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IMPACT OF FINANCIAL LEVERAGE ON DIVIDEND POLICY: CASE OF KARACHI STOCK EXCHANGE 30 INDEX[*]

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ABSTRACT

In such a complex corporate environment it is the challenge to the finance manager of the firm in the long run prospective with the objective of maximizing the owner wealth. With the view to achieve the objectives of the organization, finance manager have to put the due attention on the capital structure of the organization. The optimum capital structures of company have to lead to more profitability. This paper investigates the impact of financial leverage on the dividend policy of the Pakistani firms. The research conducted on the Karachi stock exchange companies listed in KSE-30 index during 2005-2010. The primary objective of Karachi Stock Exchange 30 indexes is to have a bench mark by which stock prices can be compared over the time period of time. Karachi stock exchange 30 index is calculated using free float market capitalization methodology. There are fifteen companies which are continuously included in the Karachi stock exchange 30 index during the period of five years (2005-2010).

Keywords: Financial Leverage; Dividend Policy; Market Capitalization; KSE.

INTRODUCTION

Financial leverage is primary concerned with the financial activities which involve rising of funds from outsource and bearing the fix charge against it. This paper attempts to examine the impact of the financial leverage on the dividend policy of the firm including in the Karachi stock exchange 30 index. In such a complex corporate environment like in Pakistan, financial manager have to face a number of problem in order to make financial decision and maximize the profitability of the owners. The capital structure of the company represents the strength of the company. The companies which are using the optimum capital structure can able to progress as compared to companies which are not using the optimum capital structure (Al-Kuwari, 2009). The companies in the Karachi stock exchange are entered in the 30 index which are having the high market capitalization. Companies which shows high market capitalization are remain in the 30 index and the remaining are excluded from the index. During the period of 2005-2010 only fifteen companies are remain in the index. The annual report of these companies shows that some of them are having the high debts. Companies in Pakistan shows that the financial leverage is not impacting positively on the dividend amount of the shareholders. Multiple Linear regression models are applied on

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this research to get the results. This paper mainly concentrates on the exercise of financial leverage in the context of understanding its impact on the dividend per share of the company.

LITERATURE REVIEW

Aasia (2011) examined the relationship between the financial leverage on the dividend policy of the Karachi stock exchange companies listed in the 100 index. Dividend per share of the company was considers as the dependent variable and dividend yield, debt ratio, and the change in the earning was considered as the independent variable in the study. Result showed that the debt ratio of the company is not significantly impacting on the dividend policy of the company. Whereas; dividends yield have positive impact on the dividend per share amount. Gill, Biger & Tibrewala (2010) concluded that there are a number of factors which can affect on the issuance of the dividends. Dividends are helpful for improving the goodwill of the company for attracting the investors and maintaining the price of the stock in the stock market.

Chandrakumarmangalam (2010) analyzed the impact of financial leverage on the profitability of the Indian firms. Researcher examines the impact of the financial leverage, combined leverage and the operating leverage on the earning per share of the firms. Researcher concludes that there is a significant relationship between the degree of financial, operating and combined leverage on the earning per share of the companies in Indian. Fix amount of interest which the company has to pay to the lender affect significantly on the earning per share. There was a positive relationship between the degree of financial leverage and the earning per share. The profitability and wealth of a firm can maximize by employ more debt.

Al-Kuwari (2009) investigates the determinants of dividend policies for firms listed on Gulf Co-operation Council (GCC) country stock exchanges during 199 to 2003. Researcher concludes that there are a number of factors which can affect on the dividend policy of the company. Government owner ship, firm size and the firm current profitability is positively impact on the dividend policy of the firm. The firms with the optimum capital structure are able to pay high dividends as compared to other companies.

Dynamic model of the firm with risk free debt contracts was examine by the researcher. Investment irreversibility and debt limited the costs are the model fits several stylized facts of corporate finance and asset pricing. Leverage is constant across different book to market portfolios, whereas market leverage differs significantly. The leverage of the firm effect the return of the shareholders, with the increase in the leverage the return of the shareholder going to decreases (Ozdagli, 2009).

Michael and Gallmeyer (2007) examined the impact of financial leverage on the stock return volatility in a forceful general equilibrium economy by examine the debt and equity examination of the companies. Price of share, leverage and the price risk was examining on the stock return valuation. With the increase in the financial leverage of the firm the firm vitality going to increases. Financial leverage adds more to the dynamics of the stock strength in the stock market. The main reason of the dynamic stock vitality is the variation in the interest rate and the market price risk in the stock market.

THEORETICAL FRAMEWORK

Curran (1987) concluded that financial leverage is the relationship between the funds and the shareholder equity as it is calculated in debt to equity ratio. Financial leverage is one of the important studies of corporate finance, which concerned with the earning of the shareholder. Operating leverage and the financial leverage are two major types of the leverage. The fix cost which an organization pays in the form of interest can affect the earnings before interest and tax of the company. Fix cost of debt which companies have to pay can also be affected on the earning of the common shareholder. With the increase in the earning before tax can lead to increase in the earning per share of the company which increases the dividend per share amount.

According to Brealey (2001), debt financing amplify the effect of change in the operating income of the shareholder. Debt financing did not affect the operating risk of the organization, but it just adds financial risk. Leverage increased the expected return of the shareholder but it also increases the risk of the firm. Both the effects of return and risk cancel, and the value of shareholder remain unchanged. Debt increases the financial risk and cause shareholder to demand a high return on their investment. Dividend policy is the trade-off between retained raining on the one hand and paying the cash to the existing shareholder, and issuing share on the other hand, the marker which is perfectly capital in nature, dividend choice would have no impact on the value of the firm. High dividend policy will be costly to firm that don't have the cash flow to support it. Firm who barrow money, it has promise to a lender to pay regular interest on the barrowed amount. During the period of good profit of the company , the shareholder enjoys all the profit of the company and during the worst condition of the company when the company face the losses shareholder have to bear all the pain. There may be the condition when a company facing very bad condition and it is unable to pay its debt. The firm is then bankrupt and shareholder can lose all its investments. Because the leverage increases the shareholder return in the good time and reduced on the bad time.

Ross (1996) examined that the financial and operating leverage are the parallel concepts. Operating leverage refer to the firm fix cost of production. Financial leverage is the extent to which a firm relies on debt and a leverage firm is a firm which contains the debt in its capital structure. Leverage firm makes interest payments regardless of the firm a sale, financial leverage refers to the firm fix cost of the financing. When the earnings before interest of the company is high it will increased the earning per share and which leads to increase in the return to the equity. Thompson (2000) evaluated that financial leverage is the relationship between the debt and the personal contribution of the firm. Financial leverage is measured by the ratio such as debt equity ratio. Financial leverage dramatically impact on the payoff of the shareholder, however financial leverage may not affect the cost of capital therefore financial leverage employs in the firms. Financial leverage directly effect on the earning per share and on the return on equity of a firm. Return on equity and the earning per share is much larger in practical variability. Financial leverage of a firm can magnify the gain and loss of the shareholder.

The major objective of this study is to find the impact of financial leverage on the dividend policy by examine the Karachi stock exchange 30 index. This research also examines the average dividend played by the companies which are continuously included in the Karachi stock exchange 30 index, which help us to identify the policies of these companies.

DATA AND METHODOLOGY

The data was collected from the Karachi stock exchange website and the annual reports of the firm. There are number of companies which are continuously listed in the Karachi stock exchange 30 index from 2005 to 2010. Fifteen companies are selected which was continuously listed in KSE 30 index from 2005 to 2010. There are some companies are not paying the regular dividend to their shareholders. The multiple regression models are applied on the data, which represents the impact of financial leverage, dividend per share and dividend yield on the dividend per share of the company.

Financial leverage is concerned with the financial activities of a company which involves rising of the funds from outside the organization. The companies have to pay the fix charge on that fix amount on the barrowed amount. A leverage ratio defines the long term solvency of the firm. There are two main ratios which are use for the calculation of financial leverage, debt equity ratio and the debt ratio. Time interest earn ratio is also helpful to determine the interest payment on the barrowed amount (Financial ratios, 2002). Financial leverage ratio which is used in this research is the debt to equity ratio.

Earnings per Share refer to the portion of the company's profit allocated to each outstanding share of the common stock. Earnings per share are the indicator of companies' profitability. Price earnings ratio is used for the calculation of the piece to earning ration of the company (Janssen, 2007). Dividend yield is usually means that the historical dividend yields. The current price of the share divided by the dividend issued in the last year. Dividend yield defines that how much a company pay out in dividend in each year relative to its share price (Janssen, dividend yield, 1999).

Hypothesis

Hypothesis 1. The leverage impact significantly on the dividend per share.
Hypothesis 2. The dividend yield impact significantly on the dividend per share.
Hypothesis 3. The earning per share impact significantly on the dividend per share.

ANALYSIS AND INTERPRETATION

This study uses the data of listed companies in Karachi stock exchange. The data was gathering from the database of the Karachi stock exchange site. The annual reports of the selected companies are examines to find out the dividend, dividend yield, debt equity ratio, and the earning per share of the companies.

TABLE 1

Model Summary

	Sig.	B	VIF	Mean	Maximum
Constant	0.026	.106			
Financial leverage (FL)	0.001	-.487	1.185	.8924	2.60
Earnings per share(EPS)	0.010	.254	1.051	3.9418	13.75
Dividend yield (DY)	0.027	2.69	1.241		
R .9162	R^2	.839			
Durbin-Watson 1.675					

Note. Here; "Sig." means significance, "B" means values of betas, and "VIF" means variance inflation factor.

$$\text{Dividend Per share} = 0.106 - .487(FL) + .254(EPS) + 2.69(DY) \qquad \text{(Eq. 1)}$$

Descriptive result of Table 1 shows that that average dividend paid to the shareholder by the selected companies are approximately Rs.4. The maximum dividend paid in this duration is Rs.14; companies are paying very less dividend to their shareholders. The average financial leverage ratios of the company are about .89 times. The significant value of the financial leverage is 0.001, which represents of the variable, so we accept H1. The significant value of dividend yield and the earning per share is 0.010 and 0.027 which represents that both the variable is significant in the study. The dividend per share of the company affected negatively due to increase in the financial leverage. The change in the financial leverage of the company by one unit results the decrease in the dividend per share by 0.487 units. The theories conclude that the increase in the financial leverage, dividend per share also be increases. In the case of Pakistan the results are different as some companies are having high debt so it results in the decrease in the dividend per share of the company. Earnings per share impact positively on the dividend per share, if earning per share increased by one unit it results 0.254 units increased in the dividend per share. Earnings per share and the dividend yield shows good results, as the increase in the earning per share shows that the companies have a good amount to distribute among the shareholders. Dividend yield impact positively on the dividend per share one unit change in the dividend yield impact positively 2.69 units in the dividend per share.

CONCLUSION

The study concludes that the debt management system of the firm is not performing. The companies are suffering with the high debt. These companies are unable to increase their profitability which leads to decrease the dividend per share. The companies which are included in the 30 index of Karachi stock exchange are not paying good dividend some of them are even not paying even the dividend. The finance managers have to emphasize on the capital structure of the firm. While taking more loan the profitability of the firm going to decreases as they have more money to produce more goods and services. Dividend yield and earnings per share is positively associated with the dividend per share.

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