622-	.000
SP	.010	.004	.126	2.740	.007
EPS	.480	.042	.633	11.539	.000
ROA	.022	.011	.104	2.071	.040
DER	.008	.002	.213	4.547	.000
R value		.832a			
R Square		.693			
Adjusted R Square		.685			
F		91.913			
Sig		.000b			
a. Dependent Variable: DY					

The following regression model illustrates this effect.

DY = -.667 + .01 SP + .48 EPS + .022 ROA + .008 DER + e

Where:

DY- Dividend Yield.

SP- Share price.

EPS- Earnings per share.

ROA- Return on Equity Assets

DER- Debt Equity Ratio

β0: Constant.

β1- β4: Coefficients

e: Error term.

To find out how much the regression model explains the variation in the dependent variables (profitability, liquidity, financial leverage and company performance), it is necessary to know the coefficients of the regression equation. Table No. (4) Shows the coefficients of the regression model, which help in obtaining the equation of the regression line between the independent variable (distributions) and the dependent variables (profitability, liquidity, financial leverage, and the company's performance).

5. Discussion and Conclusion

The study results show that there is a significant positive correlation between the dividends policies adopted by the non-financial firms listed in the Saudi Stock Exchange and the firm's value, profitability and leverage, the study also found that dividends policies have a non a significant inverse correlation with liquidity.

This result can explain in light of the signaling hypothesis, the theory suggests that companies increase their dividend payments to indicate to the market their promising future earnings potential and ability to sustain such payouts. Various studies, including those by Sari et al (2022), Prianda et al (2022), Bhuneshwari and Nimitha (2022), Chumari (2022), Alber and Alhabtour (2017), Alzomaia and Al-Khadhiri (2013), and Nissim and Ziv (2001), have yielded consistent findings in support of this idea.

We conclude that non-financial listed firms on the Saudi Stock Exchange send signals (signaling hypothesis) to current and future investors through dividends. These dividends will give investors a signal that the firm expects to increase its future earnings. As a result, the market value of shares rises, as doe's profitability. In addition, firms, instead of Earnings retention, use debts and achieve financial leverage. On the other hand, the distributions will negatively affect the firm's liquidity.

This current work sought to discover the effects resulting from the dividends policy on the firm's value, profitability, liquidity and leverage, which were interpreted in the light of the signaling hypothesis. In an emerging market such as the Saudi Stock Exchange, information related to dividends helps current and potential investors to make decisions about investment opportunities available in the market, and dividends are an important tool used by firms to attract investments.

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