EFFECT OF DIVIDEND POLICY ON STOCK PRICES FOR MANUFACTURING AND ALLIED INDUSTRY FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

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ABSTRACT

This study was geared towards investigating the effect of dividend policy on stock prices among listed Manufacturing and Allied companies in Kenya. To achieve the objective a descriptive survey design was used. The target population of the study included the top and middle level managers from operations department and finance department involved in compiling financial data leading to preparation of financial statements of all the 10 listed Manufacturing and Allied companies. The sample size of the population included 30 officers, 3 from each selected companies. The study used primary data which was collected by a semi-structured questionnaire. Data was analyzed using descriptive statistics and regression analysis. The study found that dividend policy affect stock price positively and dividend policy leads to high performance of Company's shares at NSE. It further established that free cash flow affect stock price to a great extent and an increase in Free Cash Flow lead to an increase in Stock prices. The study also established a significant relationship between tax incentives and stock prices and also a unit increase in Clientele effect lead to an increase in Stock prices. From the inferential analysis, the four independent variables that were studied explain 71.1% of the variables affecting Supply stock price as represented by R Squared (Coefficient of determinant). The ANOVA model is statistically significant in predicting how dividend policy, Free Cash Flow, Tax incentives and Clientele effect affect stock price. This was because the f-significance value of p of less than 0.05 was established (p=0.002 <0.05). The study concluded that sustenance and viability of the dividend policy in their firm is very viable and sustainable as compared to its contributions towards share prices and investment decisions at NSE affect the share prices of the company positively and paying of dividends to reduce the free cash flows had enhanced the performance of the company. The study also noted that low taxation rate of dividends acts as an incentive to investors looking to experience some tax cuts hence savings in the long run and also based on dividend policies the firms attracts different clientele and also firms paying lower dividend attract clientele that desire capital appreciation, while those firms which pay higher dividends attract clientele that require immediate income in the form of dividend. The study therefore recommended that the management of the listed firms should conduct a research on the different dividend policies to identify the one that would help to maximize their firms' stock price. Further researcher studies should be done in the Kenyan economy outside of the NSE, that is, for private firms to establish whether the same conclusions will be arrived at.

Key Words: *Dividend Policy, Free Cash Flows, Tax Incentives, Clientele Effect, Stock Prices*

INTRODUCTION

Dividend policy is concerned with financial policies regarding paying cash dividend in the present or paying an increased dividend at a later stage. Whether to issue dividends and what amount, is determined mainly on the basis of the company's unappropriated profit (excess cash) and influenced by the company's long-term earning power. When cash surplus exists and is not needed by the firm, then management is expected to pay out some or all of those surplus earnings in the form of cash dividends or to repurchase the company's stock through a share buyback program (Pandey, 2005). If there are no NPV positive opportunities, that are projects where returns exceed the hurdle rate, and excess cash surplus is not needed, then – finance theory suggests – management should return some or all of the excess cash to shareholders as dividends. This is the general case, however there are exceptions. For example, shareholders of a growth stock expect that the company will, almost by definition, retain most of the excess earnings so as to fund future growth internally (Omran & Pointon, 2004).

By withholding current dividend payments to shareholders, managers of growth companies are hoping that dividend payments will be increased proportionally higher in the future, to offset the detainment of current earnings and the internal financing of present investment projects. According to Pandey (2003), management must also choose the form of the dividend distribution, generally as cash dividends or via a share buyback. Various factors may be taken into consideration: where shareholders must pay tax on dividends, firms may elect to retain earnings or to perform a stock buyback, in both cases increasing the value of shares outstanding. Alternatively, some companies will pay "dividends" from stock rather than in cash. Financial theory suggests that the dividend policy should be set based upon the type of company and what management determines is the best use of those dividend resources for the firm to its shareholders (Dhanani, 2005).

As a general rule, shareholders of growth companies would prefer managers to have a share buyback program, whereas shareholders of value or secondary stocks would prefer the management of these companies to payout surplus earnings in the form of cash dividends (Al-Kuwari, 2009). Coming up with the dividend policy is challenging for the directors and financial manager of a company, because different investors have different views on present cash dividends and future capital gains. Another confusion that pops up is regarding the extent of effect of dividends on the share price. Due to this controversial nature of a dividend policy it is often called the dividend puzzle. Various models have been developed to help firms analyze and evaluate the perfect dividend policy. There is no agreement between these schools of thought over the relationship between dividends and the value of the share or the wealth of the shareholders in other words (Pandey, 2003).

Anand Manoj (2002) analyzed the results of 2001 survey of 81 CFOs of Business today- 500 companies in India to find out the determinants of the dividend policy decisions of the corporate India. He used factor analytic framework on the CFOs' responses to capture the determinants of the dividend policy of corporate India. The findings revealed that most of the firms have target dividend payment ratio and were in agreement with Lintner's study on dividend policy. CFO's use dividend policy as a signaling mechanism to convey information on the present and future prospects of the firm and thus affects its market value. The managers design dividend policy after taking into consideration the investors' preference for dividends and clientele effect. Dividend – paying companies were less likely to be larger and more profitable than non-paying companies, though growth opportunities do not seem to have significantly influenced the dividend policies of Indian firms. The rise of the number of firms not paying dividends is not supported by the requirements of cash for investments.

Sharma Dhiraj (2007) empirically examined the dividend behavior of select Indian firms listed on BSE from 1990 to 2005.The study analyzed whether or not the dividends are still vogue in India and tried to judge the applicability of one of the two extremely opposite schools of thoughts: relevance and irrelevance of dividend decisions. The study also analyzed the applicability of tax theory in the Indian context. The findings offered mixed and inconclusive results about tax theory indicating that the change in the tax structure does not have a substantial effect on dividend behavior of firms.

A number of conflicting theoretical models, all lacking strong empirical support, define recent attempts by researchers in finance to explain the dividend phenomenon. But to come with concrete conclusions, an intensive study of all theoretical models together with empirical proof is needed (Pandey, 2003; Dhanani, 2005; Al-Kuwari, 2009). The extensive literature on dividend policy in the last five decades have been unable to reach a consensus on research on a general dividend theory that can either explain the process of dividend decision making or predict an optimal dividend policy. Dividend policy can be of two types: managed and residual. In residual dividend policy the amount of dividend is simply the cash left after the firm makes desirable investments using NPV rule. In this case the amount of dividend is going to be highly variable and often zero. If the manager believes dividend policy is important to their investors and it positively influences share price valuation, they will adopt managed dividend policy.

According to Brealey and Myers (2002), the optimal dividend policy is the one that maximizes the company's stock price, which leads to maximization of shareholders' wealth. Whether or not dividend decisions can contribute to the value of firm is a debatable issue. Firms generally adopt dividend policies that suit the stage of life cycle they are in. For instance, high- growth firms with larger cash flows and fewer projects tend to pay more of their earnings out as dividends. The dividend policies of firms may follow several interesting patterns adding further to the complexity of such decisions (Zhou & Ruland, 2006). First, dividends tend to lag behind

earnings, that is, increases in earnings are followed by increases in dividends and decreases in earnings sometimes by dividend cuts. Second, dividends are "sticky" because firms are typically reluctant to change dividends; in particular, firms avoid cutting dividends even when earnings drop. Third, dividends tend to follow a much smoother path than do earnings.

Risk averse shareholders would be willing to invest only in those companies which pay high current returns on shares. Amidu (2007) observed that the class of investors, which includes pensioners and other small savers, are partly or fully dependent on dividend to meet their day-to-day needs. Similarly, educational institutions and charity firms prefer stable dividends, because they will not be able to carry on their current operations otherwise. Such investors would therefore, prefer companies, which pay a regular dividend every year. This clustering of stockholders in companies with dividend policies that match their preference is called clientele effect. This research therefore sought to establish whether there is an effect of dividend policy on share price of manufacturing and allied firms listed on NSE in Kenya.

STATEMENT OF THE PROBLEM

Managements' primary goal is shareholders' wealth maximization, which translates into maximizing the value of the company as measured by the price of the company's common stock. This goal can be achieved by giving the shareholders a "fair" payment on their investments. However, the impact of firm's dividend policy on shareholders wealth is still unresolved. The area of corporate dividend policy has attracted attention of management scholars and economists culminating into theoretical modelling and empirical examination. Thus, dividend policy is one of the most complex aspects in finance. According to Brealey and Myers (2002) dividend policy has been kept as the top ten puzzles in finance. The most pertinent question to be answered here is that how much cash should firms give back to their shareholders? Should corporations pay their shareholders through dividends or by repurchasing their shares, which is the least costly form of payout from tax perspective? Firms must take these important decisions period after period (some must be repeated and some need to be revaluated each period on regular basis.

Researchers Amidu (2007), Lie (2005), Zhou & Ruland (2006), Howatt et al. (2009), continue to come up with different findings about the relationship between dividend payout policy and stock prices of firms. A study by Amidu (2007) revealed that dividend policy affects firm performance as measured by its profitability. The results showed a positive and significant relationship between return on assets, return on equity, growth in sales and dividend policy. Howatt et al. (2009) also concluded that positive changes in dividends are associated with positive future changes in earnings per share. In contrast, Lie (2005) argues that there is limited evidence that dividend paying firms experience subsequent performance improvements. The behavior of corporations paying cash dividends to their shareholders is a matter of considerable interest to financial economists. Over the past three decades, a substantial amount of attention has been

directed toward the identification of the effect of dividend policy on stock prices of firms. Some researchers take a normative approach and developed various theories how firms should make their dividends policy decisions. Comparing the responses from various surveys to theoretical models, provided a way showing whether managers make dividend decisions consistent with the theoretical models. According to Allen and Michaely (1995), more theoretical and empirical work is required before a consensus can be reached.

In developing markets cash dividends are preferable by small shareholders because they rely on dividends for their consumption purposes. The firms are unable to attract funds from the shareholders unless they pay dividend. The present study contributes to the existing literature because it will update and expands the previous studies for an emerging Kenyan Securities market. A little work has been done on the divided policy based on the secondary data and focus is to test whether theoretical model holds for Kenyan case. The main focus was to identify the effect of dividend policy on stock prices for manufacturing and allied firms listed on NSE in Kenya.

OBJECTIVES OF STUDY

The main objective of the study was to establish the effect of dividend policy on stock prices among listed Manufacturing and Allied companies in Kenya.

SPECIFIC OBJECTIVES

1. To determine how dividend policy affects stock prices among listed manufacturing and Allied companies in Kenya.
2. To assess how free cash flows influence stock prices of listed Manufacturing and Allied companies in Kenya.
3. To determine how tax incentives influence stock prices of listed manufacturing and Allied companies in Kenya.
4. To examine how clientele effect affects stock prices of listed Manufacturing and Allied companies in Kenya.

THEORETICAL REVIEW

The study was guided by Miller and Modigliani's Analysis, Bird-In-The-Hand Theory, Tax-Preference Theory, Clientele Effect Theory, Dividend signaling theory and Agency Costs Theory.

Miller and Modigliani's Analysis

In 1961, two noble laureates, Merton Miller and Franco Modigliani (M&M) showed that under certain simplifying assumptions, a firms' dividend policy does not affect its value. M&M

concluded that given firms' optimal investment policy, the firm's choice of dividend policy has no impact on shareholders wealth. In other words, all dividend policies are equivalent. The analysis above implicitly assumes 100% equity financing. It can be extended to include debt financing. In this case, management can finance dividends by using both debt and equity issues. This added degree of freedom, does not affect the result. As with equity-financed dividends, no addition in value is created by debt –financing, since capital markets are perfect and complete so the amount of debt does not affect total value of the firm.

The most important insight of Miller and Modigliani's analysis is that it identifies the situations in which dividend policy can affect the firm value. It could matter, not because dividends are "safer" than capital gains, as was traditionally argued, but because one of the assumptions underlying the result is violated. The propositions rest on the following four assumptions: Information is costless and available to everyone equally. No distorting taxes exist; Floatation and transportation costs are non- existent; and non-contracting or agency cost exists. The level of dividend payments is in part determined by shareholders preference as implemented by their management representatives. However, the impact of dividend payments is borne by a variety of claim holders, including debt holders, managers, and supplier.

Bird-In-The-Hand Theory

The bird in the hand theory, hypothesized independently by Gordon (1963) and by Linter (1962) states that dividends are relevant in determining the value of the firm. This theory suggests that investors need to realize wealth in order to consume, therefore have a preference for cash dividends over capital gains. Lintner (1962) concluded that purely competitive markets, maximizing behavior, absence of issue costs and taxes, and identical interest rates to personal and corporate debtors are not sufficient to make investors indifferent to substitutions between retained earnings and debt in financing fixed budgets. Investors will always have preference for dividends as a result of time value of money.

Management must also choose the form of the dividend distribution, generally as cash dividends or via a share buyback. Various factors may be taken into consideration: where shareholders must pay tax on dividends, firms may elect to retain earnings or to perform a stock buyback, in both cases increasing the value of shares outstanding. Financial theory suggests that the dividend policy should be set based upon the type of company and what management determines is the best use of those dividend resources for the firm to its shareholders. As a general rule, shareholders of growth companies would prefer managers to have a share buyback program, whereas shareholders of value or secondary stocks would prefer the management of these companies to payout surplus earnings in the form of cash dividends.

Tax-Preference Theory

Tax preference theory is one of the major theories concerning dividend policy in an enterprise. It was first developed by R.H. Litzenberger and K. Ramaswamy. This theory claims that investors prefer lower dividend payment companies for tax reasons. They based this theory on observation of American stock market, and presented three major reasons why investors might prefer lower dividend payout companies. Unlike dividend, long-term capital gains allow the investor to defer tax payment until they decide to sell the stock. Because of time value effects, tax paid immediately has a higher effective capital cost than the same tax paid in the future. Up until 1986 in USA all dividend and only 40 percent of capital gains were taxed. At a taxation rate of 50%, this gives us a 50% tax rate on dividends and (0, 4) (0, 5) = 20% on long-term capital gains. Therefore, investors might want the companies to retain their earnings in order to avoid higher taxes. As of 1989 dividend and capital gains tax rates are equal but deferral issue still remains; If a stockholder dies, no capital gains tax is collected at all. Those who inherit the stocks can sell them on the death day at their base costs and avoid capital gains tax payment.

The dividend decision is an integral part of a company's financial decision-making as it is explicitly related to the other two major decisions — investment and financing decision. Corporate taxation influences the dividend decision in more than one way. On the one hand, it influences the net income-after-tax of the company, which, in turn, determines the capacity of the company to pay dividends, and, on the other hand, it may have implications for the net value received by the shareholders. Rate of corporate tax play an important role in determining the dividend policy, amount of dividend declared, distributed or paid by the company. A zero-dividend payout is not uncommon for young rapidly growing companies. However, companies may also be discouraged from paying higher dividends when these are doubly taxed once in the hands of the company and again in the hands of the shareholders. Personal income tax paid on dividend income amounts to a second tax on corporate profits.

Litzenberger & Ramaswamy (1979) put forward this theory claiming that investors prefer lower pay-out companies for avoidance of current taxation. Dividends are taxed at higher rates compared to capital gains hence the preference. Dividends are taxed in the year they are received while capital gains if any are taxed when stock is sold. Using the time value of money concept, dividends paid on present dividends has higher effective capital cost that capital gains taxed in future. Investors are risk averse and believe that incomes from dividends are certain rather than incomes from future capital gains; therefore they predict future capital gains to be risky propositions. They discount the future capital gains at a higher rate than the firm's earnings, thereby evaluating a higher value of the share. In short, when retention rate increases, they require a higher discounting rate. Where shareholders must pay tax on dividends, firms may elect to retain earnings or to perform a stock buyback, in both cases increasing the value of shares outstanding. Alternatively, some companies will pay "dividends" from stock rather than in cash.

Financial theory suggests that the dividend policy should be set based upon the type of company and what management determines is the best use of those dividend resources for the firm to its shareholders.

Clientele Effect Theory

Empirical evidence suggests that a firm's dividend policy tends to attract different groups of investors that is different clienteles, depending upon how these investors wish to receive their total rate of return on their investment in the company's stock. Specifically, those investors who want high current investment income and expect to forego anticipated long-term capital gains would buy the stocks of firms with a record of high dividend payouts. These might be bird-in-the-hand-type investors. Conversely, those investors who are in their prime earning and savings years might elect to own the stocks of firms with a record of low (or zero) dividend payouts. This would serve two purposes: These stockholders would defer taxes on dividends not paid out; and the foregone dividends could be plowed back into the company to earn a longer-term expected capital gain. This group might be in the tax-preference group of investors. This group's philosophy is that since they're wealthy as heck and don't need the cash (remember the proverb, "Poverty Sucks"); let the firm act as an agent for tax-deferred long-term growth. Research shows these different investor preferences regarding dividend payout patterns can be quite powerful.

Clearly, once a firm establishes its dividend payment pattern and attacks a given clientele, a shift in dividend policy would be ill-advised. While such a shift could occur, it would be tremendously disruptive to shareholders' portfolios. First, it would alter the manner in which total return would be received. Some retired shareholders who had elected high dividend payout firms would be faced with lower current income and the prospect of not being around in the distant future to enjoy the expected capital gain return that a low dividend payout profile entails. Younger investors who had elected to go with low dividend payout firms that switched to a high payout would now be faced with a higher tax burden and the prospect of not having the expected long-term capital gain. While investors could subsequently switch to firms that offered the dividend payout profile they desired, such changes would entail brokerage fees and general hassle costs. It's quite probable that a firm that caused its clientele to weather these disruptions might be rewarded with a lower stock price for their efforts. Typically, we see that once a firm establishes its dividend payout pattern they try to stick with it because they have attracted a given stockholder base.

So the general rule that we see in practice is one where the dividend policy, once established, is not subject to too much alteration. The clientele effect does a very good job in explaining this empirical finding. This line of thinking suggests that investors may have different reasons for favoring dividends as a result of institutional features such as regulatory requirements or tax differentials, or from behavioral preference. In particular, Shefrin and Thaler (1988) argue that

investors' personal life-cycle considerations determine the preference for dividends: older investors favour dividend paying stock because they substitute for a regular employment income. Allen *et al.* (2000) present a model in which dividends attract institutional investors because they are taxed less than retail investors, which in turn imposes a better governance structure. Brav and Heaton (1997) identify a preference to dividend payouts using the prudent man rules that require certain types of institutional investors to hold mature and thus dividend-paying firms. Dhaliwal, Erickson, Trezevant (1999) and Seida (2001) find empirical evidence that supports the existence of tax-based clientele for dividends. Perez-Gong alez ´ (2003) presents evidence that investors' tax status affects firm dividend policy. Hotchkiss and Lawrence (2002) find complementary evidence that firm returns are higher following dividends announcements for firms with institutional investors who favor dividends.

Signaling Theory

Dividend signaling is a theory suggesting that when a company announces an increase in dividend payouts, it is an indication it possesses positive future prospects. The thought behind this theory is directly tied to game theory; managers with good investment potential are more likely to signal. While the concept of dividend signaling has been widely contested, the theory is still a key concept utilized by proponents of inefficient markets. Because the dividend signaling theory has been treated with a skeptical eye by analysts and investors, regular testing of the theory has been performed. On the whole, studies indicate dividend signaling does occur. Increases in a company's dividend payout generally forecast positive future performance of the company's stock; while conversely, decreases in dividend payouts tend to accurately portend negative future performance by the company.

Two professors at the Massachusetts Institute of Technology (MIT), James Poterba and Lawrence Summers, wrote a series of papers from 1983 to 1985 that documented a testing of the signaling theory. After obtaining empirical data on the relative market value of dividends and capital gains, the effect of dividend taxation on dividend payout and the effect of dividend taxation on investment, Poterba and Lawrence developed a "traditional view" of dividends that includes the theories that dividends signal some private information about profitability, and stock prices tend to rise when a company announces an increase in dividend payouts and fall when dividends are set to be decreased. The dividend signaling theory suggests companies paying the highest level of dividends are, or should be, more profitable than otherwise identical companies, from an investor's viewpoint, paying smaller levels of dividends. This basic thought indicates the signaling theory can be beaten if an investor examines how extensively current dividends act as predictors of future earnings. Earlier studies, conducted from 1973 to 1978, drew the conclusion that a firm's dividends are basically unrelated to the earnings that follow. Still, a study in 1987

concluded that analysts typically correct earnings forecasts as a response to unexpected changes in dividend payouts and these corrections were a rational response.

A company with a lengthy history of dividend increases each year is signaling to the market its management and board see profits in the future. Dividends are not increased unless the board is certain the cost can be sustained. There are several stocks with histories that look like a good bet for investors seeking ever-increasing dividends, such as National Fuel Gas, the FedEx Corporation and the Franco-Nevada Corporation. Miller and Rock (1985); Bhattacharya (1979) in their model overlooked the standard finance model which assumes that in a perfect capital market, both outside investors and inside managers have access to the same information about the firm's current earnings and future opportunities. They replaced this assumption with the real world occurrence whereby managers know more about the firm's earnings and investment opportunities more than outside investors. In that case, the announcement of dividends convey certain information which is not available to the public thus the model suggest a positive relationship between asymmetry of information and dividend policy.
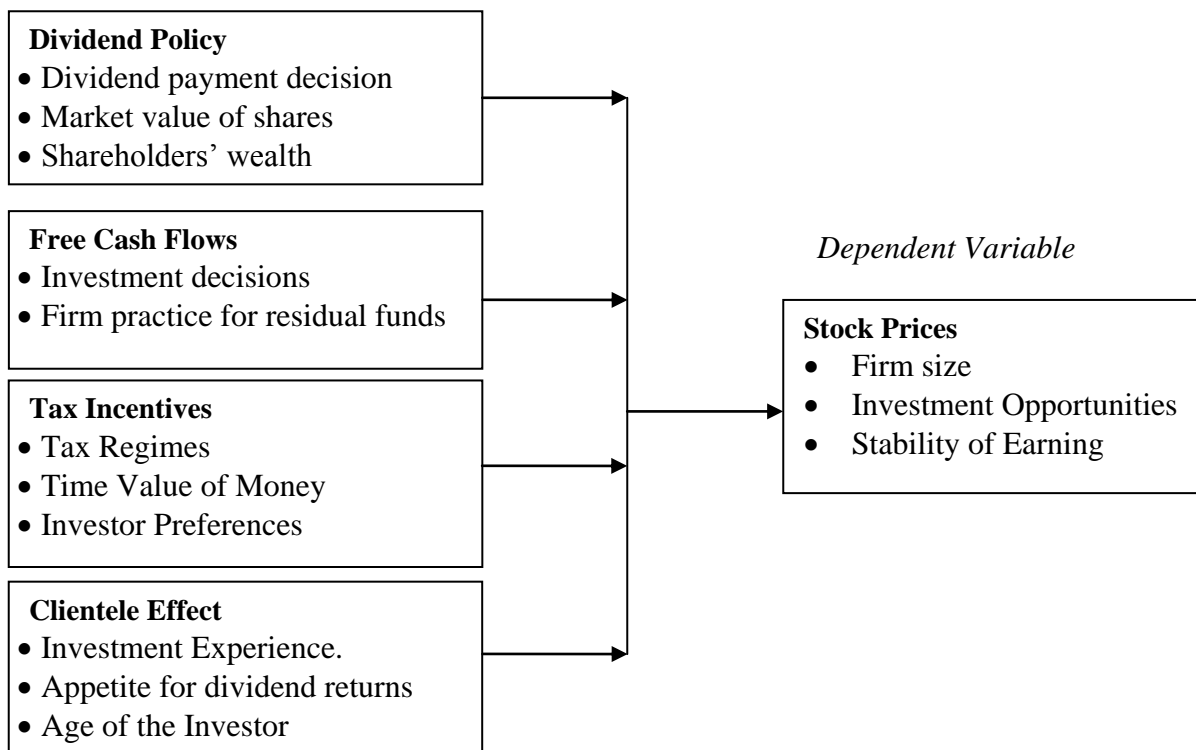
Agency Costs Theory

Traditionally, corporate dividend policy has been examined under the assumptions that the firm is one homogenous unit and that the management's objective is to maximize its value as a whole. The agency cost approach differs from the traditional approach mainly in the sense that it explicitly recognizes the firm as a collection of groups of individuals with conflicting interests and self-seeking motives. Under the agency theory, these behavioral implications cause individuals to maximize their own utility instead of maximizing the firm's wealth. According to Jensen–Meckling (1976), agency problems in corporations primarily arise from external debt and external equity. Agency theory underpins the relationship between the principal and the agent. Within the context of the firm, agency theory is primarily concerned with owner-manager relationship and with the need for shareholders to monitor management behavior.

This need arises due to the separation of ownership and control and the associated conflicts of interests that arise between shareholders (principals) and managers (agents). The agency-related rationale for paying dividends is based on the idea that monitoring of the firm and its management is helpful in reducing agency conflicts and in convincing the market that the managers are not in a position to abuse their position. Some shareholders may be monitoring managers, but the problem of collective action results in too little monitoring taking place. Easterbrook (1984) suggests that one way of solving this problem is by increasing the dividend payout ratio. When the firm increases its dividend payment, assuming it wishes to proceed with planned investment, it is forced to go to the capital market to raise additional finance.

This induces monitoring by potential investors of the firm and its management, thus reducing agency problems. Rozeff (1982) develops a model that underpins this theory, called the cost minimization model. The model combines the transaction costs that may be controlled by limiting the payout ratio, with the agency costs that may be controlled by raising the dividend payout ratio. The central idea on which the model rests is that the optimal payout ratio is at the level where the sum of these two types of costs is minimized.

CONCEPTUAL FRAMEWORK

Independent Variables

Dividend Policy
- Dividend payment decision
- Market value of shares
- Shareholders' wealth

Free Cash Flows
- Investment decisions
- Firm practice for residual funds

Dependent Variable

Tax Incentives
- Tax Regimes
- Time Value of Money
- Investor Preferences

Stock Prices
- Firm size
- Investment Opportunities
- Stability of Earning

Clientele Effect
- Investment Experience.
- Appetite for dividend returns
- Age of the Investor

Figure 1: Conceptual Framework

EMPIRICAL REVIEW

Several studies have been done on the information content of dividend announcements on the price of common shares. For example, a number of studies have analyzed the share price reaction to the announcement of changes in regular paid dividends (Ghosh and Woolridge, 2008 and Capstaff *et al*., 2004).This influence in terms of statistical significance does not differ from the impact of zero, which means there is no effect regarding the difference of tax rate on cash dividends and capital gains. A local study by Bitok (2004) on the effect of dividend policy on the value of the firms quoted at the NSE found that paying dividends reduces risk to the companies

and thus influence stock price. The study also found that dividend yields and payout ratio serves as proxies for the amount of projected growth opportunities. There are many reasons why firms pay dividends and the dividend payment directly affected the share price of the company in question. One reason is lack of investment opportunities, which promises adequate returns. Firm's cash position was the most important consideration of timing of dividends.

Modigliani and Miller (1958, 1961), hereafter referred to as MM, put forward the irrelevance theorems, more commonly known as the MM theorems and these form the foundation of modern corporate finance theory. The two main conclusions that are drawn from the MM theorems are that firm value is dependent on its current and future free cash flow. Secondly, the level of dividends (or dividend policy) does not affect firm value given that firms maximize their value through investment. The difference between equity issued and payouts of the firm is equal to its free cash flow. Hence, dividend policy is irrelevant when it comes to affecting firm value. The studies carried out by Black and Scholes (1974) and Miller and Scholes (1982) are in line with the propositions of the MM theorem. Those opposing the propositions can be classified into two groups. For instance, one group would be those who argue that a high dividend payment increases share price which in turn increases firm value and therefore decreases the cost of equity (Graham and Dodd, 1962). The other group gave evidence that higher dividend payout lead to higher required rate of returns which adversely impacts on share price Blume, (1980). In many cases, the MM theorems have been argued to be irrelevant mainly because of the assumptions based on a perfect world without taxes and no market imperfections.

However, in the real world, these assumptions do not hold. For example, International Journal of Economics, Commerce and Management, United Kingdom Licensed under Creative Common Page 7 companies pay corporate taxes and there are many imperfections which provide arbitrage opportunities. Various theories have been developed with the relaxation of MM assumptions. The theories had with main objective to explain why companies pay dividends. Black (1976) argued that there may be infinite reasons of paying dividends. According to these researchers, dividends may simply represent the return to the investor who faces a particular level of risk when investing in the company. Also, he mentioned that companies pay dividends as a means of rewarding existing shareholders but the main argument was that dividends were paid so that the company is seen as a worthwhile investment. In this case, investors were willing to acquire the firm's shares even if they are sold at a higher or premium price.

No general consensus has yet emerged after several decades of investigation, and scholars can often disagree even about the same empirical evidence (Brealey & Myers, 2002; Zhou & Ruland 2006). In perfect capital markets, M&M asserted that the value of a firm is independent of its dividend policy. However, various market imperfections exist (taxes, transaction costs, information asymmetry, agency problems, etc.) and these market imperfections have provided the basis for the development of various theories of dividend policy including tax-preference,

clientele effects, signaling, and agency costs. Amidu (2007) illustrated the lack of consensus concerning the role of dividends by his statement "The harder we look at the dividend picture, the more it seems like a puzzle with pieces that just don't fit together". In all the foregoing studies, there can be identified research gaps. First, the studies failed to establish strongly whether or not there is a correlation between dividend policies and share prices. Other factors such as earnings, book value, dividend yield, leverage, payout ratio, size, government regulations, foreign exchange rate, forces of demand and supply were identified as having more significant effect on share prices other than dividends. There was need therefore to further investigate specifically the effect of dividend policy on stock prices for manufacturing and allied industry firms listed at NSE. The study aimed at investigating the effect of dividend policy on stock prices for manufacturing and allied industry firms listed at NSE in Kenya.

RESEARCH METHODOLOGY

This study adopted a correlation research design since it sought to establish the relationship between dividend payout and stock prices. The data used in this research was obtained from the annual reports of Manufacturing and Allied companies listed in the Nairobi Securities Exchange for a four year period that is, from 2012 to 2015. Dividend payout was measured by the actual dividends paid out and by measuring net profit after tax divided by value of common stock to get the stock prices. Regression analysis was carried out to establish the relationship between dividend policy and stock prices. The target population comprised top and middle level managers from operations department and finance department involved in compiling financial data leading to preparation of financial statements of all the 10 listed Manufacturing and Allied companies. A total of thirty (30) officers were interviewed three from each company.

The researcher adapted a survey technique of all the ten listed Manufacturing & Allied Firms in Kenya which were: B.O.C Kenya Ltd, British American Tobacco Kenya Ltd, Carbacid Investments, East African Breweries Ltd, Mumias Sugar Company Ltd, Unga Group Ltd, Eveready East Africa Ltd, Kenya Orchards Ltd, A. Baumann Company Ltd and Flame Tree Group Holdings. The whole population consisted of all the ten firms from the Manufacturing & Allied segment. The researcher adapted survey method where all ten manufacturing & allied firms representing 100% manufacturing & allied Market Segment listed on the NSE were studied. The researcher used a survey of all the ten manufacturing & allied firms representing 100% manufacturing & allied Market Segment listed on the NSE. Secondary data was collected from the websites of all the ten Manufacturing & Allied firms, journals and financial statements for a period of 4 years from the year 2012 to 2015.

Primary data was collected for the purpose of this study. The research instrument for the study was questionnaires. The researcher used random sampling method. A sample size of 3 randomly selected Officers to represent top level, middle level and lower level managers involved in

compiling financial data leading to preparation of financial statements of all the 10 listed Manufacturing and Allied companies was used for the purpose of this study. The reliability test consisted of 10 percent of the sample which was 10% *(3x10) which equals 3. This gave the researcher an assurance that the chosen instrument was fit to give the desired result. Averages, dispersion frequencies and percentages accurately served this purpose. A content analysis was performed on the data to allow for in-depth understanding of the issues in the case. The data obtained after performing content analysis was cleaned and interpreted to form useful information. The content analysis technique was chosen for the purpose of having clarity, preciseness, and ease of understanding and better interpretation of the results. There was further processing for presentation of results in a variety of graphs and charts using Ms Excel. Conclusions were then drawn from the findings and recommendations made. The study was guided by the following multiple linear regression model which was fitted on the data

$$Y_i = \beta_O + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \mu_i$$

Where; Dependent variable (Y) was the Stock prices, $\beta 0$ is the regression coefficient, $\beta 1$, $\beta 2$, $\beta 3$, $\beta 4$ and $\beta 5$ are the slopes of the regression equation, X1 = dividend policy independent variable, X2 = Free Cash Flow independent variable, X3 = the Tax incentives variable X 4= Clientele effect independent variable; while α is an error term normally distributed about a mean of 0 and for purposes of computation, the α is assumed to be 0.

FINDINGS AND DISCUSSIONS

Descriptive Analysis

The study investigated on how dividend policy affects stock prices. The research noted that dividend policy affect stock price in a positive way. Further the research established sustenance and viability of the dividend policy in their firm is very viable and sustainable as compared to its contributions towards share prices. Predictions from regression model showed that unit increase in dividend policy will lead to an increase in the scores of the Stock prices. The study also established that as a result of the dividend policy the performance of Company's shares at NSE has gone high.

The study revealed that the company's free cash flow affect stock price to a great extent, predictions from regression model predicted that a unit increase in Free Cash Flow will lead to an increase in Stock prices. Also the study established a significant relationship between the Free Cash Flow and the stock prices. The study further established investment decisions at NSE affect the share prices of the company positively and paying of dividends to reduce the free cash flows had enhanced the performance of the company.

Investigation on Influence of tax incentives on stock prices of listed manufacturing and Allied companies in Kenya showed that tax incentives has a significant effect on NSE performance. The study also noted that low taxation rate of dividends acts as an incentive to investors looking to experience some tax cuts hence savings in the long run. The prediction from regression indicated that a unit increase in Tax incentives lead to an increase in Stock prices and also a significant relationship between tax incentives and stock prices was established.

Finally the study established that based on dividend policies the firms attracts different clientele and also firms paying lower dividend attract clientele that desire capital appreciation, while those firms which pay higher dividends attract clientele that require immediate income in the form of dividend. Prediction from regression indicated that a unit increase in Clientele effect lead to an increase in Stock prices and a strong relation between Clientele effect and stock prices was established.

Inferential Analysis

A multiple regression model was applied to identify the effect of stock prices among listed Manufacturing and Allied companies in Kenya. The study adopted the following regression equation to establish the relationship between variables $Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \alpha$; where Y= Stock prices, β_0 = the constant of regression, β_1, β_2, β_3, and β_4 = are the regression coefficients/weights of the following respective independent variables; x1= dividend policy, x2= Free Cash Flow, x3= Tax incentives, x4= Clientele effect and α = error term. All the four independent variables were measured using the responses on each of the variables obtained from the respondents.

Table 1: Regression Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.843a	0.711	0.691	0.012

The study used the R square. The R Square is called the coefficient of determination and tells us how the stock price varied with dividend policy, Free Cash Flow, Tax incentives and Clientele effect. The four independent variables that were studied explain 71.1% of the variables affecting Supply stock price as represented by R Squared (Coefficient of determinant). This therefore means that other variables not studied in this research contribute 28.9% of the variables affecting stock price.

Table 2: ANOVA[a]

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	100.884	4	25.221	12.321	.002[a]
Residual	51.175	25	2.047		
Total	152.059	29			

The study used ANOVA to establish the significance of the regression model from which an f-significance value of p less than 0.05 was established (p=0.002 <0.05). The model is statistically significant in predicting how dividend policy, Free Cash Flow, Tax incentives and Clientele effect affect stock price. This shows that the regression model has a less than 0.05 likelihood (probability) of giving a wrong prediction. This therefore means that the regression model has a confidence level of above 95% hence high reliability of the results. Using the F-test statistic, the sample F value had a value of 12.321 with critical f value at $\alpha = 0.05$, 4 degrees of freedom for the numerator and 25 degrees of freedom for the denominator; this implies that the regression model is statistically significant. According to Lie (2005) this is model can be used for estimating purposes.

Table 3: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	.289	0.016	.277	18.06	.002
dividend policy (X_1)	.121	.016	.0001	7.56	.001
Free Cash Flow (X_2)	.326	.019	.311	17.16	.002
Tax incentives (X_3)	.285	.028	.268	10.19	.001
Clientele effect (X_4)	.136	.012	.123	11.33	.003

a) Predictors: (Constant), dividend policy, Free Cash Flow, Tax incentives and Clientele effect.

b) Dependent Variable: Stock prices.

The established regression equation was

$$Y = 0.289+0.121X_1+0.326X_2+0.285X_3+ 0.136X_4$$

The regression equation above has established that holding all independent variables (dividend policy, Free Cash Flow, Tax incentives and Clientele effect.) constant, other variables affecting Stock prices will be 0.289. The findings also shows that taking all other independent variables at zero, a unit increase in dividend policy will lead to 0.121 increase in the scores of the Stock prices among listed Manufacturing and Allied companies in Kenya. A unit increase in Free Cash

Flow will lead to a 0.326 increase in Stock prices among listed Manufacturing and Allied companies in Kenya. On the other hand, a unit increase in Tax incentives will lead to a 0.285 increase in Stock prices among listed Manufacturing and Allied companies in Kenya and a unit increase in Clientele effect will lead to a 0.136 increase in Stock prices among listed Manufacturing and Allied companies.

This infers that Free Cash Flow affects Stock prices most followed by Tax incentives, Clientele effect and dividend policy. The study also established a significant relationship between the stock prices and the independent variables; Free Cash Flow ($p=0.002<0.05$), Tax incentives ($p=0.001<0.05$), Clientele effect ($p= 0.003<0.05$) and dividend policy ($p=0.001<0.05$). The regression coefficients were tested for significance at alfa=0.05. Significance occurs at p-values less than 0.05. From the above results, all the predictors are good predictors for the stock price. This finding is consistent with that of Easterbrook (1984) who found out that stock price is dependent on free cash flow.

CONCLUSIONS

The study concludes that dividend policy affect stock price positively. The study also concludes that dividend policy leads to high performance of Company's shares at NSE. Further the company's free cash flow affect stock price to a great extent and an increase in Free Cash Flow lead to an increase in Stock prices. Significant relationship between the Free Cash Flow and the stock prices exist. Investment decisions at NSE affect the share prices of the company positively and paying of dividends to reduce the free cash flows had enhanced the performance of the company.

Finally the study concludes that tax incentives has a significant effect on NSE performance and also low taxation rate of dividends acts as an incentive to investors looking to experience some tax cuts hence savings in the long run. A significant relationship between tax incentives and stock prices exist. Further the study concludes that based on dividend policies the firms attracts different clientele and paying lower dividend attract clientele that desire capital appreciation, while those firms which pay higher dividends attract clientele that require immediate income in the form of dividend. A unit increase in Clientele effect lead to an increase in Stock prices.

RECOMMENDATIONS

This study recommends that the management of the listed firms should conduct a research on the different dividend policies to identify the one that would help to maximize their firms' stock price. The study recommends that the firms should increase levels of free cash flows since increase in Free Cash Flow lead to increase in stock prices. The firms should also increase both short term and long term debt as well as dividend payouts as they too have significant

relationship with stock prices at the NSE. The management of the listed firms should pay the lower dividend so as to attract clientele that desire capital appreciation. The management should also increase the tax incentives so as to increase the stork prices. There is need for the companies' management to ensure availability of information to the shareholders. Provision of vital information regarding operations of the firms to the stakeholders will affect positively the performance of the firms as the shareholders will tend to invest along the trends of the business.

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