



RELATIONSHIP BETWEEN FREE CASH FLOW AND DIVIDEND A STUDY OF THE CEMENT SECTOR OF PAKISTAN

Abdul Waheed Khan¹, Zain Ullah², Fazl-e-Malik³, Imtiaz Ali⁴

ABSTRACT

This study investigates the relationship between free cash flow and dividend policy. The current study uses EBIT, Tax, Dividend, Working capital, Depreciation, Capital expenditure, and FA as an independent variable and Free Cash Flows as a dependent variable to investigate the relationship between free cash flow and dividend. Study based on the cement sector, five companies were selected actively trading in Karachi Stock Exchange, during the period 2011 to 2015. Secondary data was collected through financial statements of companies and stock prices were collected from Karachi Stock Exchange. Descriptive statistics, simple and multiple regression analysis is applied to find out the relationship of the firm. However, we found that there is a negative relationship between capital structure and stock price. The present study is a unique contribution to the existing literature of finance in the context of emerging markets like Pakistan. The study found that free cash flow and earnings per share have positive effects on the dividend policy while a negative significant relationship is found between leverage and dividend policy of listed cement companies in KSE. Companies in which a high proportion of shares are held by managers are more reluctant in paying a higher dividend. Hence, the study recommends that companies in the Cement sector should endeavor to improve the level of free cash and profitability while reducing the level of leverage thereby paying a higher dividend payout policy.

Keywords: Cash Flow, Dividend Policy, Payout, Cement Sector

INTRODUCTION

The relationship between free cash flow and dividend approach had been the subject of a few contentions. Money streams are the premise whereupon the board settles on a choice on, regardless of whether to pay profit to investors or to hold the assets for future development and development of the organizations. As indicated by Afza and Mirza (2010) money streams from activity in the organizations significantly affect profit payout in the developing economy. This implies income in an association gives data about the monetary circumstance of the firm to investors. The money streams had been considered by past specialists as a factor in deciding the profit payout approach. Fama and Jensen (1983) encouraged that free income mitigates the organization's struggle among overseeing and investors. This is because administration activity may not generally be in light of a legitimate concern for the investor. Accordingly, income was significant in deciding the degree of money profit paid by the organizations.

¹ Senior Auditor, Accounts General Office, Peshawar, KPK, Pakistan, Waheed7878@gmail.com

² Lecturer, City University Peshawar, KPK, Pakistan, uzain15@cusit.edu.pk

³ Field Manager Otsuka Pakistan Ltd, fazalmalikopl@gmail.com

⁴ Lecturer in Commerce, GCMS Peshawar City, imtiazali_uop@yahoo.com

Free income is the income made by an organization's demonstrations that are existing to pay its monetary necessities to those that have given its endowment. These incorporate its value investors and its moneylenders. Josua and Vera (2005) accept that free income is the assets existing to bosses before discretionary capital venture choices. It speaks to money that a firm can make after putting out money essential to maintain or build its benefit base. The connection between free income and profit is a noteworthy factor from the most recent couple of decades. Each firm, while managing profit strategy, consider the measure of money streams accessible with the firm. On the off chance that there are sufficient free money streams, the firm will probably offer profit to its investor and can make further speculation openings.

Research Gap

The issue identified with free income and profits arrives when troughs work for their advantages rather than investor's advantages. In Pakistan, the basic view is the firm pays low profit as considered as they hold money. The present research had attempted to feature the connection between free income and profit. The salaries per share as a proportion of productivity emphatically impact the profit payout proportion. Is to demonstrate that profit

Installment can be upgrade and impact by the degree of free money, profit per offer, and measure of the influence of recorded Cement organizations of PSE. Be that as it may, free income alone can't alleviate the contention between the investors and the executives. When the advantage of firm official and those of investors conflicts, office cost happens because of the office issue. This can manual for the use of free income for cash with an awful net present worth or liberal costs not straightforwardly related to firm process, consequently having a negative power on partnership shows. As indicated by the free income suspicion, free income can diminish with extra outgoings and verifying outside obligation financing. This mode firm can make more grounded their daily schedule. This investigation inspects the quality of the free income theory. All the more precisely, it tests for an unfavorable connection between free income and firm execution for organizations bargain in Pakistan. The lessening of free income under supervisor's controller is presented to have a positive outcome on business execution, Enhance in free income are presented to have an awful outcome. Accepted that better centrality is presently situated on corporate administration in Turkey, this present investigation's trial of the scholarly structure can add to the foundation of standards and qualities in this part. As per the free income suspicion, free income manual for organization cost and damagingly impact organization schedule; so it might be useful to acknowledge these qualities or potentially make decides that order or reduction free income in the hands of managers. To diminish free income, additional use must be in time over the corporate administration standard, which can be utilized as a political instrument by controlling foundations.

Objective and Significance of the Research

The main aim of the study is to determine the association between free cash flow and dividend. Various speculation and profit studies have shown that income is a successful method to anticipate both venture and profit. There are three essential translations of this relationship. The principal expresses that a flood in organization income is a decent pointer of expanded accessibility of profit. The subsequent understanding contends that organizations think about potential venture openings, however, are kept from contributing due to constrained access to outside wellsprings of financing. As income improves, organizations can share of appealing open doors that would be generally inaccessible. The third, known as the "free income hypothesis," states that chiefs don't act in a way predictable with benefit expansion, as the initial two translations recommend. Directors rather utilize expanded income to seek after targets that have little to do with expanding benefits and a lot to do with improving the chiefs' lives, (for example, expanding the size of their organization), or simpler.

LITERATURE REVIEW

Theoretical Review

Theories on Dividend Policy

There are many theories related to dividend policy these theories were presented (1958) by many economists Franco, Modigliani, and Moron Miller as known as MM theory. Miller Modigliani in 1961 and Miller alone presented (1977) they concluded that the value of the firm is independent of dividend policy and explained extensively. Bhattacharyya (1979) and a few others concluded a company dividend policy as an expensive tool to signal a firm's value in these was relevancy and their theories. The first one is asymmetric information about the company profits and the second one is the shareholder's liquidity and the third one is to pay a dividend and refinance cash flow and different equilibrium those firms pay a high dividend who's earning are high so they send a signal to the stock market and this signal can boom or can increase the stock prices or can make a bad and can create a bad image of the firm. As we said as a previous page the company will pay the current dividend amount. And the next few years with increasing rate and if they declining the dividend payment rate so automatically it sends a bad signal to the market.

Irrelevance Theory

Modigliani and Miller (1958, 1961) spoke to the insignificance hypothesis and those shaped reasons for the cutting edge corporate fund hypothesis. Two ends were gotten from MM speculations the first is the estimation of the firm is reliant and it's future and current free money streams, and the subsequent one is that the profit strategy does not influence the estimation of the firm which is boost by the firm through venture so the estimation of free income is expanded by the speculation. So the distinction among profit and offer issued value that distinction is equivalent to free income profit arrangement isn't significant. With regards to influence the estimation of the firm, the effect of profit approach on venture choice it is clarified that organizations must take all the new tasks with a positive net present and incentive here the fundamental issue is if the board center more around the profit strategy is viewpoint speculation arrangement. So if the firm has not free income it won't put in the new activities or will postpone

to a later date. At the point when the organization has adequate free income later on so profit arrangement has a direct impact on the venture choices.

Agency Cost-Based Theory

This hypothesis was introduced by Jensen and Meckling (1976) this hypothesis depends on the contention between the proprietors of the business and the administration of the business so proprietors are not occupied with everyday business tasks and administrators who are isolated from the business and their fundamental center is to expanded the cost of the organization and to accomplish firm objectives that will boost the abundance of the investors and if chiefs leave the objective of the firm and need to accomplish their objectives to get lavish workplaces and to get new marked vehicles, so this conduct from the directors can build the obligation level of the firm and over obligation or awful obligation Will diminish the estimation of the firm and will sink the abundance of the investors. Jensen in 1987 further clarified that all the more free income is imperative to fund the new undertakings.

Empirical Review

Kousenidis (2006) studies free cash flow to be the working income after-tax expenses, after non-cash changes, and investments in the present and long term resources. The suitable explanation is measured to be the cash created by the firm, existing for all the parties protecting the wealth of the firm (equity and economic debt. There is a mixture of sentiments in defining cash flows.

Adhikari and Duru (2006), consider cash flow to be the amount of cash existing to shareholders, without reducing the business value. They compute this indicator by deducing from the operating cash flow the amount necessary for capital expenditures, in command to continue the production capability of the firm. They admit also the potential explanation connecting to free cash flow as the cash residual at the executives' free optimal, gaining the ultimate rate by deducing from operative cash flow the expanses necessary for capital outlay, dividend fee, and credits payment.

Batrancea (2008), defines free cash flow as "money put aside", is in fact cash produced by the company for its investors, after reimbursing financial debts and accomplishment essential increase investments. A similar calculation belief is accepted by Antill Lee (2008), excepting for the non-cash features, substituted exclusively by devaluation. Robinson, Van Greening, Henry, and Brouhaha (2009) have the same vision, considering free cash flow as the operating cash flow exceeding the capital expenditure amount while accepting also the extended formula taking into account non-cash adjustments. Artiachea, Leea, Nelson & Walker (2010), consider free cash flow an assessment of the firm's liquidity, while a high numbered designates financial capability of investing in maintainable projects, without sacrificing the claims of third parties.

Dividend Policy and Retention Policy

Modigliani and Miller in 1961 challenged the belief that payment of the dividend raises the value of the company and they said the perfect market dividend decision will not affect the firm's value but two other economists Lintner 1962 and Garden 1963 supported bird in hand theory and they said that in the world of imperfect information firms pay a high dividend is related to that the firm has high value.

The cash flow declaration is about where the cash came, where it left and will go. In small, cash flow declaration displays the inevitability, control, and total of cash-arrivals and cash-discharges. Also, it is utilized in corporate development and forecasting. Accounting personal are involved in meaningful association capability to cover payroll and further direct expense. While creditors would like to see the firms able to pay back or not. Furthermore, latent shareholders have to judge the firm's economics and outworking or prospective workers that content to see the firm is capable to give reward Mulford Comiskey (2005)

Classification of Cash Flow

In cash flow reports, it has three different activities that are process, investing, and funding. Cash flow from working activities points to the cash afford or used by a firm's usual operations. This cash flow facts display the capability of the firm to be reliable in making positive cash flow from process actions. Operations activities are the main business of the firm. It is the cash that the firm creates inside. Financing activities are positioning and obtaining of possessions, plant and equipment, investment, collecting the advance, and lending money. Cash flows in investing comprise all the money delivered or used by the trade and buying of revenue-creating resources. Cash flow from investing typically makes cash losses. For instance, activities like capital expenditures for plant, possessions, and tools, the buying of investment securities, and corporate acquirement. Also, inflows were created from the investment safeties, trades, and deal of material goods. Capital expenditure is what shareholders would like to take a look at. Shareholders consider that it is essential to confirm the appropriate preservation of assets of the firm and funding the company's process competence and effectiveness.

Financing activities create cash from providing liability, repurchasing stocks; pay back the amounts on loan, paying share, and get money from stockholders. In financing activities, the cash flow is intended with the flow of cash among a company and its creditors and holders. Negative numbers may exemplify the firm salaried dividend and repurchase stock but it also might display the firm is repairing debt. Debit and equity dealings are in financing activities. The issuance of stock is far less frequent. Cash dividends paid are more essential for shareholders.

Different methods in Cash Flow

Different approaches are used in dissimilar cash flow statement setup. The first one is the second method and the other is the primary method. The secondary method regulates net revenue for substances that do not affect money. This way is extra broadly used by firms as it is easier and fewer expensive to get ready. Furthermore, it distinguishes among net revenue and net cash flow from working actions. However operative cash earnings and costs are exposed in the primary way which creates the shortest approaches to be reliable with the cash flow account's objective.

Cash Flow versus Income

It is energetic to able to realize and distinguish among the optimistic cash flow dealings and the presence of money-making. Firms do not transport in cash is not cruel that they not producing revenue. For example, the engineering company trades off partial of its plant tools because of little goods demand. Cash will be expected from the purchaser for the used equipment. Engineering Corporation is really down money on the deal. Equipment is production goods to make a working income would be better. The finest option is to trade off the equipment at value

abundant smaller than the firm salaried for it. In the year that it traded the apparatus, the firm would finish up with solid affirmative cash flow, but its present and upcoming comes possible would be quite desolate. Cash flow can be helpful whereas productivity is harmful Mulford and Comiskey (2005).

Variables

Dependent Variable

Free Cash Flow

Free cash flow that is available after paying business requirements and expenses is called free cash flow. The company needs cash flow to operate the business, the first thing business do is to keep the business going then business pay their expenses, once company paid every expense the remaining cash flow is available for the operations which give life to business, free cash flows is simply that cash flow which is in the hand and the control of the company and free to use that cash flow in any way the company wants.

Free cash flow was calculated for this research as

$$FCF = EBIT(1 - \text{Tax}) + \text{Dep} \pm \text{Change in W.C} - \text{Capital Expenditure}$$

Independent Variables

Earnings before Interest and Taxes (EBIT)

In accounting and economics, earnings before interest and taxes are appraised of company revenue that comprises all expenses excluding interest and income tax expenditures. It is the dissimilarity among operating returns and operating expenses.

$$EBIT = \text{Revenue} - \text{Operating Expenses}$$

Tax

A fee charged by a government on a good, profit, or activity. If tax is charged straight on individual or company income, then it is a straight tax. If tax is charged on the price of services or goods, formerly it is known as indirect tax. Taxation determines to finance government spending.

Depreciation

A decrease in the price of an asset over time, due in exacting to wear and tear. Depreciation is an accounting process of distributing the price of a touchable asset over its practical life. Companies decline long-term possessions for both tax and accounting determinations. For tax reasons, businesses can subtract the cost of the touchable assets they buy as business expenses; however, businesses must reduce these assets in agreement with the IRS policy about how and when the decision might be taken.

Dividend

A dividend is a payment made by a corporation to its shareholders, typically as a sharing of returns. When a business makes money or surplus, the firm is capable to put into the profit in the business called retained earnings and pay amount of the profit as a payment to shareholders.

Sharing to shareholders may be in hard cash typically a deposit into a bank account or, if the firm has a dividend reinvestment plan, the total can be paid by the issue of additional shares or share repurchase.

Working Capital

Working capital abridged WC is an economic metric that signifies operating liquidity obtainable to a corporate, corporate, or another individual, including legislative individuals Laterally by permanent assets such as plant and gear, working capital is measured a fraction of operating capital. Gross working capital is equivalent to current assets. Working capital is measured as existing assets minus existing liabilities. If existing assets are less than existing liabilities, an entity has working capital insufficiency, also known as the working capital deficiency.

Capital Expenditure

Capital spending is capitals used by a firm to obtain, promotion, and uphold physical assets such as possessions, industrial buildings, or gear. Capital Expenditure is often used to start new projects or investments by the company. This type of financial expend is also made by corporations to uphold or raise the range of their operations

Hypothesis

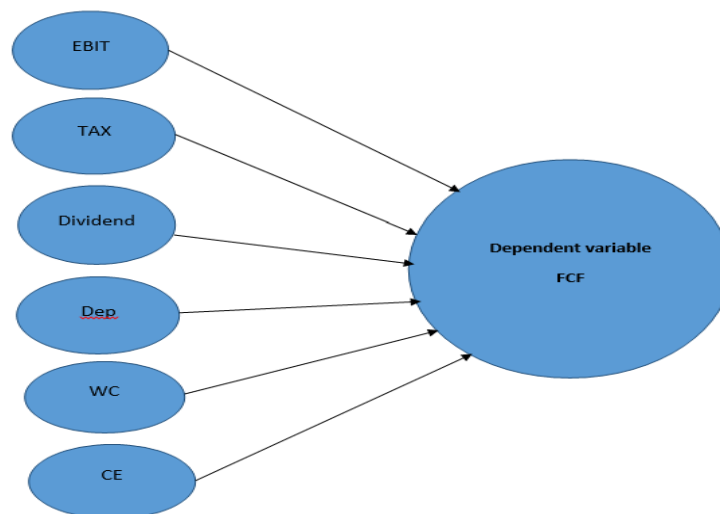
H0 The relationship between free cash flow and the dividend is insignificant.

H1 Dividends are paid-out to stockholders to prevent managers from building a needless realm in their narrow interests.

H2 EBIT, Tax, Depreciation, Capital Expenditure, Working Capital, and Dividend has a positive significant impact on Free Cash Flow.

Conceptual Model

The conceptual model represents the independent and dependent variables used in the study. In this study, we used six independent variables and one dependent variable.



METHODOLOGY

The prevailing study is following the positivism philosophy. The deductive approach is adopted by the prevailing study. A descriptive research design is utilized by the study because the current study is involved in the cause-effect of free cash flow and dividend policy.

The complete set of information that researchers desire to study is known as the population of the study. For this research study, the target population is the overall cement industry whereas to select a part of it for the testing purpose and then to apply the results with the population is known as a sample of the study (Saunders, 2007). The sample size of the study is 5 cement companies from the whole population. The current study utilized secondary data for analysis. The data was collected from the annual reports of the selected cement companies. The data is of five years from 2011 to 2015.

Model

The econometric model is used for this study

General equation

$$Y_{it} = \beta_0 + \beta_1 X_{it} + \mu_{it}$$

The formula for Free Cash Flow:

$$FCF = EBIT(1 - \text{Tax}) + \text{Dep} \pm \text{Change in W.C}$$

Capital Expenditure

Value of FCF has been calculated by using

Above formula.

$$FCF_{it} = \beta_0 + \beta_1 EBIT_{it} + \beta_2 Tax_{it} + \beta_3 Dep_{it} + \beta_4 WC_{it} + \beta_5 C.E_{it} + \mu_{it}$$

FCF= Free cash flow

EBIT= Earnings before interest and tax

Tax= Tax rate

Dep= Depreciation

WC= Working Capital

C.E= Capital Expenditure

By assuming this econometric model, made for this study. The variables used in this research are FCF as dependent and EBIT, TAX, Dividend, Depreciation, Working Capital, Capital expenditure as independent variables. Our concern is to check the connection between free cash flow and dividend. The value of free cash flow has been calculated from EBIT, change in working capital, capital expenditure, tax rate, and depreciation.

The formula for calculation free cash flow

$$FCF = EBIT(1 - \text{Tax}) + \text{Dep} \pm \text{Change in W.C} - \text{Capital Expenditure}$$

Analysis and Discussion

Result and Analysis:

This sector discusses the consequences and main decision of the replica used in this study. These models are discussed in aspect in the Methodology Section.

Table. 4.1: Descriptive Statistics

Variable	MEAN	MEDIAN	MIN	MAX	S.D.	C.V.	SKEW
EBIT	3.9E+06	2.4E+06	98626	2.1E+07	4.5E+06	1.1547	1.3031
TAX	6.5E+05	0.00000	0.00000	2.7E+06	9.2E+05	1.3929	0.97460
DEPRECIATION	1.2E+06	1.0E+06	2.4E+05	6.2E+06	1.4E+06	1.1730	1.4043
WC	2.6E+06	1.7E+06	3.5623E+05	9.8E+06	2.4E+06	0.92471	1.6136
DIV	1.3E+06	7.3E+05	0.00000	5.7E+06	1.4E+06	1.0838	1.3129
FA	2.2E+06	2.5E+07	3.4E+06	6.6E+07	1.6E+07	0.73563	0.59353
FCF	2.9E+06	1.99E+06	768E+06	1.0E+07	5.0E+06	1.6723	-0.21449
Change in wc	5.9E+05	1.9E+05	-5.3E+06	6.6E+06	1.9E+06	3.3543	0.31705
CE	2.0E+06	2.5E+05	-4.2E+06	3.3E+07	6.7E+06	3.2393	1.0525

Table 4.1 shows the result of several variables includes FCF (free cash flow), EBIT (Earnings before Interest and Taxes), Tax (Tax Rate), Dep (Depreciation), WC (Working Capital) and C.E (Capital Expenditure). The mean median of the variable EBIT is 3.96 and 2.48 respectively. Also for the Tax variable, the mean is 6.65 and 0.00 respectively. Likewise, for Depreciation variable mean value is 1.26 and 1.06. For WC the mean value is 2.64 and 1.74. The mean value for DIV is 1.36 and 7.36. For FA variable mean value is 2.24 and 2.52. The mean median of the variable FCF is 2.99 and 1.99. Change in Working Capital means the value is 5.90 and 1.93. For variable, CE means the value is 2.09 and 2.52 respectively.

The variables included in the data are FCF (free cash flow), EBIT (Earnings before Interest and Taxes), Tax (Tax Rate), Dep (Depreciation), WC (Working Capital), and C.E (Capital Expenditure). The standard deviation for variable EBIT is 4.5 and the related measure i.e. coefficient of a variable is 1.15. Also for the Tax variable, the standard deviation is 6.26 and 1.39 respectively. Likewise, for variable Depreciation, the standard deviation value is 1.48 and 1.17. For WC the standard deviation value is 2.44 and 0.92. The standard deviation value for DIV is 1.48 and 108. For FA variable standard deviation value is 1.65 and 0.73. The standard deviation median of the variable FCF is 5.01 and 1.67. For Change in Working Capital standard deviation value is 1.98 and 3.35. For variable CE standard deviation is 6.78 and 3.23 correspondingly.

Table.4.2 Coefficient

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	35679.072	356104.124		.100	.921
EBIT	1.050	.158	.960	6.642	.000
TAX	-2.032	.376	-.376	-5.410	.000
DEPRECIATION	.853	.177	.252	4.806	.000
WC	.445	.224	.211	1.981	.065
DIV	.155	.271	.046	.572	.575
FA	-.032	.027	-.105	-1.207	.245
change in WC	.837	.136	.331	6.137	.000
CE	-.999	.054	-.152	-18.556	.000

R= 0.376, R2 = 0.141, R2 adjusted = 0.069, F = 1.960 (p-value = 0.044), DW = 0.666, N = 130

The result shows that the t-value for EBIT is 6.642 with p-value .000. This shows that EBIT has a positive and significant relationship with FCF. The t-value for tax is -5.410 with p-value .000. This shows that tax has a negative and significant relationship with FCF. The t-value for Depreciation is 4.806 with p-value .000. This shows that Dep has a positive and significant relationship with FCF. The t-value for WC is 1.981 with p-value .065. This shows that WC has a positive and insignificant relationship with FCF. The t-value for Div is .572 with p-value .575. This shows that Dividend has a positive and insignificant relationship with FCF. The t-value for FA is -1.207 with p-value .241. This shows that FA has a negative and insignificant relationship with FCF. The t-value for change in WC is 6.137 with p-value .000. This shows that change in WC has a positive and significant relationship with FCF. The t-value for CE is -18.556 with p-value .000. This shows that CE has a negative and significant relationship with FCF.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions of exacting interest are the casing where a company can require to changed dividends in sort to invest in the latest rate-making venture, but where the company will be penalized by the market since shareholders are behaviorally trained to suppose that payment cuts are terrible newscast. This may consequence in companies declining to cut payments, therefore passing up high-quality schemes. This paper shows that executive message to shareholders concerning the basis for the dividend cut, supported by executive standing effects, and may alleviate this difficulty. Actual world examples are offered to demonstrate the difficulty of dividend strategy.

When the interests of firm directors and those of stockholders conflict, agency costs increase due to the agency difficulty. This can guide to the use of free cash flow for investments with an undesirable net existing value or wasteful expenses not straight connected to firm operations, so having an undesirable collision on a firm. According to the free cash flow theory, free cash flow can be reduced with dividend payouts and protecting exterior debt financing. This way companies can make stronger their performance. This study examines the soundness of the free cash flow theory. Most accurately, it tests for an undesirable connection among free cash flow and firm performance for companies traded in Pakistan. The consequences of regression disclose a negative, statistically major connection among free cash flow and dividend. The decrease of free cash flow under directors' management is displayed to have a positive outcome on firm performance, however, an increase in free cash flow is exposed to have an undesirable effect. Given that better significance is being placed on corporate governance in Turkey, this study's test of the theoretical outline can donate to the configuration of policy and principles in this area. According to the free cash flow theory, free cash flow guides to agency cost and undesirably belongings company performance; thus it can be helpful to take on these main beliefs and/or generate regulations that discipline or diminish free cash flow in the hands of executives. In sort to decrease free cash flow, dividend outflow must be controlled through corporate governance's main beliefs, which can be used as a political instrument by regulatory authorities.

According to our result, there is a positive connection between free cash flow (FCF) and stock value. In prior studies, we also locate that they have certain consequences that there is a positive connection between free cash flow and stock price. We establish that capital formation is moving 25% to the stock price, it demonstrates that capital construction does not involve too much to stock price. Some other aspects affect the stock rate of 75%. We are centering only micro factors so at the conclusion we can determine that macro factors like demand and supply, political uncertainty, price rises, etc. these aspects have a certain connection to stock rate. It is an advocate only that those who will perform research on this topic "Relationship between Free Cash Flow and Dividend", they must see macro factors as according to outcome capital construction affects 25% stock prices, so 75% effects other factors.

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