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Determinants of corporate dividend policy in emerging markets: Evidence from MENA stock markets

Imad Jabbouri

School of Business Administration, Al Akhawayn University in Ifrane, Morocco

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ABSTRACT

This study attempts to identify the main factors influencing dividend policy in MENA emerging markets during the period between 2004 and 2013. Using panel data analysis, the study documents that dividend policy is positively related to size, current profit, and liquidity and negatively associated with leverage, growth, free cash flow and the state of the economy. The negative relationship with free cash flow could be indicative of potential agency problems in this region. This relationship is more pronounced in markets with high information asymmetry and weak investors' protection. Managers of MENA firms seem to increase dividend payouts during economic slumps in an attempt to reassure investors fearing insiders' expropriation. These signals become irrelevant when country governance mechanisms are powerful and investor protection is factual. Understanding dividend policy enhances the forecast of dividend payments and the choice of the appropriate valuation models, which increase investors' confidence and boost market activity and economic growth. Evidence of agency problems in MENA markets could persuade regulators to instigate new and foster existing governance mechanisms to address this prominent issue. The results should encourage policy makers, board of directors, analysts, institutional investors as well as other investors to scrutinize corporate governance issues to restore the integrity of local markets.

1. Introduction

Dividend policy refers to the payout policy that a firm follows in determining the size and pattern of cash distributions to shareholders overtime (Baker et al., 2011). The term *policy* rejects the possibility of randomness and arbitrariness in determining its pattern and size and implies some consistency and predictability (Allen and Michaely, 2003). In spite of the extensive research on dividend policy for many decades, no universally accepted explanation is achieved (Baker et al., 2011). In markets that are far from being perfect, distinguished by information asymmetry, agency problems of debt and equity, and prudent and, often, irrational investors, the irrelevance theory proposed by Miller and Modigliani (1961) is no more a satisfactory answer. Hakansson (1982, p. 415) notes that "dividends continue to flood the empirical world with cash as regularly and as consistently as the sun scorches the desert, and one is hard put to characterize this pattern as being founded on irrelevance". Therefore, more efforts should be put in place to clarify the picture and uncover the puzzle.

Another issue that contributes to the fuzzy picture of dividend policy and hinders the elaboration of new perspectives is the consistent focus of prior research on developed markets with an extreme negligence of developing and emerging

E-mail address: I.jabbouri@aui.ma

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markets. It is suggested that corporate finance models are developed with assumptions that are consistent with developed countries, which causes these models to fail when tested in emerging ones (Bekaert and Harvey, 2000). In the same line, Lagoarde-Segot (2013b) contends that managerial models are developed in Western countries, which make them poor guides to business decisions when applied in a different institutional context. Black (1976) found substantial differences in dividend policy between developed and emerging capital markets. For instance, it is argued that banks dominate financial systems and control the financings channels of closely held firms in emerging markets. In this context, direct communication with creditors and shareholders along with regular site visits enable these investors to have access to confidential information, which limits the signaling power of dividend payments (Aivazian et al., 2003). Lagoarde-Segot (2013b) argues that these differences raise a challenge for academics and practitioners. To overcome this challenge and develop adequate approaches for doing business in these markets, the author suggests revisiting established models while taking into consideration the specificities of emerging and developing countries.

The objective of this research is to explore dividend policy in Middle East and North Africa (MENA) and identify its main determinants. The study uses a sample of firms from ten MENA countries over the period between 2004 and 2013 to gain a different perspective on the topic. This research will use panel data analysis to test for the impact on dividend policy of the most important factors identified in the literature. These factors include: size of the firm, financial leverage, growth, current profit, expected future profits, historical pattern of dividends, liquidity, free cash flow and the state of the economy. The choice of these factors is motivated by prior empirical literature that shows their influence on dividend behavior in developed markets.

The rest of the paper is organized as follows. Section 2 delineates the motivation and background of the study. Section 3 introduces the testing environment. Section 4 presents the research hypotheses. Section 5 outlines the set-up of data and methodology, and defines the different measures and variable used in this research. Section 6 illustrates the empirical procedure and Section 7 discusses the results. Section 8 presents the robustness tests before concluding in Section 9.

2. Motivation and background

Dividend policy continues to retain the interest of management, shareholders, creditors, and academics. The importance attached to this corporate decision arises from its interconnection with other corporate decisions, such as investing and financing, and its impact on shareholders' wealth and on the whole economy. Allen and Michaely (1995) report the influence of dividend policy on the firm's investing and financing policies as well as other areas of corporate finance. Several other studies report the impact dividend policy has on the stock price through the information contents embedded in the dividend decision (Black and Scholes, 1974; DeAngelo and DeAngelo, 2006; Grullon et al., 2002; Walter, 1956). Since both management and insiders are reluctant to disseminate the true economic conditions of their firms (Leuz et al., 2003), investors welcome substantial cash signals that convey relevant information and lower the estimation risk. Given the influence dividend policy has on investors' decisions, management pay a close attention to this critical task, setting the dividend policy (Allen and Michaely, 1995; Baker and Powell, 1999; Baker et al., 1985). Further, dividend income is an integral part of the national income; therefore, it helps grasp an idea about the overall performance of the economy (Papadopoulos and Charalambidis, 2007).

Dividend policy has retained scholars' attention since the 50s of the last century (Gordon, 1959; Lintner, 1956, 1962; Miller and Modigliani, 1961) and remains as the most debated issue (Hafeez and Attiya, 2009) and one of the most challenging topics in modern financial economics (Black and Scholes, 1974; Frankfurter and Wood, 2002) in both developed and emerging economies. The first study on the topic was conducted by Lintner (1956); and despite the efforts of scholars during the last few decades to reveal the secrets of dividend policy, they were unable to provide an acceptable explanation for the observed dividend behavior. This fact paved the way for the introduction of the dividends puzzle concept (Black, 1976). Feldstein and Green (1983, p. 17) support black's conclusion and note that: "The nearly universal policy of paying substantial dividends is the primary puzzle in the economics of corporate finance." Baker, Powell, and Veit (2000, p. 255) offer additional support for this view: "Despite this voluminous amount of research, we still do not have all the answers to the dividend puzzle." This controversy makes dividend policy a topic of ongoing debate (Baker et al., 2002) in both developed and developing countries (Hafeez and Attiya, 2009). One of the most important unanswered questions in this debate is what are the factors that determine dividend policy? As Baker et al. (2011) note, this issue has vexed financial economists for more than 50 years.

This study focuses on MENA emerging markets. Amidu (2007) recommends, for future research, to extend the investigation on dividend policy to other emerging markets, especially those in MENA region. In the same line, Lagoarde-Segot (2013b) highlights the importance of international business studies that should focus on reexamining established models and knowledge in light of the particularities of emerging and developing economies. Baker et al. (2011) link the differences among payout policies in emerging and developed financial markets to the availability of good projects in high-growth economies, the difficulty in raising equity capital and the influence of controlling shareholders who may prefer reinvestment to distribution. Thus, dividend policy in emerging markets is different, in nature and characteristics, from that of developed markets (Black, 1976; Glen et al., 1995). The debate on dividend policy can gain additional insights by investigating MENA emerging markets.

The central motivation of this study is to bridge the existing gap in the literature by exploring the factors influencing dividend policy in MENA emerging markets. This research has important implications for both theory and practice. It will extend the literature on dividend policy by identifying for the first time the determinants of dividend policy in MENA