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Determinants of Dividend Payout in Private Insurance Companies of Ethiopia

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ABSTRACT

This study aimed to identify determinants of dividend payout in Ethiopian private insurance companies. To achieve this objective, a quantitative research approach was used. Secondary data from ten insurance companies for eleven years period from 2010 to 2020 were used as panel data for analysis. The study analyzed both internal and macroeconomic variables; profitability, liquidity, leverage, firm size, firm age, and growth from internal factors and GDP and inflation from Macroeconomic variables. The random effect model was used to identify the effect of each explanatory variable on the dividend payout of Ethiopian private insurance companies. The result showed that profitability, liquidity, and firm size were found significant factors in dividend payout. Contrary to the predictions, the remaining variables-firm age, leverage, growth, GDP, and Inflation found to be insignificant. Thus, profitability, liquidity, and firm size have a positive and significant effect on dividend payout as predicted. Therefore, Ethiopian private insurance company managers should prioritize profitability, liquidity, and firm size when making dividend payout decisions.

1. INTRODUCTION:

Dividend payout policy plays a significant role in deciding what proportion of the income should be reinvested and what proportion should be divided to shareholders as a return on their investment. Management should consider dividend policy decisions because if a firm resolves to pay more dividends, it retains fewer funds for investment purposes, and the company may be forced to return to capital markets to earn funds (Baker and Powell, 2000).

Dividend policy can be varied through different companies. In addition, it has different meanings as the shareholders need. High divination does not imply that having high profit as a low percentage of dividends does not show the loss of the insurance companies. For this reason, the dividend is the most complicated issue to decide. It determines other performance and objectives (Chigazie, 2010). Dividend policy is one of the crucial decisions in corporate finance. The dividend is the issuing of profit to the shareholders. Corporate dividend policy has been examined by financial managers, and firms at massive. Firms are faced with the dilemma, of sharing dividends to stockholders and retaining their earnings with the view to reinvesting it back into the business to promote growth of the business. As the business extended, the earning flow of the stockholders grows over time. The decision of the firm regarding how much earnings could be paid out as dividends and how much could be retained is the concern of the dividend policy decision (Marfo et al., 2011).

Researchers have declared that firms use dividends as a structure for financial signaling to outsiders with regard to the stability and growth prospects of the firm. Paying out more cash dividends will lead to increase in the price of the stock. However, increasing cash dividends refers to that less money is available for reinvestment. Reinvesting back fewer earnings into the business will under the expected growth rate (Masum, 2014).

Even though much research conducted by several researchers, the issue of the dividend policy factor remains unresolved. Beary and Myers (2005) listed issuing dividends as one of the top ten important unresolved issues in the field of advanced corporate finance. Black and Scholes (1974) concluded that dividends are the inital puzzle in the economics of finance. Black (1976, p.5) wrote that "the harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just do not fit together". Alternatively, earnings retained are the major internal sources of financing the growth of the firm. In practice, every firm follows some kind of dividend policy, which holds a portion of the net earnings in such a manner that it will not constitute a threat to dividend payment (Chigazie, 2010).

Even now, researchers produce considerable attention and thought to solve the dividend puzzle, resulting in a large number of conflicting hypotheses, theories, and explanations. Researchers have initially focused on developed markets; however, additional insight into the dividend policy debate can be gained by an investigation of developing countries, such as Ethiopia which is currently lacking in the literature.

To this end, this study examined the determinants of dividend payout of insurance companies in Ethiopia. In addition, based on the result of the investigation suggestions and recommendations will be made for stakeholders of insurance companies for their better decision.

1.1. Statement of Problem

Dividend policy is controversial. Many doubtful reasons are given for why dividend policy might be significant, and many of the declares made about dividend policies are economically illogical. Even, in the real world of corporate finance, determining the most related dividend policy is considered an important issue (Ross 2003, p.633). Dividend policy has been the subject of considerable debate since Miller and Modigliani (1961) illustrated under the condition of perfect capital market and zero taxes, dividends were irrelevant.

But financial researchers and practitioners have disagreed with Miller and Modigliani's proposal and have argued that they based their proposal on perfect capital market assumptions; assumptions that do not exist in the real world. At the same time, Gordon (1962) and Walter (1963), proved dividends to be related to the valuation of the firm and hence the shareholders are seen to be not at all disinterested as to the payment of dividends and retention of profits.

The above debate has changed into much controversy after Black (1976) called it a “Puzzle” whose pieces do not fit together. Since then, the amount of empirical and theoretical research on dividend policy has increased dramatically (Baker, 1999). However, Allen et al. (2000, p.2499) put it in a nutshell “Although several theories have been put forward in the literature to explain their pervasive presence, dividends endure one of the thorniest puzzles in corporate finance”. Recently, Brealey et al. (2008) claim that even if numerous researchers have attempted to solve the "dividend puzzle" identified in Black (1976), these studies have not yet come to an unequivocal solution.

Research into dividend policy has seen not only that a general theory of dividend policy remains elusive, but also that corporate dividend practices differ over time, among firms and across countries. Moreover, the empirical results on dividend policy are inconclusive. Existing studies appear to focus on the dividend behaviors of companies in developed economies, but the proof from developing economies is very limited. Therefore, examining the dividend policies of firms in developing countries like Ethiopia will offer more insights into the factors that influence corporate dividend decisions.

According to Amidu and Abor, (2006) who investigated the determinants of dividend payouts in Ghana, found that the payout ratios are positively related to profitability, cash flow, and tax but negatively related to growth and risk. Over time, factors that affect the dividend policy of a company have increased substantially and opened a wide discussion among investors and researchers. This has determined the researchers to go deeper into the issue and try to examine the influencing factors that might be considered by the management of Ethiopian insurance companies in deciding the appropriate dividend policy. As far as the researcher's knowledge the dividend policy issue in Ethiopia has been studied by (Dagnaw, 2009; Kinfe, 2011; Nuredin, 2012; Simegn, 2013; and Mitiku, 2015). All of the above research was focused on the banking sector but (Nuredin, 2012; Henok 2016; Samuel, 2017; and Habtamu, 2019) the researchers' conclusion has a big difference in some variables for instance the variable firm size and leverage are insignificant in the study of (Samuel, 2017; Habtamu, 2019; and Nuredin, 2012) but they are significant in the study of Henok (2016). In addition, liquidity has a positive effect on the dividend payout ratio in the study of (Samuel, 2017; Habtamu, 2019; and Nuredin, 2012) but it has a negative impact in the study of Henok (2019). Generally, there are literature gaps in the studies.

Therefore, further research is required to study the dividend policy of firms in developing countries. This study presented results about the determinants of dividend payouts of Ethiopian insurance companies and the results will contribute to filling the literature gap that occurs in developing country context. Furthermore, the desire of this study is to identify the major factors that determine Ethiopian insurance companies' dividend payout.

2. Objective of the study

The main objective of this study is to examine the determinants of dividend payout of insurance companies in Ethiopia by considering both internal and external factors.

3. Research Methodology

To achieve this purpose explanatory research design was used for the study. The explanatory type of research design helps to identify and evaluate the causal relationships between the different variables under consideration (Marczyk et al., 2005). Explanatory research determining the relationship between the dependent variable (Dividend Payout Ratio) with firm-specific independent variables (profitability, liquidity, leverage, growth opportunity, firm size, and firm age) and External factors inflation and GDP. The study described the results by comparing them with empirical evidence. Hypotheses were formulated and tested based on empirical reviews.

In this study, the quantitative approach was used. The quantitative approach is often concerned with establishing relationships between variables (Theobald, et al., 2002). According to Patel and Davidsson (2003), a quantitative method means that measurements going to be done when collecting data. This will be followed by statistical analysis and processing procedure that is based on the collected data. Aliaga and Gunderson, (2002) defined, in contrast, that quantitative research is

explaining phenomena by collecting numerical data that are analyzed using mathematically based methods.

The study aims to generalize the facts established in the sampled Ethiopian insurance companies as regards the determinants of dividend payout. This generalization under the quantitative method can be collected through a systematic way of seeking facts and causes of phenomena, focusing on the analysis of numerical data, uses of controlled measurements, and statistical analysis to test the stated hypotheses. The researcher gathered numerical data of variables from financial reports of ten consecutive years from ten Ethiopian insurance companies. The study followed a quantitative approach to analyze those phenomena of a company that appear to affect the dividend payout decision.

Quantitative and secondary data type was used for this research for panel data analysis. These data were from financial statements of selected companies which were collected from headquarters and, GDP and inflation-related data from NBE from the year 2010 to 2020 of 10 insurance companies. Brook, (2008), also stated that a panel data set has two major advantages; first, it can address a broader range of issues and tackle more complex problems than pure time series or pure cross-sectional data alone, and by appropriately structuring the model, the researcher can withdraw the impact of certain forms of omitted variable bias in the regression result. Second, it is often examined how the relationships between variables change. Hence, by merging cross-sectional data and time series data, the researcher can increase the number of degrees of freedom, and thus the power of the test, by employing information on the dynamic behavior of a large number of entities at the same time. Furthermore, Hsiao, (2003) narrates a panel or a longitudinal data set as one that follows a given sample of individuals over time, and thus provides multiple experiences on each individual in the sample.

The target population of the study was all insurance companies operating in Ethiopia. Currently, there are 18 insurance and one reinsurer companies in Ethiopia. Of these, only one is a government-owned company and others are private companies. This study used 10 insurance companies out of 19 insurance companies. To discuss dividend policies it needs companies that have more than 10 years' dividend history. Based on this, the selected Insurance companies were; Nyala Insurance Share Company, Awash Insurance Share Company, Nile Insurance Share Company, Lion Insurance Share Company, National Insurance Corporation Share Company, Nib Insurance Share Company, Global Insurance Share Company, United Insurance Share Company, Africa Insurance Share Company, and Oromia insurance share company. The study used a purposive sampling technique based on the years of operation and availability of data.

3.1. Model Specification

According to William et al., (2010), model construction includes specifying relationships between two or more variables; perhaps extending to the development of predictive or descriptive equations.

To achieve the aim of this study, the Random effect panel data regression model was used. Panel data involves the pooling of observations on a cross-section of units over several periods and provides findings that are simply not detectable in pure cross-sections or pure time series studies (Freeman et al., 1982). The general form of the panel data model can be specified as:

$$Yi,t=\alpha i+\beta Xi,t + \varepsilon i,t$$

$$\boldsymbol{DPO} = \boldsymbol{\beta 0} + \boldsymbol{\beta} 1\text{INFit} + \boldsymbol{\beta} 2\text{GROit} + \boldsymbol{\beta} 3\boldsymbol{PR}\text{Fit} + \boldsymbol{\beta} 4\boldsymbol{LIQ}\text{i, t} + \boldsymbol{\beta} 5\boldsymbol{LEV}\text{it} + \boldsymbol{\beta} 6\text{SIZit} + \boldsymbol{\beta} 7\text{GDPit} + \boldsymbol{\beta} 8\text{AGEit} + \text{Є i, t}$$

Where;-

DPO: Dividend Payout Ratio = Dividend / Net Profit

INF: inflation= (the price index the year-the price index of the previous year)/the price index of the previous year X 100

PRO: Profitability = Net Profit / total asset

SIZ: Firm size= Natural logarithm of total assets

GRO: Growth = (current year net income – previous year net income) / previous year net income

LIQ: Liquidity = Current Assets/ Current Liability

LEV: Financial Leverage = Total Liability/ Total assets

GDP: Growth Domestic Product annual real GDP growth rate.

AGE: Firm age

βo: Constant term

β1, 2, 3, …..8 are parameters to be estimated;

Є : is the error component for the company i at time t assumed to have to mean zero

E [Є it] =0

i = Insurance company i = 1, . . .10; and t = the index of time periods and t = 1, . . . 11

4. RESULT AND DISCUSSION

Before running the regression, the data sets were checked for certain diagnosis tests. Normality, Multi-collinearity, heteroscedasticity, Omitted variable, and autocorrelation tests have been made to fit the Classical linear regression Model (CLRM) assumptions and to assure that the model is applicable.

There are two frequently used models for the estimation of panel data analysis. These are the Fixed Effect Model (FEM) and the Random Effect Model (REM) (Gujarati, 2004. The choice of a fixed effect model over a random effect model or vice versa is based on the use of Haussmann's test. The Haussmann's test, a model specification test was engaged for this study to conclude the more appropriate model from the fixed effect model (FEM) and Random Effect Model (REM). Based on the Haussmann test Random effect model was used.

Table 1: Random Effect Regression Result

Random-effects GLS regression				Number of obs =	108	
R-sq:	within = 0.4349			Number of groups =	10	
	overall = 0.3379			Wald chi2(8) =	71.46	
				Prob > chi2 =	0.0000	
DPO	**Coef.**	**Std. Err.**	**z**	**P>|z|**	**[95% Conf.**	**Interval]**
AGE	-0.0048255	0.0098564	-0.49	0.624	-0.0241437	0.0144926
SIZ	0.1243145	0.0537282	2.31	0.021	0.0190091	0.2296199
GRO	-0.0753584	0.0570322	-1.32	0.186	-0.1871395	0.0364227
LEV	-0.5654053	0.3608163	-1.57	0.117	-1.272592	0.1417816
LIQ	0.3210471	0.1325258	2.42	0.015	0.0613012	0.580793
PRF	2.251775	0.6686089	3.37	0.001	0.9413256	3.562224
INF	0.0017282	0.0024576	0.7	0.482	0.0030885	0.006545
gdp	0.0042409	0.0146157	-0.29	0.772	0.0328872	0.0244053
_cons	1.765002	1.117776	-1.58	0.114	3.955803	0.4257996
rho	**.36778136**					

Source: STATA 15 from annual reports of sampled insurers

From the random effect regression; the result independent variables firm size, liquidity, and profitability of insurers have an important effect on the dependent variable, a dividend payout ratio of the insurers at a 5% significance level. While the firm's age, growth, leverage inflation and GDP have an insignificant effect on the dividend payout of the insurers at a 5% significance level. The R-squared value was 43.5% indicating that 43.5% of the variation in the result of dividend payout ratio was caused by variability of the independent variables used in the model. Furthermore, the Wald chi2(8) was 71.46 and the probability of not rejecting the null hypothesis that there is no statistically important relationship existing between the dependent variable (DPO) and the independent variables, is 0.000000 indicating that the overall model is highly important at 1% and that all the independent variables are collectively significant in result in variation in dividend payout.

Profitability (PRF) and Dividend payout (DPO)

Profitability is found to be a positive and statistically significant determinant of the dividend payout ratio in private insurers of Ethiopia during the study period.

The findings are in line with the hypothesis formulated by the researcher regarding the significance and the sign.

From the above random effect regression output table 1, the coefficient of profitability (PRF) measured by return on asset is 2.25 and its P-value is 0.001. Holding other independent variables constant at their average value, when profitability increases by one percent, the dividend payout ratio (DPO) of sampled Ethiopian insurance companies will increase by 225% and be statistically important at a 1% significant level. Therefore, the researcher failed to reject the null hypothesis that profitability has a significant positive effect on dividend payout. This shows that there is no sufficient evidence to support the insignificant negative relationship between the dividend payout ratio and profitability.

The relationship between profitability (ROA) and dividend payout ratio (DPO) is positive as expected and this could be attributed to the fact that more profitable firms lead to paying more dividends. This finding is similar to the finding of (Bayelign and Ayalew, 2022; Workneh, 2021; Haimanot and Ravi, 2019; Pruitt and Gitman, 1991; Baker and Powell, 2000; Amidu & Abor, 2006; Al-Malkawi et al., 2007 and Nuredin, 2012). However; it contradicts the finding of (Temesgen, 2016; Anupam, 2012; Baker & Gandhi, 2007; and Christopher and Rim, 2014).

In addition, the finding is consistent with the agency cost and free cash flow hypothesis, where managers want to minimize the agency cost to shareholders. Insurers, that earn a higher annual profit, tend to pay a higher dividend to the shareholders. One of the reasons for this can be the lack of profitable investment opportunities in the country. This may suggest that Ethiopian insurers pay dividends by considering the level of profit.

Liquidity (LIQ) and Dividend Payout Ratio (DPO)

Liquidity is found to be a positive and statistically significant determinant of the dividend payout ratio across the sampled Ethiopian private insurance companies. From the regression result, the coefficient and probability of liquidity were 0.32 and 0.015 respectively. This showed that cash position is one of the important factors for the decision of dividend payment. This finding goes in line with the agency theory of Jansen (1986) which stated that companies with greater free cash flow have higher dividend payout ratios. Based on this theory, firms that have higher liquid assets are more open to agency problems than a firm with lesser liquid assets.

Haimanot and Ravi (2019), and Temesgen (2016) stated in their finding that liquidity had a significant and positive effect on the dividend payment of private insurance companies in Ethiopia. In addition, the findings of Werkineh (2021), and Bayelign and Ayalew (2022), on private commercial banks of Ethiopia showed the same, liquidity had a significant and positive effect on dividend payout decisions.

This result supports the signaling theory of Gupta and Banga (2010) Firms with higher cash accessibility can pay higher dividends than firms with lower cash levels. The finding is also consistent with agency theory, that firms with high cash and cash equivalent asset flows pay higher dividends to diminish the agency conflict between their managers and shareholders (Jensen, 1986).

Firm Size (SIZ) and Dividend Payout (DPO)

Firm size is expressed by using the log of the total company's assets. From the regression result above, the coefficient and probability were 0.124 and 0.021 respectively showing that asset size is a significant factor in dividend payout and had a positive effect on dividend payout of sampled private insurance companies of Ethiopia.

Firms with larger sizes tend to have lower transaction costs associated with acquiring new financing as compared to small firms. This supports the agency cost theory that the size of the company can be used as a proxy for external capital market access and larger insurers can manage to pay higher cash dividends because they have fewer limitations in acquiring external funds from the capital markets and have lower costs (Bayelign and Ayalew, 2022). The finding is consistent with the results of (Chekole, 2016; Seifu, 2018; Birhan et al., 2020; Kumar, 2021 and Heaney, 2007). On the contrary, (Saje E.M., 2015) found that bank size has a negative impact on dividend payout ratio by stating that

the Ethiopian banking industry is in its growth stage and the relatively larger banks compete to increase their market share to preserve their recent status. In addition to this, Medhe et al. (2010) and Desta (2021) found that size is not a statistically significant factor for a firm's dividend payout.

Insurers Age (AGE) and Dividend Payout (DPO)

The relationship between firm age and dividend payout was expected to have a positive relation. From the regression result above, the coefficient of firm age is -0.0049 and p value 0.62 which is insignificant at a 5% significance level but has a negative relation with dividend payout. As a result, the researcher rejects the hypothesis age has a positive and important effect on dividend payout.

Desta (2021) found that the age of the firm has an insignificant effect on dividend payout in Ethiopian private commercial banks. On the contrary, Temesgen and Vankati (2016) stated that firm age has a positive and significant effect on the dividend payout of Ethiopian insurance companies. The finding contradicts the life cycle theory that states relatively matured companies pay more dividends because when companies get mature interest for investment and growth decreases.

Leverage (LEV) and Dividend Payout (DPO)

Leverage which is measured by total liability to total asset ratio (debt ratio) was expected to be a significant factor in dividend payout with a negative effect. According to the random effect regression finding the coefficient and probability are -0.56 and 0.11 respectively. This is insignificant.

The negative relationship between leverage and dividend payout is in line with agency cost theory explained by the companies with lower leverage ratios tend to pay more dividends and companies with higher leverage ratios pay less dividends. Bayelign and Ayalew (2022) stated leverage is a significant variable in determining dividend payout in Ethiopian private commercial banks. On the contrary, the research of Haimanot and Jaladi (2019), Workneh (2021), and Temesgen and Venkati (2016) showed that leverage is an insignificant factor in dividend payout.

The possible reason for the insignificance of leverage for dividend payout can be due to the low level of long-term liability of insurers in Ethiopia. This is due to regulatory restrictions from NBE about the amount of long-term liability.

Growth (GRO) and Dividend Payout (DPO)

Growth, which is calculated by the ratio of net income increment, was expected to be the significant factor of dividend decisions with a negative effect. From the regression result, growth has a coefficient of -0.075 and a probability of 0.18. so this is insignificant for dividend payout.

In the research of Temesgen and Venkati (2016), growth was found to be an insignificant factor in dividend payout in Ethiopian insurance companies. On the contrary, the previous works of (Haimanot and Jaladi, 2019; Birhan et.al, 2020; Abor and Amidu,2006; Al-Malkawi et.al., 2007 and Nuredin, 2012) found growth as an important factor of dividend payout with a negative relationship in Ethiopian private commercial Banks.

GDP and Dividend Payout (DPO)

GDP which is a real annual gross domestic product of the country was hypothesized to have a positive and important effect on the dividend payout of insurance companies of Ethiopia. From the random regression result above the coefficient and probability are -0.004 and 0.77 respectively. This shows the reverse relationship between dividend payout and GDP but this effect is insignificant at a 5% significance level.

This finding is in line with the result of Werkineh (2021), who stated that GDP is an insignificant factor in dividend payout in Ethiopian private commercial banks. On the contrary, Haimanote and Jaladi (2019) found a positive and significant relationship between GDP and dividend payout in Ethiopian insurance companies. The result is also different from the finding of (Bragoli, 2014) who stated the country's economy experienced an expansion during the study period which led companies to make a profit and pay more dividends because there is more cash to pay to shareholders and (Abdul Ghafoor, 2014) who stated in his finding that increase in the GDP is assumed to increase in the corporate earnings of different companies, which ultimately leads to increase the dividend payout ratio.

Inflation (INF) and dividend Payout (DPO)

The inflation rate which is measured by the price index of all commodities was expected to have a negative and important effect on dividend payout decisions in Ethiopian insurance companies. The random effect regression result above showed that coefficient of 0.0017 and a probability of 0.48. This means Inflation has a positive effect on dividend payout but the effect is irrelavent at a 5% significance level.

This result is consistent with the finding of (Workineh, 2021) who found the inflation insignificant factor of dividend payout in Ethiopian private commercial banks. This finding contradicts the results of (Haimanote and Jaladi, 2019). When inflation in one country becomes high, most firms usually maintain a large portion of their earnings to avoid a drop in their balance of operation and to compensate for the reduction in the purchasing power of money and firms would not be interested in paying more dividends (Ghafoor, 2014). According to Haimanote and Jaladi (2019), inflation has a negative and important effect on dividend payout.

5. CONCLUSION

Dividend policy is one of the very important issues that determine what funds flow to investors and what funds are retained by the firm for future reinvestment. This study aimed to identify the most important factor that affects the dividend payout of private insurance companies operating in Ethiopia. Thus, the variables of two categories internal factor and macroeconomic factors. Internal explanatory variables were profitability (ROA), liquidity (current ratio), Firm size, Firm Age, Leverage, and Growth included to analyze their effects on dividend payout. GDP rate and annual Inflation were the two macroeconomic explanatory variables used to identify their effect on the dividend payout of Ethiopian

private insurers. To achieve the objectives, eight research questions and eight hypotheses were formulated. To address, research questions, test hypotheses, and answer overall study questions, a quantitative research approach was used. The analysis was performed on secondary data from audited annual reports of sampled 10 insurance companies operating in Ethiopia for the period of eleven years from 2010 to 2020 and the macroeconomic data from NBE. A random effect model was used for panel regression. Classical linear multiple regression assumptions were fulfilled by appropriate tests (multicollinearity, autocorrelation, heteroscedasticity, normality, and omitted variable bias).

From the regression results, liquidity, firm size, and profitability were found the most important factors of dividend payout in sampled Ethiopian private insurance companies. liquidity, firm size, and profitability showed a positive relationship with dividend payout, this means insurance companies that earn higher annual profit tends to pay more dividend to their shareholders. This supports the pecking order and signaling theory of dividend policy. In other cases, insurance companies that have higher liquidity ratios or with proper cash balances tend to pay more dividends to their shareholders. In addition to this insurance company with higher asset value tends to pay more dividends to its shareholders. This finding supports the agency cost theory which states that dividends act as a protection for investors because dividends reduce the excess cash available to managers after investment and operational activities. With the excess cash, managers may invest it in less-than-desirable investment opportunities, which may have undesirable risk and return characteristics for the investors. However, growth, leverage, firm age GDP, and inflation were found irrelevant factors of dividend payout decisions in Ethiopian private insurance companies.

In general result of this finding suggested that companies that are more profitable, in a good liquidity position, and have higher asset value pays more dividend. Profitability, liquidity, and firm size were found the most important factors in determining the dividend policy of private insurance companies in Ethiopia.

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