Profitability, Dividend Policy and Stock Prices: A Case Study on Kuwaiti Insurance Companies

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ABSTRACT

There has always been controversy among researchers over how dividend policies affect share prices, and this equivocal relationship varies throughout international markets. This study is set to examine the relation between share prices and number of dividend policy and profitability variables. Based on the information from five insurance companies that are listed on Kuwait Stock Exchange (KSE) over the period 2014 and 2022, findings indicates that 55.3% of stock prices could be explained by factors related to profitability and dividend policy. The relationship between stock price, as a dependent variable, and earnings per share (EPS), dividend yield (DY), earning to price ratio (EP), risk premium (RP), and retention ratio (RR), as independent variables, was investigated in this study using OLS regression approach. The results of the regression analysis demonstrated a significant direct relationship between stock price and earnings per share (EPS), suggesting that investors choose highly profitable shares. At the 99% confidence level, the earnings to price ratio (EP) likewise revealed a statistically significant direct relationship with the stock price. At 90% confidence level, risk premium (RP) also shown a substantial direct relationship. The only variable that significantly correlated negatively with share prices was dividend yield (DY), suggesting that investors choose more stable payouts over uncertain future capital gains. Conversely, the retention ratio (RR) demonstrated a negligible direct impact on share prices.

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Introduction

Capital markets are the most favored investment venues for investors. For instance, in the United States, over half of the population owns stocks, and in Australia, the same is true. However, there are differences in the perspectives of investors regarding stock dividends. Some investors want large dividends and consistent cash flows from their investments, while others would rather see the business keep its profits and reinvest them to grow their operations hoping in making more money later on through capital gains. Researchers are wondering if these preferences for dividend payments have an impact on the stock price.

Regarding the effect of dividend policy on companies share prices, it can be seen that researches are divided into two camps. The first one, led by Miller and Modigliani (1961) and Black and Scholes (1974) see that there is no relation between dividends and share prices, which is called the irrelevance theory. While the other camp, which is led by Gordon (1959) believes that there is a strong relation between the amounts of dividends a company pays and its share price, which is known as the relevance theory.

In supporting the irrelevance theory, Allen and Rachim (1996) examined the data of 173 Australian listed stocks and concluded that there is no relationship between the dividend yield and stock market price. Jakata and Nyamugure (2014) studied the effect of dividend policy on share prices and found no relation between them when examining the data of selected firms on the Zimbabwean stock exchange (ZSE) over the period 2003-2011. AlAli et al. (2019) used the data of four insurance companies listed at Kuwait Stock Exchange (KSE) over the period 2009-2017 to examine the relation between dividend yield and stock price and found...
statistically significant negative relation between them. In supporting the relevance theory, Ohiaeri et al. (2019) stated that investors prefer an increase in the number of dividends previously distributed and that increased dividends obtained by investors will increase interest in investing and share prices will increase along with increased investor confidence and company value. Campbell and Shiller (1988) examined the relationship between stock prices, earnings and expected dividends and concluded that earnings and dividends are powerful in predicting stock returns over several years. Akbar and Baig (2010) studied a sample of 79 companies listed at Karachi Stock Exchange (KSE) for the period of 2004 to 2007. Results of their study showed that dividends; either cash dividend or stock dividend or both had positive effect on stock prices. Based on the conflicted results and the ambiguous relation between dividend policy and stock prices, Black (1976) summarized that argument by stating that “The harder we look at the dividend picture, it seems like a puzzle with pieces that don’t fit together”.

This research is set to examine the effect of number of profitability and dividend policy factors on the stock prices of insurance companies listed at Kuwait stock exchange (KSE). Earnings per share (EPS) is calculated by dividing the company net profit by the number of outstanding shares. It is often used by investors in their stock evaluation analysis. Vetereina et al. (2020) stated that Earnings per share (EPS) has a significant positive effect on stock prices. The greater the EPS of the company will provide a reasonably good return (Fauza and Mustanda, 2016). This will encourage investors to make even more substantial investments leading to a higher share price of the company (Innafisah, 2019). In his study, AlAli (2020) used the data of 10 banks listed at Kuwait stock exchange (KSE) over the period 2008-2018 and concluded that there is a significant positive relation between stock price and earning per share (EPS). Arsal (2021) looked at the impact of earnings per share (EPS) and dividends per share (DPS) on the stock prices of companies listed at Indonesian stock exchange over the period 2014-2017 and found that earning per share (EPS) had significant positive impact on share prices but dividend per share (DPS) did not.

Dividend yield (DY) is another factor affecting the share price of a company; it is the amount of dividends a company pays per share compared to the market price of the share. It is used by investors to measure the compensation they get for investing in that stock. According to Ohiaeri et al. (2019), dividend yield is used to measure the return on investment in shares received by investors in one year. The higher amount of dividends paid, compared to the stock price, will increase investors motivation to buy company shares and therefore increase share prices. In their study, Osaikwe et al. (2019) concluded that dividend yield is more important to the investors than the absolute value paid out as dividend. Dividend yield is considered an important variable that is used by many researchers to examine its effect on share prices. When examining the effect of dividend policy on stock prices of companies listed in the Nigerian Stock Exchange, Okafor et al. (2011) found that dividend policy, including dividend yield, were relevant in determining share prices. Using a sample of fifty five companies listed at Karachi Stock Exchange (KSE), Khan et al. (2011) found that dividend yield, earnings per share, return on equity and profit after tax were positively related to stock prices while retention ratio had negative impact on stock prices.

Earning to share price ratio (EP) indicates the yield where the investor bought his stocks in regard to the earning of the firm. In a perfect market, that ratio should be equal for all firms. But due to the imperfection of the market, that ratio differs from one firm to another. This ratio is used to evaluate the share price of the firm, having a higher ratio than the mean ratio of the market sector would indicate that the share price of that firm is undervalued and would lead to a price rise and vice versa. Interest rate (IR) has a huge impact in stock prices, Demirguc-Kunt and Maksimovic (1996) found that countries with low interest rate have strong stock market as compared to countries which have higher interest rate. They also mentioned that developed countries usually have low interest rates resulting in an extra-ordinary stock markets performance compared developing and under-developed countries with high interest rate. Kganyago and Gumbo (2015) stated that lower lending rates are expected to be translated into higher stock market returns. Investing in stock markets is often associated with risk, and investors need to be compensated for the risk they are taking. Risk premium (RP) is basically the difference between stock return and risk-free investments such as treasuries and bank time deposits. The higher the risk premium a company pays would encourage investors to invest in its shares leading to higher prices.

Retention ratio (RR) is a factor that is often used by researchers to examine dividend policy factors on stock prices. Retention ratio (RR) is the ratio of the company’s profit that is not distributed to investors. Retention ratio (RR) is measured by dividing the company’s profit after tax by earnings per share (EPS) (Ohiaeri, et.al 2019). Investors have mixed reactions when it comes to retention ratio, while some investors see it as a favorable ratio since the company would use that money in either the expansion of its operations or to reduce the finance burdened on the company leading to future capital gains. In his study of Kuwaiti banks, AlAli (2020) concluded that investors in Kuwaiti banks stocks prefer uncertain future capital gains over dividend payments. Other investors would prefer receiving steady cash flow from the company since it is less risky and more certain than future capital gain. Amidu (2007) concluded that investors prefer dividends over capital gain since they are less risky and that companies should set a high payout ratio and offer high dividend yield to maximize their share prices. Researchers showed conflicted results when it comes to the effect of retention ratio on stock prices, Khan et al. (2011) studied twenty five Chemical and Pharmaceutical companies listed in Pakistan KSE-100 Index and found insignificant negative relation between retention ratio and stock prices. Hunjra et al. (2014) also concluded that there is a negative influence between retention ratio and stock prices. On the other hand, Pani (2008) found positive relationship between retention ratio and stock prices.

Methodology

This study aims to explore the relation between dividend policies of five Kuwaiti insurance companies listed at Kuwait Stock Exchange (KSE) and their effect on stock prices over the period 2014-2022. Panel data is used to evaluate the relation between stock price (P), as a dependent variable, against earnings per share (EPS), dividend yield (DY), earning to price ratio (EP), risk premium (RP), and retention ratio (RR) as independent variables. The assumption is as follows,
\[ P = \alpha + \beta_1 \text{EPS} + \beta_2 \text{DY} + \beta_3 \text{EP} + \beta_4 \text{RP} + \beta_5 \text{RR} + \epsilon \]  

The variables under study are described in the table 1 as follows:

<table>
<thead>
<tr>
<th>Variable</th>
<th>Symbol</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share Price</td>
<td>P</td>
<td>Market share price</td>
</tr>
<tr>
<td>Earnings Per Share</td>
<td>EPS</td>
<td>Net profit divided by number of outstanding shares</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>DY</td>
<td>Dividend per share divided by share market price</td>
</tr>
<tr>
<td>Earning to price</td>
<td>EP</td>
<td>Earnings per share divided by share market price</td>
</tr>
<tr>
<td>Risk Premium</td>
<td>RP</td>
<td>Dividend yield minus bank one year deposit rate</td>
</tr>
<tr>
<td>Retention Ratio</td>
<td>RR</td>
<td>( \frac{\text{EPS} - \text{Dividend paid per share}}{\text{EPS}} )</td>
</tr>
<tr>
<td>Error term</td>
<td>( \epsilon )</td>
<td>Error term</td>
</tr>
</tbody>
</table>

### Data and Empirical Results

This research is based on the data of five insurance companies that are listed at Kuwait stock exchange (KSE) over the period 2014-2022. The data used in this research were obtained from the web sites of Kuwait Stock Exchange (KSE) and Kuwait Institute of Banking Studies (KIBS).

Descriptive Analysis is presented in table 2, where it can be seen that the average share prices was 352.65 fils (1 Kuwaiti Dinar = 1000 fils = U.S.$3.3) and the average return was 6.77%. The average earning per share in the insurance sector was 42.36 fils which represents earning to price ratio of 11.49%. By looking at the skewness of the data, it is ranging between -1.53 and 1.12 and the kurtosis ranging between 0.61 and 8.78. Skewness and kurtosis are often used to identify distribution normality of the data. According to Klein (1998), data can be labeled as normally distributed if the fall within the acceptable range of ±3 and ±10 for skewness and kurtosis respectively, and from the table it can be concluded that the data is normally distributed.

In table 3, the strongest positive correlation was between dividend yield and risk premium meaning that investors are weighing the risk-reward between risky stocks and secured bank time deposit, the higher bank deposits go, the higher investors require dividend yields. On the other hand, the strongest negative correlation was between earning to price ratio and the retention ratio. Pearson correlation matrix can also be used to detect any multicollinearity in the data. Ejigu (2016) identified 0.80 as the threshold for multicollinearity, and, on the other hand, Kramaric et al. (2017) used 0.70. In this research, a threshold of 0.70 is used to identify multicollinearity, and it can be seen that the data does not suffer from any multicollinearity.
The OLS regression output is presented in Table 4, where profitability and dividend policy variables were able to explain 55.3% of the stock price. The model can also be labeled as a “good fit” since $F$ is 0. By looking at the variables, it can be seen from the output that earning per share (EPS) had a statistically significant direct relation with stock price confirming Arsal (2021) findings. Earning to price ratio also showed significant positive relation with price which means that investors favor shares with higher earning to price ratio. When it comes to risk premium, it can be seen that there is a significant direct relation indicating that investors tend to buy shares with high premium resulting in price increase. Retention ratio also showed significant positive relation with stock prices that means that investors prefer uncertain future capital gain over steady dividend cash-flow. Dividend yield was the only factor that showed a statistically significant inverse relation with stock price which confirm AlAli et al. (2019) and contradicts Khan et al. (2011) and confirms that investor’s preference of capital gain over dividend.

### Table 4: OLS Regression Output

<table>
<thead>
<tr>
<th>Coefficients</th>
<th>Standard Error</th>
<th>t Stat</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>188.878</td>
<td>32.529</td>
<td>5.806</td>
</tr>
<tr>
<td>EPS</td>
<td>8.285***</td>
<td>0.309</td>
<td>26.806</td>
</tr>
<tr>
<td>DY</td>
<td>-20.608*</td>
<td>11.165</td>
<td>-1.846</td>
</tr>
<tr>
<td>EP</td>
<td>12.099***</td>
<td>2.280</td>
<td>5.307</td>
</tr>
<tr>
<td>RP</td>
<td>21.446*</td>
<td>11.134</td>
<td>1.926</td>
</tr>
<tr>
<td>RR</td>
<td>0.001</td>
<td>0.021</td>
<td>0.059</td>
</tr>
</tbody>
</table>

* *** represents the confidence level at 90%, 95%, and 99% respectively.

### Conclusion

The objective of this study was to investigate the impact of factors related to dividend policy and profitability on the share prices of Kuwaiti insurance companies listed on the Kuwait Stock Exchange (KSE) over the period 2014 and 2022. Earnings per share (EPS), earning to price ratio (EP), and risk premium (RP) all demonstrated substantial direct effects on share prices when the relations were examined using OLS models. However, the only variable that significantly correlated negatively with the stock prices of insurance businesses was dividend yield (DY). The only element that had a negligible direct correlation with stock price was the retention ratio (RR). The study’s findings suggest that rather than receiving immediate dividends, investors in the Kuwait Stock Exchange (KSE) would rather wait for future financial gains. The results additionally demonstrated the significant explanatory power of dividend policy and profitability determinants on stock prices reaching 55.3%, which is adequate to guide the decisions of many investors.

### Acknowledgement


**Institutional Review Board Statement:** Ethical review and approval were waived for this study, due to that the research does not deal with vulnerable groups or sensitive issues.

**Data Availability Statement:** The data presented in this study are available on request from the corresponding author. The data are not publicly available due to privacy.

**Conflicts of Interest:** The authors declare no conflict of interest.

### References


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