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Evaluation between Dividend Policies and Firm Value

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Abstract – For public companies whose shares are traded on the stock exchange, dividend distribution (dividend) policy is important. Therefore, the aim of this study is to explain the effect of dividend policies on the value of the firm by talking about dividends and dividend payment policies. When the studies in the literature are examined, it is determined that the value of companies varies depending on the dividend decisions. At the same time, valuation theories related to dividend distribution policy are being developed. The first of these is the dividend irrelevance theory, which argues that dividend distribution does not affect market value. The second is the bird in hand theory, and according to this theory, the bird profit in the hand refers to the bird capital gain on the branch. In this theory, he argues that the firm's dividend distribution policy affects market value. The last theory is the tax difference theory. According to this theory, the issue of whether the dividend policy affects the market value of the firm in terms of the taxation rate should be evaluated. Thus, it is seen that dividend policies are important in terms of the value of the companies and these findings provide valuable advice to the company managers.

Keywords – Dividend, Dividend Policies, Firm Value, Bird in Hand, Market Value

I. Introduction

The positive difference between the revenues obtained by the enterprises at the end of the accounting period and the expense expenditures made to obtain these revenues is called profit [1]. The main purpose of businesses is to make a profit [2]. The main purpose of financial management is to maximize the market value of firms or the wealth of firm shareholders [3]. The basic decisions of financial management are divided into three as financing, investment and dividend (dividend) policies [4].

Especially when we consider dividend distribution or dividend policies, it is expressed as the distribution of a part of the profit obtained by the companies to the shareholders or partners at the end of the accounting period [5]. It is implemented on the basis of some assumptions of dividend policy [6]. The first of these, "Excellent capital markets", is that no buyer or seller of securities is large enough to have a significant impact on the then-current price of their transactions. All traders have equal and no-cost access to information on the current price and all other relevant characteristics of the stocks, and there are no brokerage fees, transfer taxes or other transaction costs when securities are bought, sold, or issued. There is no tax difference between distributed and undistributed profits or dividends and capital gains. Second, "Rational behavior" means that investors always prefer more wealth to less and are indifferent to whether a particular increase in their wealth will be in the form of cash payments or an increase in the market value of their stocks. The last one, "Complete certainty", the concept of which is to create full assurance of each investor, of each company's future investment program and future profits. With this assurance, there is no need to distinguish between stocks and bonds [6].

Thus, for public companies whose shares are traded on the stock exchange, the dividend distribution policy is important [2]. A dividend policy is used as a reward for investors or to maximize firm value. Dividend policy is one of the most important financial management decisions [7]. With the dividend policies of the enterprise, it is decided how and at what rate the profit will be distributed at the end of the period and whether the profit distribution affects the value of the company is revealed. In the opinion of [6], it is stated that the value of the firm does not affect the capital structure nor does dividend decisions. However, in the opinion of [8] and [9], it is obtained that dividend decisions affect the value of the firm. Supporting this theory, [10] states that dividends have a meaningful effect on stock value, while stock price also has a meaningful effect on dividends. The signaling effect, which is dominated by those who consistently pay dividends, and the bird effect in hand also find that theories are appropriate. Similarly, [11] examines 63 non-financial firms on the Bucharest stock exchange for the period 2001-2011 and [12] examines 10 firms operating in the IDX food and beverage sub-sector in the period 2016-2019, finding that the dividend distribution policy positively affects the firm's values. [13] provides parallel findings for Indian firms in the period 1999-2018 and [14] for Australia in the period 2007-2021.

Focusing on the above assessments, the aim of this study is to explain the impact on firm value by evaluating dividends and dividend payment policies. For this purpose, the studies in the literature are examined. The rest of this work is designed as follows. In chapter 2, the studies in the literature on dividend policies are evaluated and the factors affecting dividend decisions, dividend payment policies, dividend distribution methods and the effect of dividend policy on business value are summarized. In the last part, the result of the study is mentioned.

II. LITERATURE REVIEW ON DIVIDEND POLICIES

A. *Factors Affecting Dividend Decisions*

Some factors affect the distribution of profits. Some of these are as follows.

- Legal Rules: The enterprise is required to distribute its profits according to the provisions specified in the Turkish Commercial Code [15].
- Cash Situation: Businesses have to keep cash in order to continue their daily operations. However, the fact that the company has cash in its assets is not a very appropriate idea in the inflation environment. If the company does not hold cash and invests its cash in assets, it cannot distribute profits to its partners [1].
- Borrowing Ability: Businesses can meet the resources they need by either borrowing or not distributing their profits. In general, large companies can find debt very easily and have a flexible structure in finding debt. However, if the company has large debts, it meets its need for resources by not distributing the profit instead of using debt again [16].
- Limitations on Debt Agreements: Businesses are finding loans from some credit institutions to finance their resources. However, credit institutions impose some restrictions on the business for the money they lend. These restrictions affect the firm's profit distribution. For example, it may make provision that the firm should not distribute profits until the debt payment is over. This affects the company's profit distribution [15].
- Rate of Increase in Active Values: It is seen that the enterprise is growing rapidly in the face of the developing economy. It has to invest in some assets for the business to grow. Therefore, the company should not distribute the profits but direct them to assets [15].
- New Investment Plans: In order to finance the investment plan made by the company with limited borrowing, it must direct the profit it makes to the investment. For this reason, it does not distribute its profits and uses a firm as a mutual fund [15].
- Profitability: The business distributes the profit it obtains to the partners. However, when the partners do not receive the dividend they will receive and leave it in the enterprise, they prefer not to distribute the profit, assuming that it will be distributed as more profit in the future. In other words, the probability of the company to make a profit in the future also affects the profit distribution [16].
- Opportunity to Apply to the Capital Market: Since large companies are recognized, they can procure the resources they need from the capital

markets and distribute the profit they obtain. However, small firms are not able to meet the resources they need from the capital market because they are unrecognized and risky in paying off debt. For this reason, the profit obtained by the company meets its needs as self-financing [16].

 Inflation: Transactions need cash, especially during the period of inflation in the economy. For example, if the firm is going to renew a fixed asset, the depreciation it has allocated may not be enough. Therefore, it uses the profit that is not distributed. The structure of the economy is also affected by the profit distribution of the enterprise [15].

 Tax Status of Partners: The tax payment status of the partners in the enterprise also affects the distribution of profits. Partners pay more tax on the distributed profit. However, if the partners do not take the distributed profit and leave it in the enterprise, it enables the company to increase its value. After the value of the business rises, it causes it to sell common shares and pay less tax on the income it generates. Therefore, the profit distribution of the company is also affected [1].

 Maintaining Control Authority: Some firms meet their needs as self-financing instead of offering stocks and losing management of the resources necessary for their growth, or instead of paying debt by issuing bonds [16].

 Managers' Attitude: Some managers may not distribute the profit but direct it to the growth and market value of the company, while others may distribute the profit with the idea that not distributing the profit may reduce the value of the company. It depends entirely on the management policy of the company manager [16].

B. *Dividend Payment Policies*

The ratio of the portion of profit, which is the positive difference between income and expenses at the end of the period in enterprises, is determined according to the proportion of funds invested by investors, according to the expectations of investors, according to the tax deduction to be deducted and the earnings of the capital they invest. The rate of profit distributed in our country varies. The reason for this is due to the fluctuations in the economy [16]. A distribution policy that both increases the market value of the company and meets the expectations of the investor should be determined in the profit distribution policy in the enterprises. There are some policies that our business considers in the payment of dividends ([1], [16])

 Stable Dividend Policy: The portion of the profit to be distributed at the end of the period is the distribution of profit in an amount that increases steadily according to the financial condition of the company. The advantage of this policy for investors is that the amount of profit distributed increases as a result of increasing economic developments in the enterprise.

 Fixed Rate Dividend Distribution Policy: According to this distribution policy, firms are determined to determine the rate of profit distributed according to the fluctuations in the economy. If there are negative developments in the economy, the rate of profit distributed decreases, but if positive developments are experienced, the rate of profit distributed increases.

 Fixed Dividend Distribution Policy: The distributed portion of the profit obtained by the entity is distributed to the investors at the end of each period according to this distribution policy. This policy is advantageous as it provides a steady return in an uncertain economic environment. But investors expect an increasing rate of return, not a fixed return. Since investors have these expectations, it causes the market value of the companies implementing this policy to decrease.

 Fixed Dividend and Addition Payment Policy: According to this distribution policy, a certain profit distribution rate is determined first, regardless of the economic conditions of the company, the part of the profit to be distributed by the company. Then an additional payment is made to this rate. It has a minimum return for investors.

C. *Whether or Not the Company Decides to Distribute Dividends and Forms of Dividend Distribution*

Whether businesses decide to distribute dividends or not depends on the investment opportunities they will find in the market. If the company is likely to find investment opportunities in the market, the dividend distribution rate is low. However, if there is no investment opportunity in the market, the dividend distribution rate is high. Therefore, it is considered as a financing decision that will finance the resources of the company. In order to decide whether or not to distribute the profits of our business, it must be analysed according to the Walter formula and is as follows ([1], [4]):

r > ke should not distribute the entire profit of the firm,

r < ke firm can distribute the entire profit.

P = Market price of the stock,
D = Profit distributed per share,
E = Profit per share,
r = Profitability of investment,
ke = It is the rate of return of the market.

For example, if we assume that the company's growth rate is 22%, the market rate of return is 19%, and the stock has a profit of 5 TL per share, how much of this profit should be distributed so that the market value of the company is higher?

r = 0,22 and ke = 0,19
"r > ke" The firm should not distribute the profit.

Assuming that the entity distributes $3 from a profit of $5 per share, the market price of the stock is;

P = = 27,98 TL.

If the business distributes all the profit, i.e. $5, the market price of the stock;

P = = 26,32 TL.

If the business does not distribute any profits, the market price of the stock;

P = = 30,47 TL.

Thus, since there is an "r > ke" in enterprises, the non-distribution of profit has revealed that it will increase the market value.

At the same time, the study mentions that dividend distribution in enterprises is made in different ways. The first of these is the form of distribution of cash dividends. Businesses may regularly pay cash once, twice or more times a year for the profit to be distributed at the end of the period. In our country, cash profit payments are made once a year. Sometimes companies pay extra cash profit on the condition that it is not repeated, or they pay special dividends based on an unusual event. In addition, the fund obtained as a result of the full or partial sale of the company is distributed in the name of cash liquidation profit [17];

The second is referred to as stock repurchase. The profits that the enterprises will distribute at the end of the period are distributed not in cash, but through the repurchase of shares. In this way, the number of available shares of the firm decreases [17]. The last is the payment of dividends as a debt note. When it needs funds for its business activities, it uses the profit to be distributed by giving interest-bearing bonds to its partners for certain periods of time [1]

Therefore, when the cash flow obtained by the company at the end of the period with its additional investment is accepted as TL 2,000,000 and this cash flow is distributed in the form of regular cash dividend payments to 1,150,000 existing stocks;

$$\text{Profit Per Share} = \frac{Net\ profit}{Number\ of\ shares} = 1{,}74\ \text{TL}$$

It is determined that a regular cash dividend payment of TL 1.74 will be made to the enterprise.

D. *Impact of Dividend Policy on Firm Value*

As a result of the evaluation made above regarding the payment of dividends, payment methods and whether dividend payment can be decided, companies make an optimal decision in profit distribution and the optimal decision to be made will maximize the value of the company, while the wrong decision to be made in this regard will adversely affect the value of the firm [18]. The business also takes into account the cash situation when distributing its profits. In general, it does not distribute the profits of the companies in the development stages and is used as auto-financing and the profit obtained in the maturation stages is distributed. The enterprise is required to calculate the optimal profit distribution rate [19]. Some theories arise when determining the most appropriate dividend distribution decision. Some of these are;

a.Dividend Irrelevance Theory: This theory, put forward by [6], states that whether or not the firm distributes the profits it obtains never affects its value. Whether the enterprise distributes a high rate of dividends or distributes a small percentage of dividends, it affects the risk and the value of earning power, not the profit distributed by the firm. There are some assumptions about the lack of a relationship between the dividend and the value of the firm. These are [17];

 There is no tax payment in the market,

 Businesses can access the information they want at any time,

 It is not very important that the cost of the debt used by the enterprise is above the cost of capital,

 The investment policies and financing policies of the enterprise are independent of each other,

 There are no transaction costs.

b. The Bird in Hand Theory: According to the view of [8] and Gordon [9], the dividend to be distributed by the firm is the bird in hand, but the capital gain of the firm is the bird in the branch [15]. The bird in the branch is always risky, but the risk of the bird in hand is low. Therefore, if investors avoid risk, their income expectation will be low, but if they do not avoid risk, they will expect more income. Investors' expectations increase or decrease the cost of equity. The cost of equity decreases and the value of the firm increases If investors receive their share of the profit, because they avoid risk. However, if investors leave the profit in the company, they will not be risk averse, the risk will increase, the cost of equity will increase and thus the value of the firm will decrease [20]. According to the bird in hand theory, dividends have two more effects. These are the signal effect and the customer dividend effect.

 Signal Effect: Investors who will invest in the business examine the dividend status in the company's financial statements for past periods. If there is an increase in the dividend situation, it indicates that the company will be good in the future or if there is a decrease, the company will experience negative events in the future. In other words, the company's dividend distribution creates a signal effect for those who will invest. This increases or decreases the value of the company [20]. Thus, according to dividend signal theory, a dividend payment can be considered by the market as a positive sign of a firm's future performance [7]. [21], which investigated the effect of the dividend policy of non-financial companies on firm value in Pakistan during the period 2006-2013, endorses the signal theory. The researcher finds that if a firm's annual reports show more earnings per share, it can create more company value accordingly.

 Customer Impact: Some investors focus on the firm's dividend yield in the short term by avoiding risk, or some investors take the risk and focus on long-term capital gains. Thus, companies decide how to distribute their profits according to the expectations of the investor. This decision of the enterprise affects the value of the company [19].

c. Tax Difference Theory: According to the theory of [22], the willingness of the partners to pay less tax and the idea of benefiting from the time value of money also affect the value of the firm. When the partners receive their profit, they may decide to leave the profit in the business if it causes them to pay taxes with a higher tax rate. However, if the partners do not receive their profits on the condition that they pay less tax or pay the tax later, they expect return as capital gains ([19], [23]).

III. CONCLUSION

One of the main goals of businesses is to make a profit so that they can survive. Deciding whether to distribute the profits obtained is being investigated by many researchers. The reason for this is that whether or not firms make the decision to distribute their profits affects the value of those firms, that is, the stock prices. Therefore, the aim of this study is to evaluate the effect of dividend policies on company value by explaining the dividend policies, payments and distribution methods of the firms.

When the previous studies in the literature are examined, the value of the firms varies depending on the dividend distribution decisions. In the financial literature, how the dividend policy affects the firm value is discussed and valuation theories related to the dividend policy are developed. The former argues that dividend distribution does not affect market value in the theory developed by [6], while the second, in the theory developed by [8] and [9], argues that the firm's dividend policy affects market value. The third view, in the theory developed by [22], states that whether the dividend distribution policy affects the market value of the firm should be looked at from the point of view of the taxation rate. As a result, it is seen that dividend policies are important in terms of the value of companies.

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