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Dividend Stability and Sustainability in CEE Region

Julia Bistrova [1,*] and Natalja Lace[2]

[1] Riga Technical University, Kalnciema iela 6, Riga, LV-1048, Latvia
[2] Riga Technical University, Kalnciema iela 6, Riga, LV-1048, Latvia

E-Mails: Julija.Bistrova@rtu.lv; Natalja.Lace@rtu.lv

* Author to whom correspondence should be addressed; Tel.: +371 29858756

Abstract: High dividend paying companies from emerging markets become good alternative to investing in developed markets due to current low interest rates environment. Dividend paying stocks provide certain stability of return, offer lower risk, attractive valuations. Besides, dividend paying firms usually have sustainable and predicted cash flows, which allow stable dividend payments. The present paper provides research results and discussion on dividend stability and sustainability in emerging markets of Central and Eastern European region. Though the emerging market companies do not have a robust history of rewarding their investors with dividends yet, the study results show that the payout ratios declined only slightly during the financial crisis of 2008-2009. The share of dividend-paying companies during the recession did not drop below 50% threshold, while in peak years the share of dividend paying companies was about 57% of the analyzed sample of 117 CEE companies. The present paper provides also an insight into the earnings and dividend patterns and analyzes their correlation. Globally the power of dividends becomes substantial when it comes to their reinvestment, which is also studied in the present research in order to determine the role of dividend payments as a constituent of the total shareholder return. The authors test the hypothesis of whether high dividend paying stocks are able to generate sustainable market outperformance.

Keywords: Sustainability, dividends, total return, CEE countries, financial crisis

1. Introduction

The famous Black's (1976) quote "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just do not fit together" precisely addresses the comprehensive issue of the dividend policies. The problems of dividend payouts, its determinants, its stability are widely discussed in the financial management resulting in the numerous empirical and theoretical papers. Signaling theory, which gains importance within the modern capital markets, can provide certain hints for the dividend puzzle: the dividend announcements almost always are followed by the firm's price increase, while the announcements about the dividend reduction have a significant negative reaction on the stock price (Koch, Shenoy, 1999; Lee, Xiao, 2003; Guttman et al., 2007; Hussainey; Aal-Eisa, 2009; Fairchild, 2010). When the dividends are being initiated or raised the management signals about the quality of earnings, about earnings stability and sustainability, which is the main concern of the firm's shareholders. Financial managers deciding on the dividend increase focus on maintaining stable or increasing earnings aiming to sustain smooth dividend stream (Lintner, 1956; Skinner, 2004; Brav et al., 2005; DeAngelo et al., 2006).

However, the research is mainly done on the sample of companies quoted in the developed markets and the topic of dividend seems to be under-researched in the developing countries. While the emerging markets dividend paying companies are becoming good choice for the investment portfolio due to their ability to provide higher capital growth on top of the attractive dividend yields. Besides, according to Manu Vandenbulck (2012), at the moment the dividend yield of emerging market stocks is 3%, which is higher than on some major developed markets such as the US at 2% dividend yield and Japan at 2.6%. Moreover, emerging market companies become more willing to attract more investors by increasing share of profits paid out – 35% currently vs. 10% in 2000. Therefore, the present research focuses on the emerging CEE countries with the purpose to study the stability and sustainability of dividends there, paying particular attention on the crisis years of 2008 and 2009.

The authors stated the following hypotheses prior to the research:

Hypothesis I: Central and Eastern European companies are able to offer stable and sustainable dividend payouts, even during the financial crisis period.

Hypothesis II: Investors more willingly invest in the dividend paying companies and the dividends make significant part of the total return.

The authors employ various statistical methods to prove the hypotheses. Besides, the authors also develop a model portfolio including the reinvested dividends to determine the role of dividends in obtaining higher total return.

2. Dividend Policy Stability – Literature Review

Sustainability influences the decisions on policy as well as the investor perception. Sustained and growing earnings and dividends provide high predictability of future returns and, thus, have substantial positive impact on the investment return (Barth et al. 1999, Koch, Sun, 2004). Losses and dividend reduction decline become a signal of future performance deterioration (Hayn, 1995 Degeorge et al., 1999). Lintner (1956) was the first to state that the firms try to maintain stability of the dividend policy and that the dividends are indicators of the future performance. Thus, the major determinants of the dividend policy have to be current earnings and past dividends. Lintner's model has been tested in a variety of the developed markets as well as in the emerging markets.

Glen, Karmokolias, Miller and Shah (1995) discover significant differences in the dividend policies of companies in developed and emerging markets: dividends are lower in emerging markets, while the companies there do not pursue stable dividend payout policy. Lintner's model, that the earnings determine the dividends and that the companies try to avoid volatility of dividends, was confirmed in

India (Pandey, Bhat, 1994), in Singapore (Ariff, Johnson, 1994), in Turkey (Adaoglu, 2000). Pandey (2003), analyzing Malaysian firms, state that the companies pursue less stable dividend payout policy compared to the companies in developed markets: there is a high probability that the dividends will be increased in case of increased earnings and that the dividends will be omitted in case of the negative earnings.

The studies on the emerging markets do not provide a consensus regarding the dividend stability and sustainability. Thus, the present study would contribute in studying this problem further.

3. Dividend as a Significant Part of Shareholders Wealth – Literature Review

Miller and Modigliani (1961) state that the firm's value is independent of its dividend policy, which contradicts with the 'bird in hand' theory (Gordon, 1963) saying that investors do prefer dividend payments over the capital gains to minimize the investment risk. Theoretical statements are being tested by the empirical studies. For instance, Baker et al. (1986) conducted a survey, the results of which revealed that the managers believe each firm should have an optimal payout ratio and that it influences firm's value. These results were supported by the survey conducted in 1999 by Baker and Powell. The study of Robert Arnott (2003) provides evidence that over 200-year period dividends produced the largest component of an annual equity returns – 5% of the overall total return of 7.9%. More recent analysis of the period from 1975 to 2011 shows that the dividend income is the most important components in the total return after inflation.

Gul et al. (2012) discovered that the market-to-book values are significantly higher for the dividend payers compared to the non-paying companies. Running multiple regression, they found out that there is a significant relationship between shareholders wealth and the dividends paid out.

4. Research Methodology

The authors of the present research analyzed 117 companies, which are included in the main lists of the CEE (Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Romania, Poland, Slovakia, Slovenia) stock exchanges to find out how significant are dividends in generation of the total shareholders return as well as to describe the sustainability of the dividend payments in CEE region. The authors selected the following analysis period: January 2005 to June 2012 as the quality of earlier periods' data is questionable, which might lead to the incorrect results. Quantitative and financial data for the present research needs were extracted from the annual reports of the analyzed companies. The stock prices were compiled using the historical data provided by the local stock exchanges.

The assessment of the dividend sustainability and stability was based on the comparison of the earnings and dividend dynamics during the positive and negative stock market movement. Besides, the stability of the dividend yield and the dividend payout ratios are considered throughout the study period.

Dividend significance as a part of the total return was evaluated by decomposing of the total return into inflation, reinvested dividends and other factors. Moreover, the total performance of the dividend paying companies was compared to the performance of the stock market as well as to the performance of the companies, which do not pay dividends.

Total return was calculated by adding the reinvested dividend value to the price of the company. Share repurchases were not considered in this study, as this phenomenon appears to be rather rare in the CEE region.

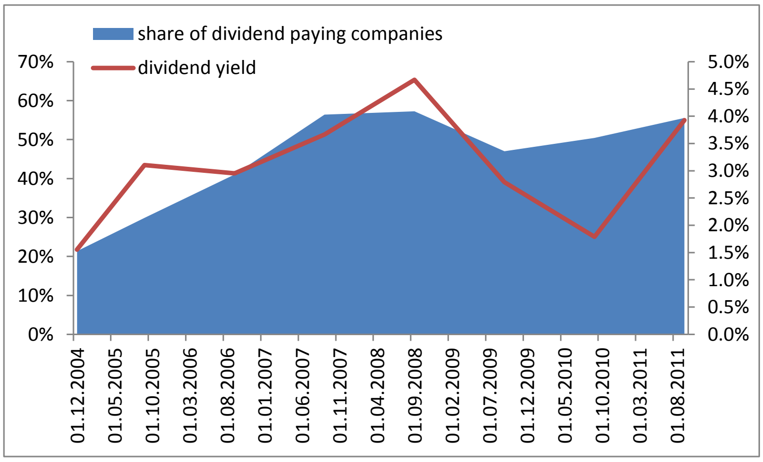
5. Results and Discussion

5.1. Sustainable Dividend Payments in CEE

Average dividend yield in the CEE countries ranges from 2% to 5% (Figure 1), which appears to be relatively high, which is rather surprising, taking into account the nature of the developing markets, which often means that companies are in the developing phase and, therefore, require large capex. Partly this can be explained by the favourable dividend tax policy.

Dividends in the CEE equity market are paid by almost half of the companies in the analyzed sample. The share declined due to the financial crisis, but later managed to recover to the pre-crisis level, the same as the dividend yields.

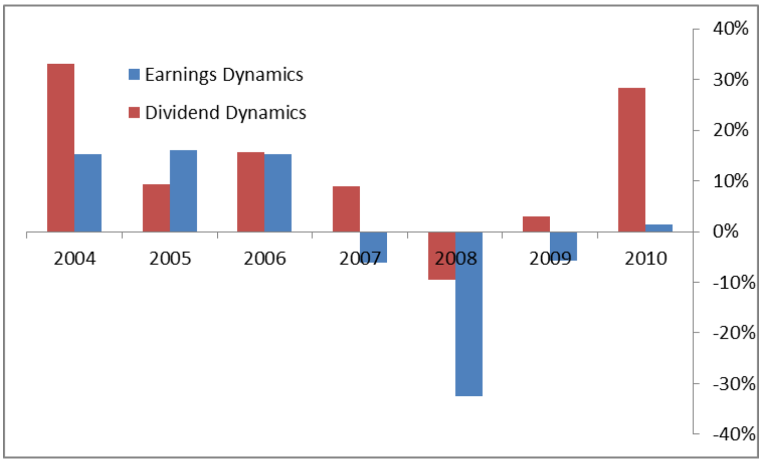
Figure 1. Dividend Yield and Share of Dividend Paying Companies in CEE



Current dividend payout ratio in Central and Eastern Europe is around 30%, which is rather modest but is recovering after the dividend cuts due to the financial crisis. Besides, the low level of the ratio is explained by the developing stage of many companies listed in CEE countries. To compare, payout ratio in USA is 27%, while in Europe it is around 40% (Blackrock, 2012). Low payout ratio in USA is compensated by the share repurchases, which are common among the US companies

The comparison of the earnings and dividend dynamics of CEE market provides us with the evidence of significantly lower downside volatility of the dividends compared to the downside volatility of earnings (Figure 2). There was a positive change in average dividends paid for 2007 and 2009, while the average earnings still suffered a reduction due to the deteriorated economic environment. Thus, the dividend-paying companies are able to guarantee stable cash flow and are capable to offer a cushion during the market downside. Large increases in the dividend payments for 2004 and 2010 are explained by a number of companies, which initiated dividend payments.

Figure 2. Average Earnings and Dividend Dynamics in CEE



The most critical period studied within the research was the time of the global financial crisis, as a result of which 14 companies or 23% of the total number of dividend payers ceased dividend payments. The overall downward trend in the dividend payments in 2008 and in 2009 was seen with 61% and 44% of dividend paying companies respectively. However the downside magnitude was not as extreme as in the case of earnings decline.

5.2. Dividends – the Major Component of Total Return

To find out the significance of the dividend payments importance to generate shareholders wealth, the authors decomposed the annual total return into return from dividends, inflation and other factors. The results presented in Figure 3 provide an evidence that the dividends play major role in generating total return after the average inflation during the period of 2005-2012 in CEE countries – annual dividend income, which assumes also reinvested dividends, was 4.4%, while the annual total return was 10.3%.

Figure 3. Total Return of 117 CEE Companies Decomposition

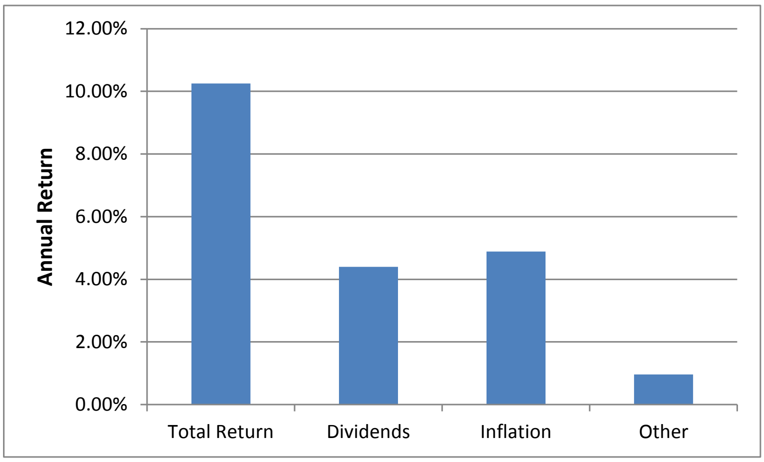
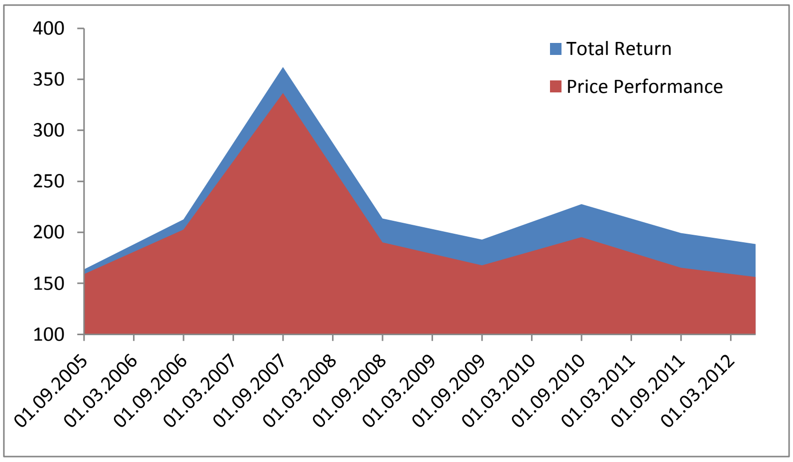


Figure 4 chart shows the magnitude of the total return, calculated with the reinvested dividends, compared to the price return of the CEE stocks, indicating the sustained investment returns during the financial crisis. The cushion of the reinvested dividends provided so called "safety net" when the crisis overwhelmed the global financial markets and when the emerging markets' asset prices suffered from the major cash outflows as the large emerging market investors, foreign financial institutions, were desperately looking for the liquidity.

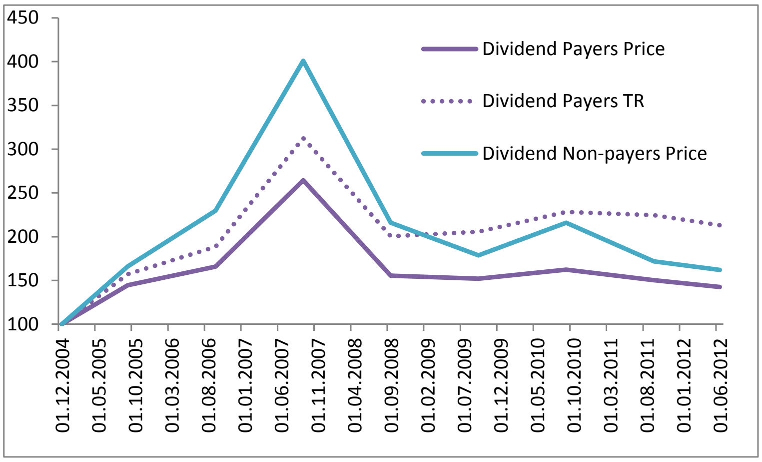
Figure 4. Price Performance and Total Return of the CEE stocks



The CEE price return for 7.5 year investment holding period totaled 56.2%, while the total return of the market was 88.5%. Therefore, the dividends paid by CEE companies are capable of enhancing investment returns and softening the losses during the crisis.

Figure 5 shows the dynamics of the 100$ investment in the CEE dividend paying and non-paying companies during the period of 2005-2012 years. Though the price return of the dividend payers lagged behind the non-payers, the total return of the dividend payers still managed to provide consistent and sustainable return thanks to the reinvested dividends. The chart clearly demonstrates high growth of the non-payers during the market boom as well as their impetuous drop in 2007-2009. When the dividend-payers continued their fall in 2009, the total return of the CEE dividend payers entered positive trend.

Figure 5. Price and Total Return (TR) of the Dividend-paying and Non-dividend Paying Stocks



6. Conclusions

The findings of the present study provide an insight into the dividend payments in Central and Eastern European market, which can become a lucrative investment target due to the relatively high dividend yields and stable payout ratios. The authors cannot reject the Hypothesis I about the stability and sustainability of the dividend payments in CEE countries as the dividends did not experience such dramatic decline as the earnings did for three years in a row (dividends declined just for financial year 2008). Dividend yields and payout ratios experienced a decline due to the financial crisis, but managed to recover rapidly. However, to prove the stated hypothesis, the authors need more robust evidence to confirm dividend stability. Therefore, the authors in further studies of dividends in CEE could test Lintner's model as well as compare dividend volatility in CEE and developed markets.

Hypothesis II about the dividends' role significance in generation of total returns was proved in the course of the research. The findings show that after the inflation dividends appear to be the most important component of total shareholders wealth. Dividend-paying companies were able to outperform non-payers over the period analyzed. Moreover, the dividends were capable of softening the freefall of asset prices experienced by many investors in 2008 and 2009.

Conflict of Interest

The authors declare no conflict of interest.

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