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## FINANCIAL FLEXIBILITY AND DIVIDEND PAYOUT: EVIDENCE FROM NIGERIAN FINANCIAL SECTOR

ABDULKADIR, Rihanat Idowu <sup>1</sup>, ABDURRAHEEM, Abdulaziz Adewuyi <sup>2</sup> & SIYANBOLA, Akeem Adetunji <sup>3</sup>

<sup>1&2</sup> Department of Finance, Faculty of Management Sciences, University of Ilorin, Kwara State

<sup>3</sup>Department of Accounting, Federal University, Wukari, Taraba State

### Abstract

*Recent decline in the average payout ratios and suspected decline in financial flexibility of firms listed in the financial service sector of the Nigerian Stock Exchange stimulates the interest to conduct this study. The study examines whether dividend payment decisions can be explained by the financial flexibility of the sampled firms. To achieve this, the study obtained data from the published financial statements of the firms. Binomial logistic regression and panel linear regression were employed to investigate how financial flexibility explains “decision to pay or not to pay” and “amount of dividends paid” respectively. Findings indicate that financial flexibility (measured by cashflow) influences firms’ decision “to pay” or “not to pay” as well as the amount of dividends paid. Findings indicate further that profitability and size are also important determinants of the amount of dividend payout. The result of the study is in line with signaling theory which indicates that payment of dividend is a signal of financial health of the firm. In line with findings, the study concludes that dividend payout of firms in the financial service sector of the Nigerian Stock Exchange is strictly guided by their financial health. Thus, the study recommends that regulatory authorities should adopt policy measures that will enhance firm’s financial flexibility to strengthen their ability for the attainment of overall objective of the firm (maximization of shareholders’ wealth).*

**Keywords:** Cashflow; Dividend; Financial flexibility; Leverage; Signaling

### 1. INTRODUCTION

In recent times, financial flexibility has been recognized as a core determinant in corporate financial policies. Financial flexibility is the firm’s ability to avert underinvestment and costly financial distress (Bonaime, Hankins & Harford, 2014; Graham & Harvey, 2001; Denis, 2011). Firms pursue financial flexibility through their capital structure, cash management or payout policies (Ferrando, Marchica & Mura, 2016). While financially flexible firms have better ability to raise external funds resulting from unexpected needs, the less flexible firms are more susceptible to decline in cashflow (Arslan-Ayaydin, Florackis & Ozkan, 2014). Thus, financially

Corresponding Author: +2348034355144

E-mail Address: [riolaq29@yahoo.com](mailto:riolaq29@yahoo.com),

flexible firms are more able to respond to unforeseen setbacks and have better ability to thrive in the face of economic hardship.

However, a firm's need for financial flexibility may conflict with the need to return excess profits to shareholders as dividends. Firms may adopt a conservative payout policy in order to maintain financial flexibility. This may conflict with the firm's goal of maximizing shareholders' wealth through dividend payment and may generate adverse market reaction. Thus, the need arises to examine whether payout policy of a firm is affected by its financial flexibility considerations. Considerable studies (Allen & Michaely, 2003; Bonaime et al. 2014; DeAngelo & DeAngelo, 2007; Graham & Harvey, 2001; Harris, 2015; Hirtle, 2016; Jagannathan, Stephens & Weisbach, 2000; Kamat & Kamat, 2016; Lee, Lusk & Halpenn, 2013; Lie, 2005; Pacheco & Raposo, 2007) exist in offering explanation on this relationship. However, most of the studies were conducted outside the Nigerian market. As such, results of those studies cannot be applied to the Nigerian market due to differences in market structure and dividend regulations. The Nigerian market is considered an ideal laboratory for this study as Ferrando et al. (2016) noted that financial flexibility is more valuable where financial markets are less developed. Moreso, the few studies that exists in the Nigerian market focused on non-financial firms. Very little or no attention has been paid to the financial sector probably due to their unique regulatory structure.

Consequently, this study seeks to examine how financial flexibility affects dividend payout policies of firms listed in the financial service sector of the Nigerian stock exchange. The importance of this sector cannot be overemphasized due to the financial intermediation role. Statistics show that the financial service sector had the highest number of dividend paying companies (Proshare, 2012). However, news report has shown that average payout ratios for the industry declined to 35% in year 2015 from 60% recorded in year 2013 (BusinessNews, 2015). Anecdotal evidence also suggests that Nigerian banks are reducing dividend payments in recent times. Similarly, the outlook of some of the banks were revised to negative from stable by Reuters (2016) due to suspected problems of financial flexibility. Thus, the study seeks to establish whether the dividend payment by the banks can be explained by their financial flexibility.

## 2. LITERATURE REVIEW

Theoretically, signaling theory can be used to explain the link between dividend and financial flexibility. Based on the initial work of Akerlof (1970) who pioneered the theory, authors (Bhattacharya, 1979; John & Williams, 1985; Miller & Rock, 1985) have developed different signaling models which indicate that dividend announcements convey information to investors regarding the firm's current state and future prospects. Particularly, Bhattacharya (1979) established that dividends could be employed as a sign of future cash flow in an imperfect information condition. Thus, dividend changes convey either positive information (dividend initiations/increases) or negative information (dividend omissions/decreases). Consequently, in line with the financial flexibility hypothesis, payment or increase in dividends signals there will be no shortage of funds due to certainty of improvement in performance. The hypothesis therefore holds that companies paying more dividend is a signal of high financial flexibility and

Corresponding Author: +2348034355144

E-mail Address: [riolaq29@yahoo.com](mailto:riolaq29@yahoo.com),

dividend decreases is a signal to the market that the company needs to improve its financial flexibility by preserving cash. One of the means of preserving cash is by avoiding/reducing dividend payments. Thus, in line with this hypothesis, negative relationship is expected as firms will conserve cash to achieve flexibility.

Existing empirical evidences show that financial flexibility needs of the firm drives its financial policies (Byoun, 2007; DeAngelo & DeAngelo, 2007; Rahimi & Mosari, 2016). This explains the existing literature on how financial flexibility affects dividend payout policies. Different arguments have been advanced in explaining this relationship. Abdulkadir, Abdullah, and Wong (2015) documents that firms adjust their dividend policies in a manner consistent with the need to preserve financial flexibility. On one hand, some studies reported that the need to preserve financial flexibility leads to dividend omissions by firms (Abdulkadir et al. 2015; Bulan & Subramanian, 2008; Arslan-Ayaydin et al., 2014; Ferrando et al., 2016). This is based on the expectation that firms with a greater need for financial flexibility will prefer to have higher cash holdings, lower debt (issuance of more equity) and this can be achieved by paying less dividends. King'Wara (2015) noted that having low dividend yield will assist the firm retain internal funds. Similarly, other authors (Jagannatha et al. 2000; Lie, 2005; DeAngelo & DeAngelo, 2007) contend that firms' need for financial flexibility may lead to payment of irregular dividends or payment of lower dividends (Rahimi & Mosavi, 2016). These studies noted that firms opt for stock repurchase rather than paying regular dividends due to flexibility needs. Therefore, distribution of excess funds which favours repurchases above cash dividends is consistent with financial flexibility (Allen & Michaely 2003; Bonaime et al. 2014; Graham & Harvey, 2001; Harris, 2015; Hirtle, 2016; Kamat & Kamat, 2016; Lee et al. 2013; Pacheco & Raposo, 2007). This is because dividends become a commitment into the future once declared while repurchases prevents the firm from committing itself to future payments (Jagannathan et al., 2000; Odded, 2017). Thus, these studies support inverse relationship between financial flexibility and dividend payments.

From another perspective, other stream of studies (Bulan & Subramanian, 2008) contends that poor financial flexibility leads to dividend omissions. The authors argue that dividend omitting firms are characterized with poor financial flexibility revealed in their excess leverage or high debt overhang. Other stream of findings document that firms reduce their dividends during crisis to preserve financial flexibility (Abdulkadir et al 2015; Bancel & Mitoo, 2011; Bulan & Subramanian, 2008). Specifically, Abdulkadir et al. (2015) contends that financial flexibility only becomes a priority during crisis as firms do not prioritize maintaining it before crisis.

Contrary to studies that holds that firms reduce/omit dividends due to the need for financial flexibility, other evidences (Byoun, 2007; DeAngelo & DeAngelo, 2007) indicates positive relationship as financially flexible firms maintain high dividend payout. These studies argued that financially flexible firms are usually firms with large earnings, lower leverage and higher cash holdings. Thus, they have better ability to pay higher dividends. Similarly, Chen, Harford, and Lin (2017) documents that dividend payout is a signal that the firm is unconstrained while non-payment is an indication that the firm is financially constrained. In the same vein,

King'Wara (2015) and Lie (2005) noted that decision to make or increase dividend payment is a signal that the firm currently has excessive financial flexibility.

In support of the findings that indicate better ability to pay dividends from financially flexible firms, Fliers (2016) and Almeida, Campello, and Wesbach (2004) contends that firms that are more financially flexible will be better at offsetting any disruptions and will have better ability to smooth their dividends while their financially constrained counterparts are less able to smooth dividends. Other studies (Khoramin, Taleb & Vaklifard, 2013) reported that no relationship exists between financial flexibility and dividend policy of sampled firms.

Many of these existing studies measure financial flexibility from the angle of leverage. Prior evidences (Ferrando et al., 2016; Fliers, 2016; Kaplan & Zingales, 1997; Whited & Wu, 2006) indicate that reduction in leverage creates the required financial flexibility. Other stream of studies measured financial flexibility using cash holdings (Ferrando et al., 2016; Kuti, 2011) and the studies documents that firms with lower cash levels have lower financial flexibility. The current study seeks to employ both measures of financial flexibility in examining its impact on dividend payout. This is in line with Pacheco (2007).

### 3. DATA AND METHODOLOGY

This study is based on an unbalanced panel data set of 260 firm-year observations. This was drawn from a sample of 43 companies over the period of 2005 to 2015. Data was extracted from the financial reports of the sampled financial firms obtained from the stock exchange. In order to examine the relationship between dividend and financial flexibility (while taking into cognizance other factors that might affect dividend payout), the following models are estimated:

$$\ln \frac{DIV}{(1-DIV)} = \alpha_0 + \beta_1 CF_{it} + \beta_2 LEV_{it} + \beta_3 ROA_{it} + \beta_4 SIZE_{it} + \beta_5 INV_{it} \quad (1)$$

Logit model is employed in the first model to estimate the effect of financial flexibility proxies (cashflow and leverage) on the discrete choice “to pay” or “not to pay” dividends. Other variables such as profitability, size and investment opportunities have also been included in the model as they have been widely established in the literature as determinants of dividend payout. Panel logistic regression has been employed in order to control for unobserved characteristics that are peculiar to the different firms. Thus, Hausman test was used to choose the most appropriate from fixed effect estimates and random effect estimates.

$$DIV_{it} = \alpha_0 + \beta_1 CF_{it} + \beta_2 LEV_{it} + \beta_3 ROA_{it} + \beta_4 SIZE_{it} + \beta_5 INV_{it} + \mu_{it} \quad (2)$$

Equation 2 states the general panel model for estimating effect of financial flexibility proxies (cashflow and leverage) on the amount of dividend paid. Using Breusch and Pagan Lagrangian multiplier (BP-LM) test, the most appropriate estimates between the pooled OLS versus random/fixed effects estimates is determined. Breusch and Pagan Lagrangian multiplier test cannot be applied for equation 1 due to the non-linear nature of the model. DIV in equation 1 represents the discrete choice “to pay” or “not to pay” dividends while it represents the amount

Corresponding Author: +2348034355144

E-mail Address: [riolaq29@yahoo.com](mailto:riolaq29@yahoo.com),

of dividend paid in equation 2. Two proxies of financial flexibility were used: cashflow(CF) and leverage (LEV). Cashflow is measured as net cash flow from operating activities scaled by book value of total assets, while leverage is measured as total debt scaled by book value of total assets. ROA is used to represent profitability and it is measured as profit after tax scaled by total assets. Size is measured by the logarithm of total assets while investment opportunity is measured by market to book ratio (market price per share/book value per share).

#### 4. RESULTS AND FINDINGS

The descriptive statistics of variables are shown in Table 1. The table shows 260 firm-year observations after deletion of missing values and outliers. The payout choice is a dummy variable with two outcome levels: 0 when the firm does not pay; and 1 for when the firm pays dividend. The minimum value of DIV shows that some firms did not pay dividend during the study period. The mean value shown for leverage indicates that many of the sampled firms are highly geared.

**Table 1**  
*Descriptive Statistics of Variables*

Variables	Obs	Mean	Std.Dev	Minimum	Maximum
Payout Choice (DIV)	260			0	1
Dividend (DIV)	260	4.22	9.94	0	62.79
Cashflow (CF)	260	117.52	182.18	0.0162	1108.82
Leverage (LEV)	260	3.111	9.399	0.0076	85.333
Profitability (ROA)	260	0.2099	0.7199	-1.0566	9.2148
Size	260	4.575	0.9619	0	5.5607
Investment Opp. (INV)	260	130.5	75.200	1	260

The estimation results from the logit model are presented in Table 2. Hausman test shows that  $\chi^2$  statistic of 0.86 is insignificant at ( $p > \chi^2 = 0.9733$ ). Thus, random effect estimates are preferred to the fixed effect estimates. Therefore, coefficients from the random effect estimates are reported in column 2 (model 1) to explain the influence of financial flexibility and other explanatory variables on the decision to pay dividends. Result shows that only cashflow is significant. This indicates that among the variables tested, only financial flexibility (proxied by cashflow) influences the firm's decision "to pay" or "not to pay" dividends. This implies that the higher the level of cash flow (higher financial flexibility), the higher the likelihood that the firm will pay dividend. Likelihood ratio  $\chi^2$  statistic of -125.94 is also statistically significant at 1%. This shows goodness of fit for the whole model.

**Table 2**  
**Regression Results**

	<b>Model 1</b> <b>(Random Effects Logistic</b> <b>Regression)</b> <b>(Dependent Variable = payer (0,1))</b>	<b>Model 2</b> <b>(Fixed Effects Linear</b> <b>Regression)</b> <b>(Dep. Var = Dividend/Total</b> <b>Assets)</b>
Intercept	-2.2639 (-0.70)	-17.3837** (-2.43)
Cashflow	0.0149*** (4.21)	0.0141*** (2.69)
Leverage	-0.0902 (-1.16)	0.0978 (1.16)
Profitability	0.4398 (0.90)	2.1379** (2.33)
Size	0.4608 (0.51)	6.0733*** (3.02)
Investment opportunity	-0.0062 (-0.71)	-0.0658 (-3.23)
Likelihood Ratio $\chi^2$	-125.94 (p-value = 0.0005)	
F-test		4.30 (p-value=0.0009)

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

Model 1: z-stat are in parentheses; Model 2: t-stat are in parentheses.

With respect to model 2, the study proceeds to offering explanation on the effect of financial flexibility and other variables on amount of dividend paid. In determining the most appropriate estimates between pooled OLS and random effects, BP-LM test shows that  $\chi^2(01)$  of 59.63 is significant at ( $\text{prob} > \chi^2 = 0.0000$ ). This suggests that OLS is not the appropriate model to use. Consequently, the study proceeds to comparing between random effects and fixed effects for the linear model. Hausman test shows that  $\chi^2$  statistic of 20.79 is significant at ( $p > \chi^2 = 0.0009$ ), thus fixed effects is preferred for the linear model. Coefficients for the fixed effects model are therefore presented in column 3 (model 2) of Table 1. Results indicate that three variables positively and significantly influence the amount of dividend paid. These include: cashflow; profitability and size. Thus, firms with higher level of these variables pay more dividends. The reported coefficients in the linear model shows further that firm size exerts the most significant influence on the amount of dividends paid, followed by profitability and then cash flow. F-test statistic of 4.30 is significant at 1% and this shows a good fit as it implies that the model provides a better fit than the intercept-only model.

The results above indicates that only financial flexibility is important in determining whether to pay or not to pay but other factors (profitability, size & cashflow) also counts in

Corresponding Author: +2348034355144

E-mail Address: [riolaq29@yahoo.com](mailto:riolaq29@yahoo.com),

determining how much to pay. This also shows that cashflow is a better indicator of financial flexibility as compared to leverage. Finding of the study is consistent with our expectation based on signaling theory that payment of dividend is a signal that the firm has high financial flexibility.

## 5. CONCLUSION AND RECOMMENDATION

This study examines the effect of financial flexibility on decision to pay dividends and on the amount of dividend paid by firms quoted in the financial service sector of the Nigerian stock exchange. Using non-linear and linear panel regression on 260 firm-year observations, the study found that firm's decision to pay and amount that will be paid as dividends is influenced by its financial flexibility. From the findings, the study concludes that the dividend payout decision of firms is strictly guided by their financial health (as revealed by the result on financial flexibility and financial performance). The study concludes further that bigger firms prefer to distribute more while smaller firms possibly plough back into the business for expansion. Thus, the study recommends that regulatory authorities should adopt policy measures that will enhance firms' financial flexibility in order to strengthen their ability to attain the objective of maximization of shareholders' wealth.

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