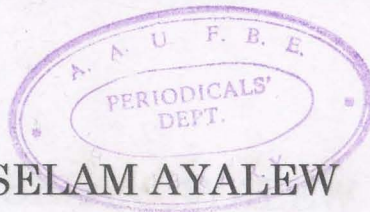


Dividend policy

Case study of Private Banks of Ethiopia



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Abstract

A number of studies have been conducted in the area of dividend policy in the developed capital markets. Few researchers also tried to investigate on dividend policy in emerging markets where the financial system is bank centered. This paper explicitly looks into the dividend decision determinants of the four private banks of Ethiopia namely Awash International Bank S.C, Bank of Abyssina S.C., Dashen Bank S.C. and Wegagen Bank S.C. from the year 1996 to 2002. The findings show that given the institutional structure of the banks, the undeveloped form of the financial markets and the age of the banks being in their early stage of growth, dividend decisions are primarily focused on fulfilling legal requirements, i.e., capital adequacy, liquidity and reserve requirements. In addition, the fund needs, the availability and access to external finance, tax, control (protection against dilution), shareholders preference and earnings are among the determinants that are identified to be factors that have dictated the dividend decisions of these banks.

Introduction

Corporate dividend policy has long been an issue of interest in the financial literatures. This issue has been examined under the assumption that the firm's objective is to maximize its market value. Dividend decision is one of the most important decisions of a company. Firstly, it affects the capital structure (financial decisions and investment decisions of the firm. The payments of dividends reduce equity in the firm as well as the cash balance of the firm. Thus, when a firm pays a dividend, it loses cash, one of its safest assets, and increases its financial leverage. Both of these effects would tend to increase the probability of bankruptcy.

Secondly, dividend policy is an integral part of company's financial and investment policy. In order to maintain a desired level of capital expenditure companies should have either to retain higher percentage of their earnings or finance their activities by borrowing or selling new equity. However, increased borrowing will increase the risk of bankruptcy as it increases the company's debt burden. Too, selling new equity will result in dilution of existing shareholders' control.

Statement of the Problem

The goal of a firm is to maximize the wealth of its shareholders. This is achieved by increasing the current and future earning power of the company. Increases in market share price and/or dividends are factors that add to the wealth of shareholders. In Ethiopia where there is no share market, however, it is difficult to determine the market price of company stocks. Thus, dividends will play an important role in maximizing shareholders return. Besides, dividend decisions are an integral part of the

company's investment and financing decisions that manage the company's growth.

In the Ethiopian economic environment where the equity market is not yet formed, the only return shareholders have been getting and still expecting from their investments is dividend. However, it is not always possible to increase dividends. There are a number of factors that hold a company back from continuously increasing dividend payments. Therefore, this study explicitly will try to address factors influencing dividend policy in the private banking industry of Ethiopia. It also will attempt to rank the significance of the identified factors with in the existing economic and market situations of Private Banks.

Objective of the study

The main objective of the research is the identification and analysis of the factors that determine the dividend decision of private banks in Ethiopia. It also tried to explore to what extent the banks under observation have considered these factors in making dividend decisions. In specific, the study has tried to focus on the following issues:

- The effect of companies dividend decision on their capital structure
- The importance of dividend policy in an economic environment where there is no equity market.
- The usefulness of dividend signaling in Ethiopian case where there is no share market.
- The role of insiders and agency costs in determining dividends.

Significance of the study

The success of companies highly rests on the quality of decisions made by top executives. Dividend decision is one of the important decisions that should be made, by executives, in line with the investment and financing decisions. Therefore, the results of this study are primarily believed to benefit executives of the firms under investigation in determining their dividend policy. It will also be relevant for all corporate share companies since they have to deal with dividends in appropriating their profits. Finally, this study is imagined to benefit academicians in laying down the groundwork for further research work in related fields.

Scope and delimitation of the problem

This study is concerned with factors influencing dividend policy in the private banking industry of Ethiopia. The study is delimited to the four private banks for the year 1996-2002: Awash International Bank S.C., Dashen Bank S.C., Bank of Abyssinia S.C. and Wegagen Bank S.C. This delimitation is made taking into consideration the age of the organizations, that is, those banks that have been in business for at least four years.

Methodology

The research has been conducted using descriptive research method. With this research method factors influencing dividend policy in the private banking industry of Ethiopia has been discussed. Data for the study has been gathered primarily using semi-structured interviews. Secondary data was gathered from annual reports, publications of the banks, company policy handbooks, websites and Journals.

Research Design

The research has been carried out in three phases. In the first phase company publications, financial reports, and manuals have been reviewed. Concurrently interview with concerned individuals i.e. financial managers and members of management board has been conducted. Data collected at this phase has been used as an input to develop questions for the structured interview that are tested in a pilot survey in phase two of the study. The answers for the questions in phase two were compared to the findings obtained in phase one of the study.

Sample

The sample size of this project was confined to private banks i.e., Awash International Bank S.C, Dashen Bank S.C., Bank of Abyssinia S.C. and Wegagen Bank S.C. The period covered years from 1996 to 2002. The sample selection is made considering the life of the banks since establishment, i.e., those banks that have been in operation for at least four years. This is done because it is believed that it will give a better picture of the dividend payment practice of the firms.

Organization of the study

The remaining part of the study is organized as follows. The second section covers the theoretical background of dividends and the results of related empirical studies. The third section deals with the analysis of findings of the study. Finally, the fourth section winds up by presenting the conclusion and recommendations.

2. Literature Review and Related Researches

2.1 An overview

Dividend is a return to shareholders on their investment. The dividend decision involves how much of the firm's earnings should be paid out in dividends and how much should be retained. A firm's earnings belong to its stockholders. Management can decide to either:

- Pay out in dividends — Provide stockholders with an immediate cash payment or
- Retain for reinvestment in the business —invest the money in business projects of the firm that are expected to enhance profitability and raise the value of the stock.

Deciding whether the firm's earnings must be retained to finance investments or be distributed to shareholders as dividends is a challenging task for management.

Companies pay dividends to reward existing shareholders and to encourage others to buy new issues of stocks at higher prices. A company that pays no dividends is demonstrating its confidence that it has attractive investment opportunities that might be missed if it paid dividends. If it makes these investments it may increase the value of the shares by more than the amount of the lost dividends. If that happens, its shareholders may be doubly better off. They end up with capital appreciation greater than the dividends they missed out on, and they find they are taxed at lower effective rates on capital appreciation than on dividends. (Fisher Black, 1976)

2.2 The Dividend Theories

The dividend policy has been a controversial issue for the last couple of decades. Why firms pay dividends and why they subsequently change their dividend has been a puzzle. Practitioners tend to think that dividends are important to prices while Scholars feel that in theory they should not make much difference. The three well-known theories of dividends are the Dividend Irrelevancy theory, Dividend Relevancy theory and the Residual theory.

2.2.1 Dividend Irrelevancy Theory

In their pioneering work, Miller and Modigliani showed that under certain assumptions the payment of a cash dividend should have no impact on a firm's share price. Under MM proposition the value of the firm is determined by the earning power of the firm's assets or its investment policy and that the manner in which the earnings stream is split between dividends and retained earnings do not affect the value of the firm. The MM dividend irrelevance viewpoint works under the following assumptions. (Jeff, 1998).

1. There are no taxes or transaction costs. In other words, financial markets are perfect.
2. All investors have the same beliefs regarding future investments, profits and dividends. This is called the *homogeneous expectations* assumption.
3. The investment policy of the firm is set ahead of time, and is not altered by changes in dividend policy.

Under such circumstances they concluded that:

- o Dividends will not have impact on the stock price

- The negative effect of not paying dividends in the short-run is compensated by the increased selling price of the stock in the future as well as larger later dividends.
- It is suggested that investors can tailor their income stream by selling off shares of a growing stock that does not pay dividends

In summary, this theory asserts that the firm's future cash flow is independent of the dividend decision, and any increase in the dividend simply results in equity dilution by the issue of more shares. This implies that the level of the firm's dividend and its subsequent change are irrelevant as far as the value of the firm is concerned.

2.2.2 Dividend Relevancy Theory

Supporters of this view argue that dividend becomes relevant as far as market imperfections exist. Dividend is vital because it affects the financing and investing decisions of the company, which in turn determines the firm value. Contenders of this view point, by relaxing the Miller and Modigliani (MM) perfect market imperfections, argue that in a world with market imperfection such as taxes, floatation costs, and transaction costs, a company's dividend policy affects its market value. The arguments for the dividend relevancy theory include:

Birds in the hand theory: According to this theory proposed by John Lintner and Myron Gordon, investors prefer high-payout firms because they like a certain amount of money today rather than an uncertain amount of dividend tomorrow. Dividends are believed to resolve the uncertainties of investors and reduce their required rate of return on

equity. In addition stockholders want the money in hand since they do not trust management to use the money to promote growth of the stock value.

Informational contents (signaling) effect: Dividend payments and announcements convey information to investors about management's future expectations of the firm. The reaction of investors to dividend actions may be reflected on stock prices for the reasons:

- Continuation of a dividend policy signals that the company is sound, even in the fact of a downturn in business.
- Increase in dividends is viewed as a statement that management is confident in the future earnings' improvement is seen as permanent.
- Reduction in dividends is taken as terrible news, which prompts investors to sell off the stock, subsequently lowering the price.

Therefore, managements sometimes maintain or even raise dividends in an attempt to prevent negative investor reactions to serious problems.

Clientele effect: this implies that investors are attracted to firms whose dividend policies meet their particular needs. Tax- exempt organizations and low income tax investors may seek out firms that pay large cash dividends. On the other hand investors who want to minimize their taxes or do not need cash income may prefer firms with no or low dividends.

Expectation Theory: Investors form expectations of what a company's next dividend will be and can become alarmed if those expectations are not met, even if the dividends paid is steady or increasing.

2.2.3 The Residual Dividend Theory

The third theory of dividends asserts that dividends are paid out of the residual or the leftover earnings remaining after profitable investment opportunities are exhausted. The residual dividend theory focuses on the firm's internal need for capital. It recognizes the cost effectiveness of retained earnings and will fund all viable projects with retained earnings before paying dividends. This theory implies that dividends are passive decision variables and that stockholders are indifferent to the division of funds between retained earnings rather than pay them out in dividends if the return on the reinvested earnings exceeds the rate of return the investors can obtain on other investment of comparable risk. However, one weakness of the residual theory is that it ignores what investors feel about receiving dividends.

2.3 Forms of dividend Payments

Companies pay dividends either in cash or other forms. Cash dividends are the most commonly used forms of dividend payments. Firms may also declare dividends in the form of Stock Splits, Dividend Reinvestment Plans, and Stock Repurchases.

Stock Dividends: A stock dividend is the payment of additional stock to stockholders. It represents nothing more than a recapitalization of the company, a stockholder's proportional ownership remains unchanged.

Stock Split: Stock split refers to the issuance of new shares in numbers proportionate to those already outstanding. This process does not result in

any change in ownership or control however reduces the par value of the stock proportionally.

Dividend Reinvestment Plans (DRIPS): Many large companies instituted dividend reinvestment plans by which a stockholder can reinvest his dividends in the stock of the paying corporation. Under these plans, stockholder is given a choice between receiving cash dividends and reinvesting them in the company. DRIPS typically come in two flavors:

- 1) "Old Stock" type of plan: Under this kind of a plan, if a stockholder elects reinvestment, a bank, acting on behalf of the company, takes the total funds available for reinvestment, purchases the company's existing stock in the market and allocates the purchased shares to each participating stockholder's account.

The advantage to investors is that transaction costs are low compared to typical brokerage costs because high volumes of shares are purchased. Too, it provides the company with a source of new equity that is free of flotation costs

- 2) "New Stock" type of plan: Under this type of plan, if a stockholder elects reinvestment, the company invests the dividends in new shares, which means this brings in additional equity capital to the firm. Companies typically offer 3 to 5 percent discounts (against the prevailing market price), so that investors can get in cheap.

The advantage to investors is that they can get into a company's stock that they like, at a cheaper price. The advantage to

companies is that they can raise equity without all the floatation costs.

Whichever the type of DRIPS plan, investors are taxed on the dividends even though they receive stock and not cash dividends.

Stock Repurchases—(Alternative to a dividend): Firm with cash in hand may use the money to buy some of its own stock. Stock repurchase reduces the number of shares outstanding, thereby increasing the earnings per share of the remaining stock. If the market maintains a constant price/earnings ratio, this will cause the price of the stock to increase. Therefore, the individual stockholder will see a capital appreciation in their stock holdings. This substitutes a potential capital gain for current cash income.

- Stocks can be repurchased in three ways
 - *Purchase on the open market*—this can effect the market price if a large number of shares are to be acquired
 - *Tender offer*—Purchase shares at a set price from any stockholders interested in selling
 - *Negotiate a deal with a large investor*—This usually involves purchasing the stock at a premium with money that belongs to all stockholders

In theory, shareholders are indifferent between cash dividends and share repurchases because their wealth would be identical in both cases. Share repurchases, through the reduction of shares, it will result in an increase in the value of the remaining shares. In reality, dividends are taxed as regular income, while share repurchases may be taxed as capital gains, thus,

creating a tax advantage to the repurchase alternative. On the other hand if repurchases are made through a tender offer, the firm incurs considerable transaction costs. These costs tend to offset some of the tax advantages.

There can be a variety of motives for repurchases including excess cash (that can cause agency costs and other problems if not disposed of), stock is undervalued, a need to eliminate small shareholders, to increase leverage, to increase reported earnings, and to consolidate shareholder control for large shareholders.

Firms that repurchase shares can be less leveraged, less profitable, and slower-growing than other firms. However, the stock market response will depend on how the corporation's motives are perceived.

2.4 Determinants of Dividend Policy

A firm's dividend policy represents a plan of action to be followed whenever the dividend decision must be made. The dividend policy must be formulated with two basic objectives in mind.

- 1) Maximizing the wealth of the firm's owners
- 2) Providing for sufficient financing

These two objectives must be fulfilled in light of a number of factors. These include:

Legal rules: most states (countries) have laws that regulate dividend payments of that firm which is chartered in that state can make. Legal rules have a significant effect because they provide the framework within which the dividend policy will be formulated.

a) *Capital impairment rule*: protect creditors by forbidding the payment of dividends from capital. "In some states capital is defined to include only the par value of the common stock; in others, capital is more broadly defined to include both the par value of common stock and the capital in excess of par account" (Baker, 1987)

b) *Insolvency rule*: corporations cannot borrow funds to pay dividends while insolvent.

c) *Net earnings rule*: requires that the firm have generated earnings before it is permitted to pay any cash dividends.

The above three legal restrictions affect different companies in different ways. Especially new or small firms, with a minimum of accumulated retained earnings, are more likely to be influenced by these rules in determining their dividend policy. (Moyer, 1981)

Liquidity position: Profits held as retained earnings are generally invested in assets required for the conduct of the business. A company that is growing and profitable may not be liquid. Therefore, it may be difficult to pay cash dividends because of its liquidity position. On the other hand, Jensen (1986) views that if firm has free cash flow, it is better off sharing them with shareholders as dividend payout (or retire the firm's debt) in order to reduce the possibility of these funds being wasted on unprofitable (negative net present value) projects.

Access to external financing: the more access a firm has to financial markets, the better ability it will have to pay cash dividends. Large well established firms with records of profitability and stability of earnings has easy access to different sources of financing. However, a small firm whose

stock is closely held and infrequently traded finds it difficult to sell new equity shares in the market to raise fund.

Shareholders preference: in closely held corporations with relatively few shareholders management usually knows the dividend desire of its shareholders and may act accordingly. If most shareholders are in high income tax bracket and prefer capital gain to current income, the firm can establish a low payout. In large corporations whose shares are widely held, dividend policy can be set considering market conditions. These include investment opportunities, cash flow need, and access to the financial markets and other related factors.

Control (protection against dilution) if a firm pays out higher percentage of earnings, new equity will have to be raised in order to recapture the additional dollar paid in dividends. In doing so, the existing shareholders control of the firm will be diluted. Therefore, some firms prefer to retain more of their earnings and pay out lower dividends rather than risk dilution. Though raising external capital in the form of debt can be used as an alternative to high earning retention, it increases the risk of the firm. (Moyer, 1981)

Stability of earnings: a firm that has relatively stable earnings is more likely to pay higher dividends because it will be able to predict its future earnings.

Need to repay debt: if a firm used debt to finance activities and wants to retire, it will require the retention of earnings.

Restriction on debt contract: debt contracts, particularly when long-term debt is involved, frequently restrict a firm's ability to pay cash dividends.

Inflation: "In an inflationary environment, funds generated by depreciation are often not sufficient to replace firm's assets as they become obsolete. Under these circumstances a firm may be forced to retain a higher percentage of earnings in order to maintain the earning power of its asset base" (ibid)

Growth Prospects: fast growing companies are usually in need of funds to finance their activities so they retain and reinvest higher percentage of their earnings rather than pay them out. On the other hand, more mature companies often pay out higher dividends.

2.5 Empirical Studies and Implications for Payout

Many studies have been conducted on dividend policy, focusing on the determinants of dividend yield and the dividend payout rate. Brennan (1970) showed how the differential taxation of dividends versus capital gains would induce a firm to minimize its dividend payments. This practice in the US gave rise to tax rules designed to prevent improper accumulation of funds within a company.

Information effects can explain both the size and the change in the dividend. Studies by Miller and Modigliani (1960) and Watts (1970) showed that changes in dividend have an informational impact on the share price. Initiating a dividend increases the share price and cutting a dividend results in a price decline. (Aivazian, 2001)

Gordon (1962) tried to show the dependence of dividend policy on investment policy and that investors viewed capital gains as riskier than

dividends. With the rise of dispersed share ownership and the separation of ownership from control, managers frequently face very little supervision of their investment decisions. As a result there is a natural tendency on their part to view the shareholder as just another 'stakeholder' and the corporate free cash flow as belonging to "the corporation" and not to the shareholder.

Jensen et al. (1992) identified insider ownership as one of the most influential determinants of dividend policy. They found out that if the insider owners hold the major share of the company then management naturally prefers not to declare more dividends but increases directors fees and so on. On the other hand, Miller and Rock (1985) argued that insider ownership is relevant to assessment of dividend signals. In addition, Holder et al. (1998) investigated the relationship between dividend policy decisions and investment decisions of the firms of 477 NYSE listed companies and he also found a very strong influence of agency costs on dividend policy decision of the firm.

The other agency problem associated with dividend policy pertains to the conflict between debt holders and shareholders; dividend payment potentially transfers wealth from bondholders to shareholders by reducing the expected value of the firm at the maturity of the bond and increasing the risk of default. If a firm is closely held there might be easier and less costly ways of communicating future profits than by paying a dividend.

A study conducted in emerging equity markets by Glen et al [1995] identified some characteristics of emerging equity markets with regard to payments of dividends. These include:

1. Emerging market firms do have a target dividend payout rate, like their developed country counterparts, but they are generally less concerned with volatility in dividends over time.
2. Shareholders exert a great deal of influence on dividend policy. This is obviously true when there is a single shareholder with a majority interest in the firm, but it is also true for firms with a well- diversified shareholder base.
3. Governments play a major role in the dividend decision- making process. Armed with the belief that investors need protection from unscrupulous firms, governments have identified a number of ways they can ensure that investors, especially minority investors, are paid their due and that the interests of creditors are not overlooked.
4. Little evidence on signaling or the irrelevance hypothesis exists.

3. Findings and Analysis

3.1 Institutional Back Ground

Following the Licensing and Supervising Banking Business Proclamation No. 83/1994 and 84/1994, about eight private banks have emerged and joined the market since 1994. The first private bank to take this initiative was Awash International Bank S.C. which was established and started operation in 1995. Table 1 presents information about subscribed and paid up capital, number of founding shareholders and date of establishment of the first four banks.

Table-1 General information about the Banks

<i>Name of the bank</i>	<i>Date of Establishment</i>	<i>Subscribed Capital</i>	<i>Paid Up capital (Initially)</i>	<i>No. of Founder Share holders</i>
Awash International Bank S.C.	1995	50,000,000	19,838,632	479
Dashen bank S.C.	1995	50,000,000	14,900,000	11
Bank of Abyssinia S.C.	1997	50,000,000	18,808,500	131
Wegagen Bank S.C.	1997	60,000,000	42,752,756	16

Source: Memorandum of Association and Annual reports of the banks

Nature of Business

Banks have unique characteristics that distinguish them from other firms.

Three characteristics of banks as identified by Kotch (1995) are:

- Most banks own few fixed assets because their function is primarily financial
- Many bank liabilities are payable on demand or carry short term maturates
- Banks operate with less equity capital than non-financial companies, which increases financial leverage and volatility of earnings.

Nature of Assets and Liabilities

The major proportion of Banks' assets and liabilities are highly liquid. The major components of bank assets are cash assets, securities and Loans and advances. Cash assets include vault cash, reserve deposit held with National Bank of Ethiopia and cash balance held with correspondent banks (local and foreign). Securities are financial instruments that include treasury bills and Government Bonds. Bank's current liability constitutes deposits – checking deposits, saving deposits, time deposits and all liabilities that are payable within 30 days.

The equity capital of banks includes the Share Capital and Legal Reserve. Some banks may include special reserve and retained earnings account in the equity capital section of their balance sheet.

The major income streams of banks are interest income – (earned from loans and advances) and commissions.

3.2 Forms of Dividend Payments

The companies under study have declared dividends during the period's 1996 -2002. Some of the companies chose not to distribute cash dividends,

instead the whole amount of the declared dividends were capitalized. This practice is similar to paying cash dividends by issuing additional shares where the ultimate effect in both cases is to increase the number of share capitals. Not all companies declared dividends as soon as they made profits. Those companies that chose to pay cash dividends waited some years to pay, however, those that capitalized by issuing additional shares started to declare from the time they started to make a profit.

3.3 Factors influencing Dividend policy- Ethiopian Private Banks

The impact and the level of importance of factors influencing dividend decisions differs from company to company depending on

- The institutional structure – whether it is a financial institution or non financial institution,
- The stage of business life cycle of the company - early stage, growth, maturity and decline, and
- The level of development of the financial markets in which the company is operating in.

Within the context of the Ethiopian financial markets and legal structure some of the factors that can influence the dividend decisions of Private Banks are identified as Legal and Statutory Requirements, Liquidity, Control (protection against dilution), Tax, Shareholders Preference, Availability and Access to External Financing, Funds Needs of the Company and earnings.

Legal and Statutory Requirements

The legal and statutory requirements of banks can be classified as:

- Legal requirements
- Supervisory requirements

Legal requirements

The legal rules that dictate the operation of bank activities that ultimately impact the dividend decisions of the banks are those enlisted in proclamation no. 84/1994. These rules prohibit any bank from paying out dividends if:

- *The bank's capital is not fully paid* - (i.e. there is an impairment of its paid up capital). When any company starts operation it is not uncommon to find a partially paid up capital. In Ethiopian case, the companies are required only paying 25% of the subscribed capital upon formation. Until the paid up capital is fully paid no bank can pay cash dividends.
- *All of the bank's capitalized expenditures are not fully recovered*. Capitalized expenditures include preliminary expenses, share selling commission, brokerage losses incurred by the bank and any other item of expenditure not represented by tangible asset.
- *The minimum required amount is not transferred to the reserve accounts*. The law requires the banks to transfer 25% or more of current net earnings to legal reserve account.

Capital Adequacy Requirement: Article 13 no 1 of proclamation no 84/1994 requires all licensed banks to maintain capital which is the greater of Birr 10

million or 8% of the bank's risk weighted assets in terms of the most recent annual balance sheet.

Supervisory Requirements

The National Bank of Ethiopia (NBE) is the supreme body which supervises and controls the activities of all banks in Ethiopia. NBE issues a number of directives that govern the activities of the banks – both private and state owned. These directives directly or indirectly impact the dividend decisions of the banks. The important ones for our discussion are:

- *Liquidity requirement*: all banks are required to maintain liquid assets of not less than 15% of its current liabilities.
- *Reserve requirement*: all licensed banks are required to maintain a reserve which is 5% of the current liabilities (deposits).

It is apparent to fulfill these two requirements in order to stay in operation. Unless these requirements are fulfilled the companies cannot pay any dividend to the shareholders. In support of the reserve requirement, it is stated in the memorandum of association of the companies that distribution of dividends from net profits should be effected after transfer of the legal reserve fund and other reserve funds as approved from time to time by the general meeting of the shareholders.

Liquidity

The institutional structure of the companies necessitates them to be liquid at any point in time. The liquidity ratio of the banks under study was well above (on average more than 30%) of the statutory requirement of 15%. Though their liquidity position was above the required level, dividend payments were

not effected. This was due to the higher importance given to the legal factors.

Control(Protection against dilution)

Among the four companies two of them have a policy not to increase number of shareholders with out the consent and approval of the existing shareholders. For this reason the company shares are held by a small number of shareholders that constitute more than 50% of the company shares. (Refer Table-2)

Table – 2 Summary of the shareholders status

	Awash	Dashen	Wegagen	Abyssinia
No. of Founding shareholders	479	11	16	131
No share holders (in 2001)	1423	33	38	1100
No of shareholders who own the largest portion (%) of shares	5 own about 10% of the shares	4 own more than 75% of the shares	5 own more than 65% of the shares	5 own 31% of the shares

The fact that the banks are closely held by small number of shareholders leads the decisions of dividend payments to be aligned with the needs and expectations of the shareholders. As it can be seen in table-2 a few number of individuals own a large portion of company shares. This is emphasized in the closely held banks. However, in the other banks where there are a

number of shareholders, it is difficult to know the interest of the shareholders. Thus, the management would be forced to determine the level of dividend to be paid.

Tax

There might be some shareholders who want to benefit from the capital gains arising from price appreciation of shares in the future rather than current earnings. However, in Ethiopia the tax rate on dividends is flat rate of 10% for all individuals whereas capital gains arising from sale of capital shares are taxed at 15%. Under this situation, as rational investor, individuals would tend to prefer receiving dividends at a lesser tax than gaining income by selling their shares which will be taxed at a higher rate. In addition, the uncertainties attached to the future of companies operating in unstable political and economic environment will tend investors to choose dividends to capital gains.

Shareholders Preference

As the theory and the empirical results showed in closely held companies with relatively small number of shareholders, it is usually easy for management to determine the desire of the shareholders especially, in such cases where the dividend decision is made by the General Assembly (Annual Shareholders Meeting). The board of directors presents the summary of the company's financial and operational results to the General Assembly to decide on the appropriation of the operational results.

Although some of the banks capitalized the declared dividend and issued shares in proportion to their holdings, those shareholders who want to receive cash immediately got the cash dividend by the approval of the board

of directors. Similarly, any one who wants to sell its share capital, except for Wegagen Bank S.C and Dashen Banks S.C., can sell its shares to whomever he/she wants. In case of these two banks, shares may be transferred to an outside person only after prior approval of the Board of Directors. In such situation preemptive rights of the shareholders is still preserved. Every transfer of registered shares is made in writing and in such form as the Board of Directors from time to time may approve. The holder of the registered shares shall be entered in the bank's share register three full days before the date of a meeting.

The board of directors is composed of twelve people that are selected from the shareholders. The board of directors has the power to appoint or replace the General Manager of the company. It also decides on any kind of decision that has long term impact and requires huge capital outlay. This practice reduces the agency cost, since the major decisions are made by the shareholders themselves, which is in the interest of the shareholders.

Availability and Access for External Financing

The financial market in Ethiopia is highly undeveloped. Bank loans and sale of equity shares are the only external sources that are available for companies to finance activities. When there is a need to finance activities from external sources, banks can use the inter-bank money market

Sale of equity shares has been used as a financing instrument. Companies issued shares to raise money. However not all banks sold to the general public. Two of the banks have a strict rule not to sell shares to new individuals. If the company has a need to sell new shares, the existing shareholders have a preemptive right. However, if a new individual approaches to buy, the other shareholders have to approve his/her

incoming. Due to this reason these banks opted to finance using the internally generated funds.

From the four banks under study two of the Banks have sold shares to the general public. The newly issued shares were sold at a premium. The existing shareholders and employees were offered at relatively lesser price than it was given to the outsiders (general public). Because the existing shareholders and the employees of the bank have a preemptive rights over the outsiders who want to buy the newly issued shares, most of the shares were bought by existing shareholders and employees.

Fund Needs of the Company

Over the early stage of the company's life cycle, it is rare to pay cash dividends. The banks under study are all in their infancy stage, the older one from the group is only 7 years old which is Awash International Bank S.C. These banks have a high growth prospect and they need funds for financing their expanding activities. As can be seen in Table 2 and Chart 1 the revenue of the banks is growing very fast. This shows the increasing level of the banks' activities which requires an injection of funds to finance these activities.

Management's decision on dividend payments is influenced by the company's financial need. If the company has promising investment opportunities, and is growing, it is apparent to retain internally generated funds. They might also require raising funds from outside sources depending on the NPV of the projects. In Ethiopia where there is undeveloped financial market and no stock market, the cheapest and easy way of raising funds for these banks is retained earnings. Thus, firms are highly dependent on internally generated funds and bank loans. The fact

that the services provided by financial institutions are limited, too, gives the firms hard time to raise funds from external sources. Therefore, the firms' fund needs is one factor that explains why these firms didn't pay cash dividends during first couple of years of their operation.

Table: 3 Percentage growths in Revenues

	1998	1999	2000	2001	2002
Awash	31%	69%	108%	167%	-
Dashen	8%	17%	108%	201%	232%
Wegagen	-	340%	425%	675%	718%
BOA	198%	717%	1152%	2037%	-

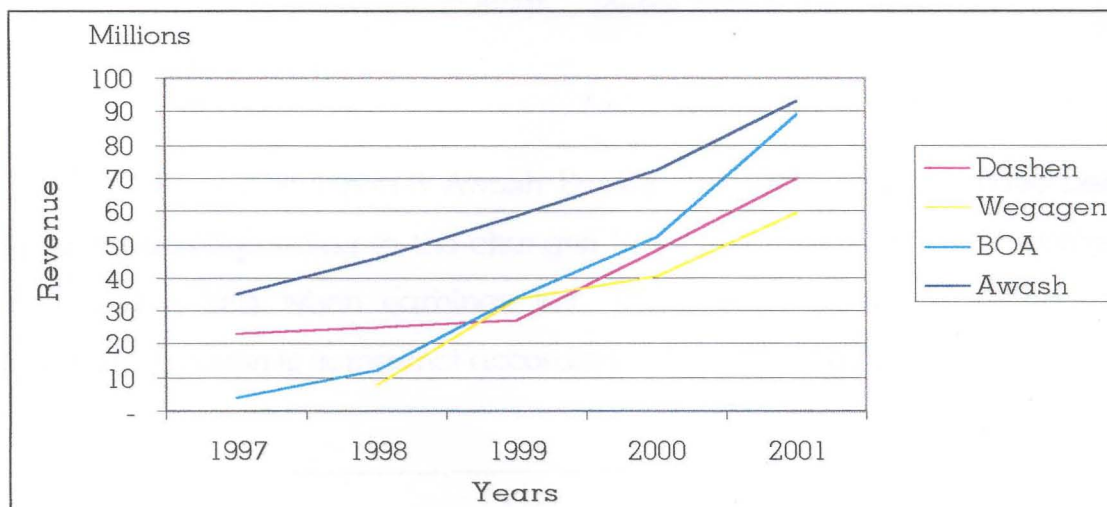


Chart 1 Growth in Revenues

3.4 Earnings vs. Dividends

As it has been discussed in the literatures, profit is one factor that determines the dividend decisions of companies. The net earnings after tax of each company have been growing thought at different rate. (Refer Chart 2 below).

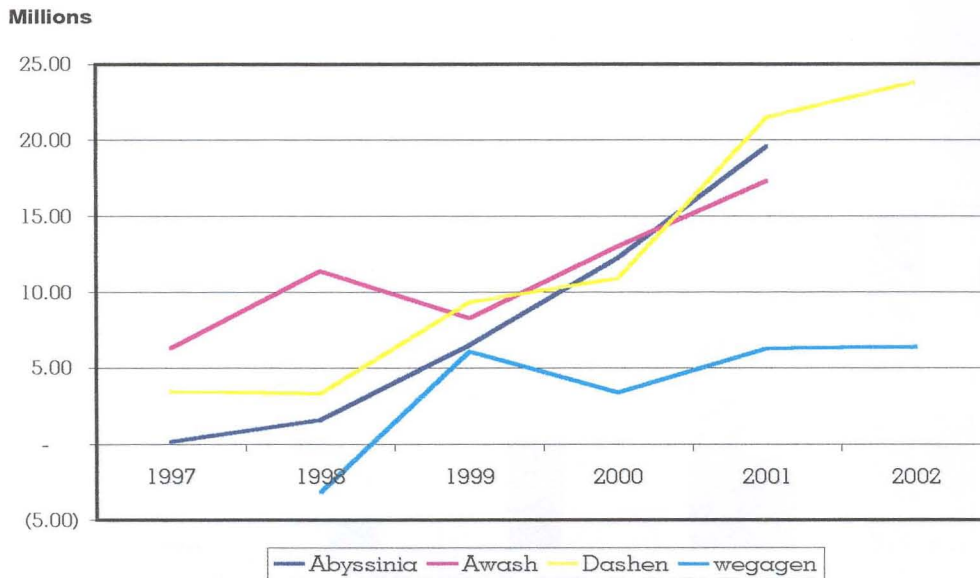


Chart-2: Growth in Earnings

As can be seen in Chart-3 Awash Bank's dividend payments have been growing corresponding to the changes in earnings. It rises when earnings rise and it falls when earnings fall. This explains that the company's dividend decision is somewhat according to the changes in earnings.



Chart -3 Relationships between Earnings and Dividend Payments – Awash International Bank S.C.

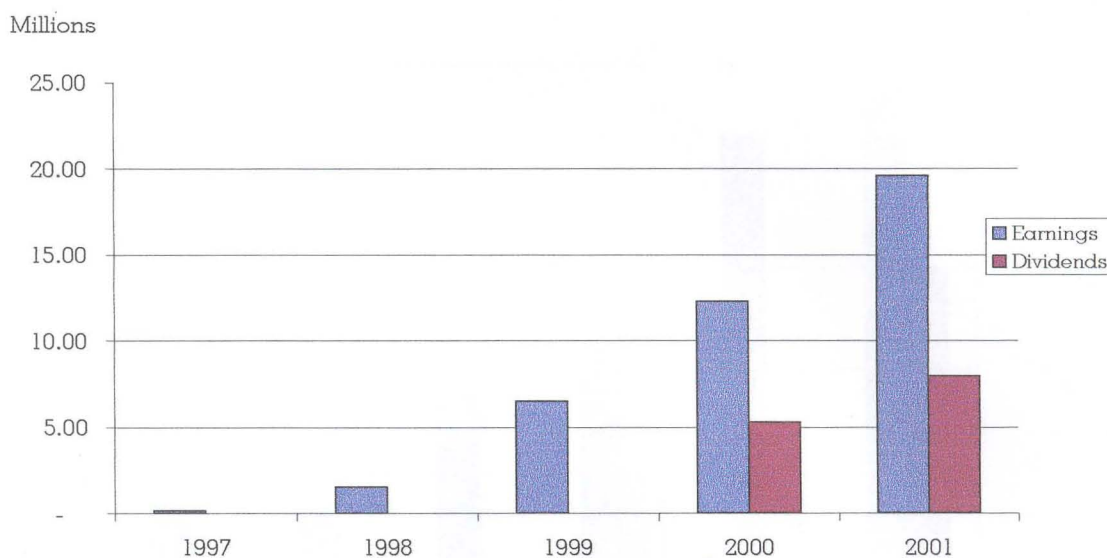


Chart -4 Relationships between Earnings and Dividend Payments – Bank of Abyssinia S.C.

The earnings of Bank of Abyssinia S.C have been growing (Chart 2). It has declared dividends in years 2000 and 2001 which is an amount equal to the retained earnings brought forward. In other words, all that is remaining in the retained earnings account this year is paid in dividends the next year (See Table-4). The bank has declared all the earning remaining after deducting the transfers to legal and special reserves, that is, 65% of the earnings. (www.bankofabyssinia.com).

Table 4: Earnings after Tax, Retained Earnings and Dividends of Bank of Abyssinia

	1999	2000	2001
Net Earnings After Profit	6,507,537	12,275,105	19,600,616
Retained Earnings	5,276,643	7,978,818	12,722,981
Dividends Declared	-	5,276,643	7,978,818

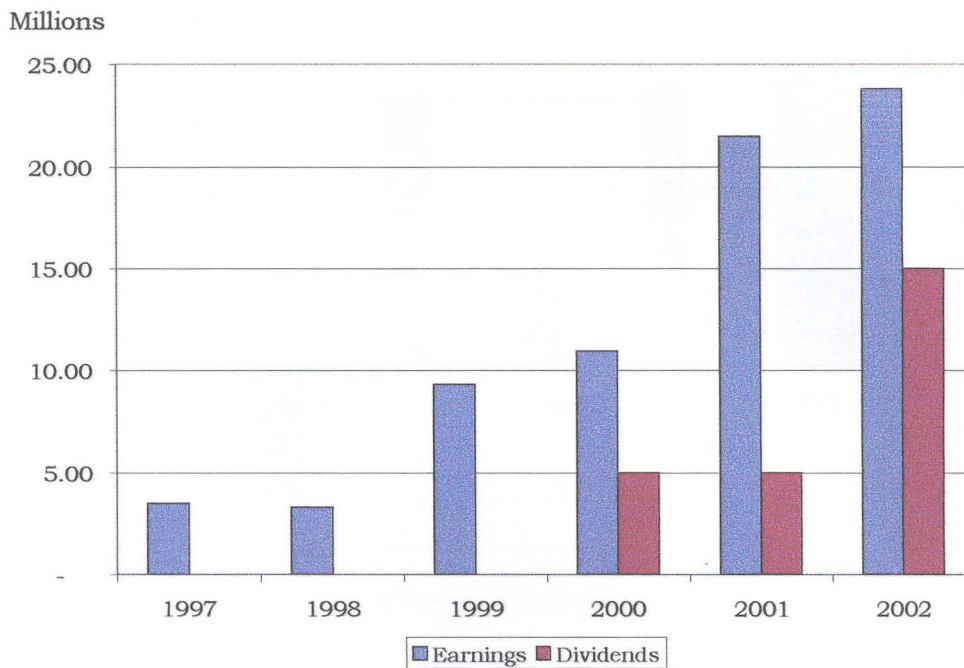


Chart-4 Relationships between Earnings and Dividend Payments – Dashen Bank S.C

When we look at the dividend payments of Dashen Bank S.C, it declared dividends on the fourth year of its operation and it was paid in cash. The first two payments were equal regard less of the increasing earnings. However, the third payment which was made in 2002 has increased by 200%. This payment was effected from the retained earnings.

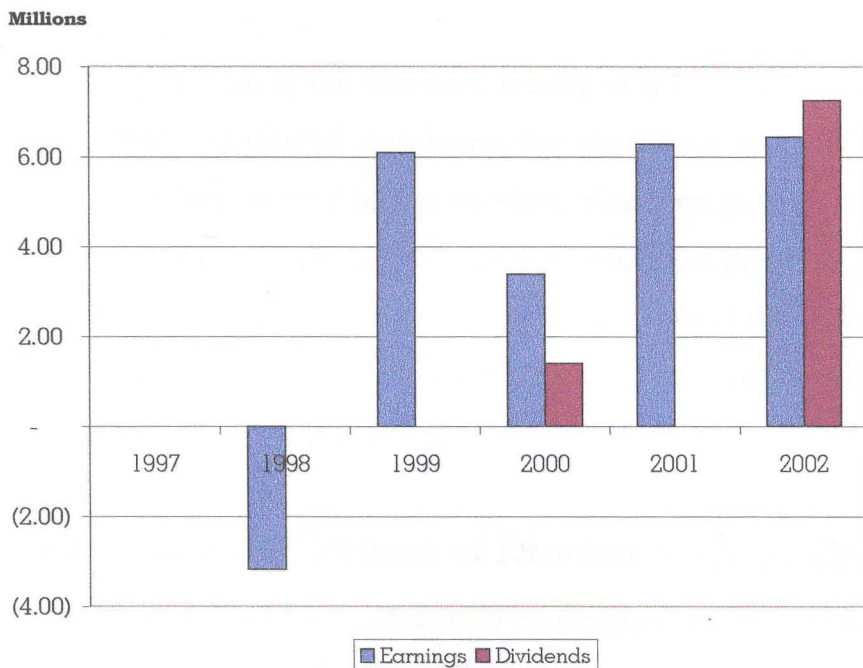


Chart -6 Relationships between Earnings and Dividend Payments – Wegagen bank

As can be seen in Chart-6 Wegagen Bank S.C has declared in year 2000 and year 2002 which has no link to those year's earnings. For that matter, dividends declared in 2002 were higher than that year's earnings.

In summary, except Awash Bank S.C, the rest three started payment of dividends after some time they made profits. Dividends have increased although there is no noticeable way of linking the trends in earnings and dividends of these banks. (See charts 4, 5 & 6). The dividends of Bank of Abyssinia in year 2002 were greater than that year's earnings showing that dividends are paid out of retained earnings not current earnings.

3.5 Equity structure

The equity portion of the balance sheets of the banks has increased. Some of the banks declared dividends by simultaneously issuing new shares which ultimately increased the number of shares outstanding and amount of paid up capital. As a result of this they used the internally generated funds for meeting their financing needs and also raised the level of their paid up capital without going through the troubles of new share issue (incurring announcement, brokerage and other related costs).

3.6 Information Content of Dividends (Signaling)

Dividend payments are used as a mechanism of signaling management's future expectation of the firm. This is true for companies that operate in a well-developed stock market and have highly traded shares. The fact that shares are not freely traded in the open market makes the role of dividend announcements in conveying valuable information to the investor less important. This is because some of the banks do not encourage new investors to buy new shares. In other words, the banks do not want to expand their shareholder base. For this reason the internally generated information is used for their own consumption since the management is not concerned in welcoming new shareholders. Therefore the use of dividends as signals for conveying valuable information for the public is less important in case of closely held banks at least for a time being.

4. Summary and Conclusions

- Dividend decision is one area of corporate decision which should be given due attention. All of the banks under study were young (in their early stage of the business lifecycle), though they declared dividends. Some of the banks capitalized the dividends by simultaneously issuing new shares. The others waited a couple of years by retaining all the company earnings, and started to pay cash dividends.
- Due to the institutional structure of the banks, all of them gave priority to adhere the legal requirements and supervisory requirements before paying out cash dividends.
- The second most important factor is the difficulty of raising funds from external sources. This situation forced the banks to highly depend on the internally generated funds. Due to this reason the banks under study chose to capitalize the dividend payments by issuing additional shares in proportion to their share capital. The ultimate effect of this decision was to increase the level of the paid up capital of the bank until it reaches the subscribed capital.
- Since all the banks were in their growth stage, they needed funds for financing their expanding activities. In order to meet this financing requirement they preferred to retain the internally generated funds by
 - not paying cash dividends and
 - capitalizing the declared dividends

- The shareholders preference and the need to control are one of the factors which is of less significance in case of the two banks which are closely held by few number of share holders. Even though, the other two banks have relatively large number of shareholders, the majority of shares are held by few numbers of individuals which gave them the highest voting power over the minority shareholders.
- The heavy reliance on bank financing and the non existence of capital markets as a source of finance in Ethiopia, reduces the signaling value associated with dividends.
- Banks should take into consideration the differential taxes on dividends and capital gains in passing dividend decisions. The lower taxation on dividends coupled with the uncertainties of the future makes them more attractive than capital gains.

Over all, the dividend decisions of the banks under observation given the institutional structure of the banks, the undeveloped form of the financial markets and the banks being in their early stage of growth, dividend decisions are primarily focused on fulfilling legal requirements. In addition, the fund requirements, the availability and access to external finance, tax, control (protection against dilution), shareholders preference and earnings are factors identified that influence the dividend decisions of these banks. Therefore, executives of the banks should analyze these factors according to their relative significance in determining their dividend policy.

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