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DIVIDEND POLICY OF PUBLIC COMPANIES IN BOSNIA AND HERZEGOVINA

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Abstract:
This paper provides insight in dividend policy of publicly listed companies in Bosnia and Herzegovina and investigates appearance of dividend smoothing behavior. The results show increase in portion of dividend paying companies over time while dividend smoothing phenomenon is virtually non-existent. On the other hand, when companies decide to pay dividends they, on average, distribute high portion of profit to shareholders. The paper also provides discussion about capital market development, investor protection and ownership concentration as potential factors affecting importance of dividend payouts. Research results indicate that insufficiently developed capital market characterized with low investor protection and concentrated ownership structure undermine the importance of dividend smoothing practices.

Keywords: dividends, dividend policy, dividend stability, dividend smoothing behavior, capital market development.

Jel Classification: G35

INTRODUCTION

Dividend decision is one of the most important financial decisions in corporate management. Main goal of dividend decision is to determine how much money a company will distribute to existing shareholders. This decision depends on several factors. Previous researches identified main internal determinants of dividend payout: profitability, size, investment opportunities and debt level (Fama and Babiak 1968; Fama i French 2001; Rozeff 1982; Baker et al. 1985; Denis and Osobov 2008; Aivazian et al. 2003; Bebczuk 2004; Kowalevski et al. 2007; Statescu 2004). Influence of particular factors on dividend payout differ across countries, but in general, widespread evidence show that profitability and size have positive effects on dividend payout ratios, while investment opportunities and debt level negatively impact dividend payout level. Other authors (e.g. La porta et al. 2000; Banerjee et al. 2007) focus on external drivers of dividend policy including capital market development, stock market

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liquidity, structure of financial system and investor protection rules among others. The aim of this paper is descriptive analysis of dividends in Bosnia and Herzegovina and identification of potential factors that may affect importance of dividend policy.

The paper is organized in the following manner: after introduction, the second part provides overview of previous empirical work on dividend payout practices while the third part analyses references regarding relationship between capital market development and dividend policy. The fourth part presents selected data used in the empirical study. The fifth part presents descriptive statistics of dividend payouts in Bosnia and Herzegovina and analysis of its capital market development, while the sixth part of the paper brings summary and concluding remarks.

DIVIDEND POLICY: PREVIOUS EMPIRICAL STUDIES

It is well known that huge part of previous empirical work on dividend policy practices was focused on countries with developed capital markets like United States and Great Britain. In the early study of dividend behaviour among US companies Lintner (1956) found that managers tend to smooth dividends - adjusting the dividend level toward long-term target. According to Lintner, managers are reluctant to cut dividends, while they raise them only if they expect that the future cash flows could support the new dividend level. Managers appear to believe that investors put premium on companies with stable dividends. Subsequent research has confirmed Lintner's findings (Fama and Babiak 1968; Aivazian et al. 2006; Brav et al. 2005). Glen et al. (1995) also report that firms in developed countries tend to smooth dividend per share, while firms in emerging markets focus on stable dividend payout ratios.

Incentive for this kind of behaviour is analyzed in sight of information asymmetry and agency conflicts among managers and shareholders. In a situation with information asymmetry between corporate insiders and outside shareholders dividend payout could be used as signalling mechanism about future prospects of company. On the other side, ownership structure is considered to be the main reason of agency conflict occurrence. If corporate ownership is widely dispersed among shareholders, then agency conflict is likely to happen between them and company management. Hence, dividends can serve as a potential mechanism which may mitigate this kind of conflict as dividend payout decreases cash flow disposable for irrational investment behavior (Easterbrook 1984; Jensen 1986).

CAPITAL MARKET DEVELOPMENT

Companies operating in different conditions of capital market development and corporate governance settings differ in terms of ownership structure and the way in which they finance investment projects. Since the degree of information asymmetry and agency conflict varies across countries, dissimilar role of dividend among countries could be a reflection of aforementioned differences. According to Stiglitz (1985) and James (1987) bank loans are characterized with less information asymmetry and agency conflicts in comparison to stock market financing. Also, level of ownership concentration is much higher in civil law countries and bank-oriented systems[2] which are present in most continental European countries (La Porta et al. 1998; Shleifer and Vishny 1997). Under such conditions it is reasonable to expect that dividend policy as signalling or control mechanism is less important in bank-oriented financial systems where capital market is less developed and companies are financed exclusively trough bank loan arrangement.

La Porta et al. (1996) presents evidence indicating that legal rules protecting investors and the quality of their enforcement differ greatly and systematically across countries. Authors conclude that, as good legal environment protects the potential financiers against expropriation by entrepreneurs; it raises their willingness to surrender funds in exchange for securities and hence expands the scope of capital markets. Their results show that civil law countries have weakest investor protection and the least developed capital markets, compared to common law countries (La Porta et al. 1997). They have also found that concentration of ownership of shares in the largest public companies is negatively related to investor protection, consistent with the hypothesis that small, diversified shareholders are unlikely to be important in countries that fail to protect their rights (La Porta et al. 1998).

On the other hand, La Porta et al. (2000) tested two agency models of dividends – "outcome model" and "substitute model". The first model states that dividends are an outcome of effective legal protection which provides investors with tools that can be used to pressure corporate insiders to distribute cash. In contrast, the substitute model indicates that lack of transparency and inadequate investor protection can make dividend policy important in emerging capital markets as mechanism for reputation building. This hypothesis states that companies in emerging capital markets can use dividend smoothing to attract investors and provide external financing. From this point of view dividends are seen as a substitute for effective legal protection. Authors have found consistent support for outcome model of dividends i.e. companies in countries with better investor protection pay higher dividends and vice versa.

DATA SELECTION AND SOURCES

Final research sample consists of 35 companies listed on two stock exchanges in Bosnia and Herzegovina (Sarajevo Stock Exchange and Banja Luka Stock Exchange). Period of analysis is 6 years (2007–2012). Dividend data (dividends per share and payout ratios) for the present research are extracted from annual reports of the analyzed companies and official statistical reports published on web sites of above mentioned exchanges. Dividends per share figures include extra/special dividends. Companies from financial sector are excluded from the sample due to specific operating characteristics. Also, companies with missing data for one of research variables at any point of time are excluded from the sample. Additionally, data for ownership concentration are downloaded from official web sites of Registry of securities of Federation of Bosnia and Herzegovina and Central Registry of Securities of Republic of Srpska. Descriptive statistics is calculated using statistical software package STATA.

[2] Commercial banks play an important role of finance providers.

THE ROLE OF DIVIDENDS IN BOSNIA AND HERZEGOVINA

Capital Market of Bosnia and Herzegovina is divided between two Stock Exchanges – Sarajevo Stock Exchange and Banja Luka Stock Exchange, both founded in 2001. Financial instruments traded on these exchanges include stocks, bonds and treasury bills. At the end of 2012 total market capitalization of listed companies was 7.799.587.707 BAM (Bosnia Convertible Mark). In comparison with the advanced transition economies capital market in Bosnia and Herzegovina is underdeveloped and less used as source of funds for domestic companies.

Table 1 shows the number of listed companies with positive business results and the portion of dividend payers among those profitable companies.

Table 1. Portion of dividend paying companies

	2007	2008	2009	2010	2011	2012
Number of analyzed firms	35	35	35	35	35	35
Portion of profitable firms	0.86	0.97	0.91	0.89	0.89	0.77
Portion of dividend paying firms	0.27	0.38	0.38	0.48	0.42	0.44
Average payout ratio	0.50	0.75	0.57	0.92	0.74	0.76

As we can see from Table 1 the highest portion of profitable firms was in 2008. Precisely, 97 percent of analyzed firms were profitable, while 38 percent of them paid dividends with average payout ratio of 75 percent. On the other side, lowest level of profitable firms was in 2012 (77%) but almost half of them (48 %) paid out dividends with average payout ratio of 76 per cent. Over the analyzed period portion of payers raised from 27% in 2007 to 44% in 2012 which is still two times smaller in comparison to proportion of dividend-paying companies in developed Europe presented with MSCI Europe index[3] (94.6%) at the end of April 2012 (FactSet 2012).

Payout ratio

This section provides descriptive statistics of dividend payout ratios among dividend paying companies in 6 year period. While this proportion varied significantly over the years, it never fell below 50%, and in the average, companies distributed about 72% of net income to their shareholders which is relatively high in comparison to MSCI Europe aggregate payout ratio which was just under 60% (59.0%) at the end of April (Factset 2012). This could be due to periods when payout ratio was above 100 per cent where companies paid dividends from retained earnings in past years. Anyway, taking these events out of sample, overall payout ratio is still relatively high – about 61 percent.

[3] The MSCI Europe index captures large and mid cap representation across 15 developed markets countries in Europe.

Table 2. Descriptive Statistics of Payout Ratios

Variable	Observations	Mean	Std. Dev.	Min	Max
Payout ratio (2007)	8	0.50	0.22	0.29	0.95
Payout ratio (2008)	13	0.75	0.55	0.2	2.33
Payout ratio (2009)	12	0.57	0.32	0.01	1.24
Payout ratio (2010)	15	0.92	0.68	0.24	2.70
Payout ratio (2011)	13	0.74	0.45	0.15	1.91
Payout ratio (2012)	12	0.76	0.33	0.29	1.37
Overall	**74**	**0.72**	**0.48**	**0.01**	**2.7**

Table 2 reports the number of firms that paid dividends every year from 2007 to 2012. As we can see from the table above, removing non-dividend paying firms reduces the number of sample companies from 35 to 8 in 2007 with average payout ratio of 50 per cent. This was the lowest level in the six year period. Highest average payout ratio was recorded in 2010 when 15 companies distributed about 92 percent of net income to their shareholders. Figure 1 shows the distribution of the payout ratios over the entire period.

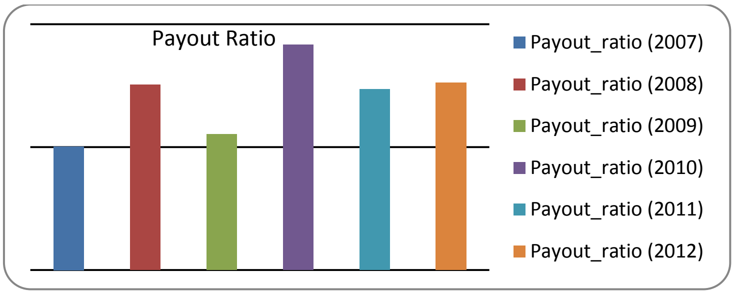

Figure 1. Payout ratio trough 6 year period

Dividend Stability

According to Guttman et al. (2008) dividend-smoothing practice is defined as keeping the dividends per-share constant over two or more consecutive years. Examination of dividend smoothing behavior of publicly listed companies in Bosnia and Herzegovina has shown that 14 percent or only five companies in the analyzed sample were engaged in dividend smoothing practices. Also, only 5 companies paid out dividends over 6 consecutive years, while 7 companies did the same thing five years in a row. Figure 2 illustrates dividend paying companies engaged in dividend smoothing practices over the five years period. In each year between 2008 and 2012 we can see the number of companies that paid dividends over two consecutive years as well as the number of companies that held dividend per share constant over this period. As we can see from the Figure 2 dividend smoothing behavior is recognized in one or two companies depending on the year.

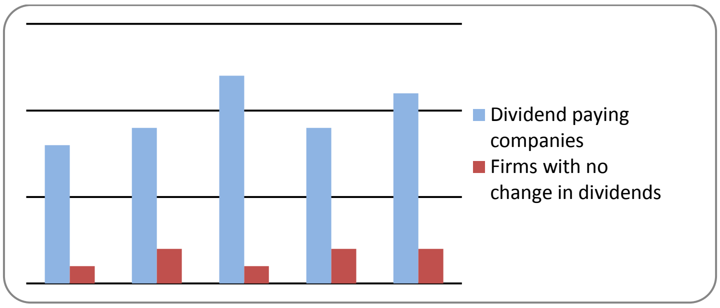

Figure 2. Number of companies not changing dividends

Analysis of previous empirical work indicates that companies operating in developed capital markets pay attention to dividend payout patterns believing that market will attach greater value to companies engaged in dividend smoothing practices. Glen et al. (1995) found that companies in transition countries focus on payout ratio stability instead of smoothing absolute dividend per share. Due to small sample of dividend paying events it is impossible to derive valid conclusion about stability of payout ratios among public companies in Bosnia and Herzegovina. On the other hand, existing data suggest that smoothing dividend per share is a rare practice among dividend paying companies.

Capital Market Development, Investor Protection and Ownership Concentration

Literature analysis indicates that capital market size, investor protection, structure of financial system and ownership concentration are important factors affecting dividend policy. In general, Bosnia and Herzegovina follows continental model of financial structure with banks playing a dominant role while capital market is less developed and less used as a source of investment funds. Development toward healthier capital market is constrained due to inconsistent financial reporting practices, lack of transparency and public mistrust of voucher privatization programs which entailed numerous corruption affairs. According to Transparency International`s Corruption Perception Index for 2013 (Transparency International) Bosnia and Herzegovina takes 72nd place out of 176 countries on par with countries such as Serbia, Brazil and South African Republic which indicates a dangerous level of corruption and discourages investors' willingness to participate in financing investment projects. Having in mind that market size is positively correlated with the ability to mobilize capital and diversify risk, this could be a serious obstacle in capital market development.

The size of the capital market in Bosnia and Herzegovina, measured with market capitalization of listed companies (as per cent of GDP) is not far away from the developed Europe. As we can see from the Figure 3, market capitalization of listed companies at the end of 2012 was 30.31 per cent of GDP, which places Bosnia and Herzegovina among countries with well-developed capital markets. However, this indicator can be misleading if trading activity does not support the prices used in calculating market capitalization of listed companies.

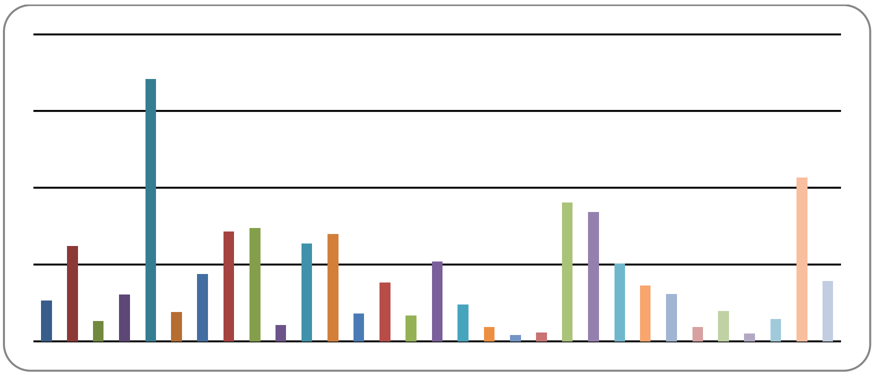

Figure 3. Market Capitalization of listed companies (% of GDP)[4]

The real picture of capital market development in Bosnia and Herzegovina can be seen trough Figure 4 which shows stock market activity measured by turnover ratio, or the value of shares traded as a percentage of average market capitalization.[5] Taking value of 1.39 per cent, this indicator points to poor trading activity and undeveloped capital market, in spite of even two operating stock exchanges.

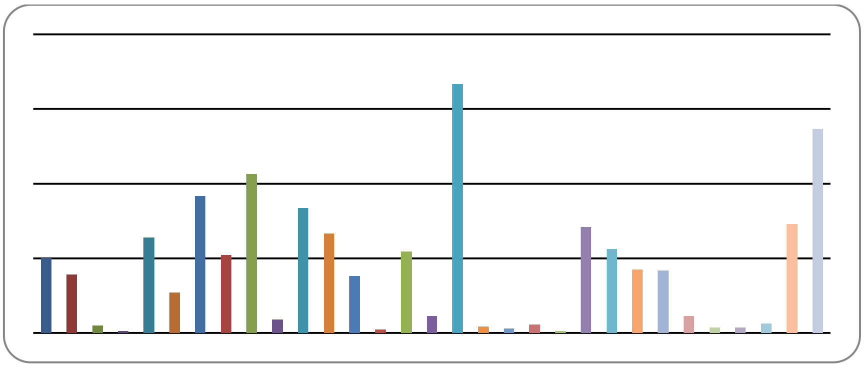

Figure 4. Stocks traded, turnover ratio (%)[6]

The reason for this situation in the capital market in Bosnia and Herzegovina may be found in the legal environment embodied in country laws that may affect investors' confidence and influence the functioning of stock market. Bosnia and Herzegovina is considered to be a country whose legal rules originate in civil law which, in general, means weaker investor protection and therefore less developed capital market. This broad conclusion is based on previous work of La Porta et al. (1997, 1998) although Bosnia and Herzegovina was not a part of the research sample in their study. Reasoning behind this thesis is quite simple - investors are willing to invest in countries which inherited legal rules that prevent misuse of their money. Additionally, presence of

[4] Source: World Bank, http://data.worldbank.org/

[5] Average market capitalization is calculated as the average of end-of-period values for the current period and the previous period.

[6] Source: World Bank, http://data.worldbank.org/

several structural impediments such as lack of transparency, low financial reporting quality, failure to comply with principles of corporate governance and inability of regulatory institutions to cope with minority shareholders expropriations leads to the conclusion that Bosnia and Herzegovina probably failed to protect rights of investors. Only official measure of investor protection which includes Bosnia and Herzegovina is Strength of Investor Protection Index[7] issued by the World Bank in Doing Business Report. Value attached to Bosnia and Herzegovina for 2013 is 4.7 which places it on the 115th place out of 189 countries. This indicates that protection of interests of minority shareholders is, in the least, questionable.

In order to offset insufficient investor protection and consume their investment rights investors can acquire significant portion of shares which will provide them with the high level of influence in corporate decision making process. It is well known that companies in common-law settings usually have dispersed ownership which leaves management with considerable level of discretion. In contrast, companies operating in civil-law settings have more concentrated ownership in response to weaker protection of investors. As expected, research results show that ownership structure of publicly listed companies in Bosnia and Herzegovina, measured by cumulative holdings of top five owners at the end of 2013, is highly concentrated. This result suggests that ownership concentration could be a substitute mechanism for poor investor protection in case of Bosnia and Herzegovina.

Table 3. Descriptive statistics of ownership concentration

Variable	Observations	Mean	Std. Dev.	Min	Max
Ownership Concentration (Top 5 shareholders)	35	82.31	13.97	38.52	97.57
Ownership Concentration (Largest shareholder)	35	54.54	22.70	14.48	93.27

As we can see from Table 3, top five owners of analyzed companies, in average, hold 82.31 percent of issued shares while the largest owner in average controls more than 50 per cent (54.54%) of the capital. Presented data point to the conclusion that most companies are owner controlled even among dividend paying companies (i.e. companies that paid dividends at least three times in six years). Precisely, out of 14 dividend payers, 57% of them are controlled by the largest owner. Additionally, the reason for the high degree of ownership concentration may also be found in the slow process of privatization which resulted in high portion of ownership structure controlled by the government i.e. about 37% of companies in the sample are government owned (more than 50 per cent of voting power). Having in mind the identified level of ownership concentration it is reasonable to expect the emergence of agency conflict between controlling and minority shareholders. Therefore, if legal protection for outside shareholders is weak, high payout ratios among dividend payers may indicate that some companies pay dividends in order to build reputation on good treatment of shareholders.

[7] Strength of Investor Protection Index measures the strength of minority shareholder protections against misuse of corporate assets by directors for their personal gain.

CONCLUSION

The findings reported in this paper provide new evidence on dividend payouts among companies trading on stock exchanges in Bosnia and Herzegovina. Research results indicate that dividend paying companies in Bosnia and Herzegovina have the policy to return high portion of earnings to their shareholders. However, the small portion of companies which pay dividends consecutively indicates that companies in Bosnia and Herzegovina do not attach great importance to dividend policy while dividend smoothing phenomenon is virtually absent.

Analyzing factors of dividend policy in Bosnia and Herzegovina one could suggest that existence of structural impediments like poor investor protection and insufficiently developed capital market undermine the importance of dividend smoothing as signalling or control mechanism. From this point of view the high level of ownership concentration found in the research seems to be the substitute for low investor protection. On the other hand, high portion of earnings distributed to poorly protected shareholders may be seen as a reputation building practice.

This study has serious data limitation due to the lack of data caused by low quality of financial reporting practices. Therefore, it is impossible to draw strong statistical inference about major determinants of previously identified level of dividend payouts. Link between the above mentioned factors and dividend policy can only be suggested. Additionally, the findings of this study can be seen as generalized conclusions based on previous empirical work and descriptive statistics of research variables.

Further empirical investigation of causal relationship between matrix of capital market development variables and importance of dividend policy represented through dividend smoothing measures on a broader sample of countries could be a fruitful avenue for future research. In the light of internal factors affecting dividend policy, further research may be focused on the analysis of characteristics of dividend paying companies in Bosnia and Herzegovina in order to address the question of what drives certain dividend payout patterns.

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