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The Relationship between Financial Flexibility and Dividend Payouts: A Case of Listed Firms in Kenya

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Abstract
Dividend payouts must be viewed as part of an integrated financial strategy that include a company's future funding needs and have costs and benefit implications on financial flexibility since they involve amounts and timing of cash flows. The study found out that there exists a relationship between the financial flexibility and dividend policy and that the probability and amount of dividends decrease as the value of financial flexibility increases.
Keywords: Financial flexibility, dividend policy, Nairobi Securities Exchange

1. Introduction

In surveys analysing current practice of corporate finance with particular focus on the areas of capital budgeting and capital structure among American and European chief financial officers, findings suggest that the sole most important determinant of a firm's capital structure is the aspiration to preserve financial flexibility (Graham and Harvey (2002), Bancel and Mittoo (2004) and Brounen et al. (2004)). Financial flexibility is a firm's capacity to mobilize its financial resources in response to uncertain future contingencies (Byoun 2011) or a firm's ability to access financing at a low cost and respond to unexpected changes in the firm's cash flows or investment opportunities in a timely manner (Denis, 2011). The Financial Accounting Standards Board (FASB) defines it as the ability of an entity to take effective actions to alter amounts and timing of cash flows so that it can respond to unexpected needs and opportunities (FASB, 2008).

Financial flexibility may come either from internal capital or external capital. The external sources of capital are debt financing and equity financing. A financially flexible business may have a large inflow of cash from operations, large borrowing capabilities, or assets that can be realized quickly in significant amounts (FASB, 1980b). Financially flexible firms are able to avoid financial distress in the face of crisis and to readily fund investment when profitable opportunities arise. While firms with financial flexibility enjoy easier access to external capital markets to meet funding needs arising from unanticipated earnings shortfalls and/or new growth opportunities, those that are less flexible are more vulnerable to sudden drops in their cash flows (Ayaydin, Florackis & Ozkan 2014).

Reflected in cash holding theory, the concept of financial flexibility matters in the presence of financing frictions, under which firms have precautionary incentives to stockpile cash. Specifically, the precautionary savings hypothesis posits that firms hold cash as a buffer to shield from adverse cash flow shocks due to costly external financing. Opler, et al. (1999), Harford (1999), Bates, Kahle and Stulz (2009), and Duchin (2010), among others provide evidence of precautionary savings' role in cash policy. Cash studies typically control for leverage and sometimes cash substitutes such as net working capital. Almeida, et al. (2004) and Faulkender and Wang (2006) have shown that cash policy is more important when firms are financially constrained.

Theoretically, dividend payments convey information about future prospects. Firms pay out dividends only if managers expect future funds to be adequate. A decision to make dividend payments or increase payments conveys that the firm currently has excessive financial flexibility (i.e., high cash levels or low debt ratios) or that managers perceive operating cash flow to become stronger or more certain, and vice versa for a decision to decrease payouts. To my knowledge, no extant study has directly tested the role of financial flexibility in shaping payout decisions in Kenya. Dividend policy must be viewed as part of an integrated financial strategy that includes a company's future funding needs. This paper examines the relationship between financial flexibility and dividend policy in Kenya in the periods 2008-2012.

2. Hypotheses

H_1: There is a relationship between financial flexibility and dividend policy.
H_2: Firms with a high value of financial flexibility have lower dividend payouts.

3. Literature Review

One of the central challenges in financial economics is the quest to understand the payout behavior of firms. While it is well known that payout decisions are irrelevant in perfect capital markets (Miller and Modigliani

(1961)), intense discussions among managers, shareholders, researchers, and other commentators suggest that payouts do matter. Moreover, survey results suggest that financial managers attribute substantial weight to financial flexibility considerations when they decide on their capital structure (Graham and Harvey (2001)) and prefer repurchasing shares to paying cash dividends, because they perceive repurchases as a more flexible means of payout (Brav, Graham, Harvey, and Michaely (2005)).

According to DeAngeloa, DeAngeloa & Stulz (2006) dividends tend to be paid by mature, established firms, plausibly reflecting a financial life cycle in which young firms face relatively abundant investment opportunities with limited resources so that retention dominates distribution, whereas mature firms are better candidates to pay dividends because they have higher profitability and fewer attractive investment opportunities. This view is also advanced by Bulan, Subramanian and Tanlu (2007) who found out that the optimal dividend policy of a firm depends on the firm's stage in its life cycle. The underlying premise is that firms generally follow a life-cycle trajectory from origin to maturity that is associated with a shrinking investment opportunity set, declining growth rate, and decreasing cost of raising external capital. The optimal dividend policy, derived from a trade-off between the costs and benefits of raising capital for new investments, evolves with these life-cycle-related changes. As the firm becomes more mature the optimal payout ratio increases.

Cash holdings and retained cash flows come at cost as they are subject to tax disadvantage, have high opportunity costs and they raise agency problems due to shareholders' limited monitoring ability towards the use of funds (Jensen (1986). Furthermore, cash holdings provide rather short-term than long-term liquidity and are often insufficient for large investment projects. Therefore, firms with ample cash flows prefer paying out dividends to shareholders than introducing more debt to capital structure and focus on increasing the company's ability to access external capital markets. Financial flexibility results from the company's unused debt capacity as the unused debt capacity denotes the amount of debt a firm can issue without facing constraints and excess cost of capital (Hess and Immenkötter, 2014).

As dividend cuts are easily observable, managers damage their reputation if they reduce the ordinary dividend without a credible reason for distress. Empirically, managers rarely cut regular dividends at non-distressed firms (DeAngelo et al. 1992); in fact managers are reluctant to reduce dividends for any reason. Thus, dividends are paid by firms with higher permanent operating cash flows, while repurchases are used by firms with higher temporary, non-operating cash flows (Jagannathan et al. 2000). Managers can incorporate financial flexibility into their equity payout policies by having low ordinary dividend yield, thereby retaining internal funds. As internal funds increase, managers have the option to issue a transitory equity payout, extra dividend or stock repurchase, to mitigate agency costs (Jagannathan et al. 2000, Lie 2005).

Gamba & Triantis (2008) examined the impact of financial flexibility on firm value and on dynamic investment, financing and cash retention policies. Financial flexibility depends not only on direct costs of external financing, but also on corporate and personal tax rates and the liquidation value of capital. They found out that a firm can compensate for low exogenous financial flexibility (i.e., high transaction costs) by optimally managing its liquidity policy and that simultaneous borrowing and lending by the firm can be optimal in the presence of financing frictions, and that controlling leverage and liquidity policies separately can increase firm value relative to controlling only the net debt level.

Blau and Fuller (2008) developed a model of corporate dividend policy based on the idea that management values operating flexibility. By reducing dividends and conserving cash, management increases its flexibility. This improves its ability to invest in projects that it believes are good for the shareholders in the long run but which shareholders would not provide the capital for because they think the projects are value reducing. However, the cost of not paying dividends is a reduction in the current stock price. Management trades off these two aspects of dividends. Flexibility considerations help us understand various dimensions of dividend policy that existing theories do not explain.

Myers (1984) developed the pecking order model of financing decisions. The pecking order arises if the costs of issuing new securities overwhelm other costs and benefits of dividends and debt. The financing costs that produce pecking order behavior include the transaction costs associated with new issues and the costs that arise because of management's superior information about the firm's prospects and the value of its risky securities. Because of these costs, firms finance new investments first with retained earnings, then with safe debt, then with risky debt, and finally, under duress, with equity. As a result, variation in a firm's leverage is driven not by the tradeoff model's costs and benefits of debt, but rather by the firm's net cash flows (cash earnings minus investment outlays) (Fama & French 2000).

The static trade-off theory focuses on the benefits and costs of issuing debt. It predicts that an optimal target financial debt ratio exists, which maximizes the value of the firm. The optimal point can be attained when the marginal value of the benefits associated with debt issues exactly offsets the increase in the present value of the costs associated with issuing more debt (Myers, 2001). The benefits of debt are the tax deductibility of interest payments and its capacity to reduce the manager-shareholder agency conflict. The costs associated with issuing more debt are the costs of financial distress (Modigliani and Miller, 1963) and the agency costs triggered

by conflicts between shareholders and debtors (Jensen and Meckling, 1976).

According to Jensen (1986), managers tend to invest in negative net present value projects if there is an abundance of free cash flow after investments in positive net present value projects. Conflicts of interest between shareholders and managers may arise due to the excessive amount of funds which is under management's control. Investors value that excessive funds are paid out as equity payouts, instead of investing them in bad projects. Managers could promise to pay out future cash flows and still retain the control over the free cash flow. These kinds of promises are on the other hand weak since dividends can be reduced in the future. If there are cuts in dividend policies, capital markets punish this by reducing stock prices, which is consistent with agency problems of free cash flow.

Bhattacharya's signaling model of corporate dividend policy states that there is imperfect information between shareholders and management regarding firms' profitability. If there are no tax differences between capital gains and dividends, dividends will be a signal on firms' expected earnings (Bhattacharya 1980). According to Kalay (1980), managers are reluctant to cut dividends since they are a necessary condition to distribute information. Bar-Yousef and Huffman (1986) also acknowledges Bhattaraya´s model that the size of dividends is an increasing function of expected earnings. However, they find that the higher the level of expected earnings, the lower the marginal effect on dividends.

4. Theoretical Framework

The rationale behind financial flexibility and effect on dividend policy can be analyzed in the light of the benefits and costs of payouts. On the one hand, the distribution of cash among shareholders has potential benefits for the firm. In particular, distributing cash may signal good earnings prospects to equity investors. Moreover, undistributed cash may be used by managers to increase their own utility, possibly at the expense of the owners. In this framework, dividend payouts mitigate agency problems between managers and shareholders (Jensen (1986)). On the other hand, payouts come at a cost. Payouts reduce retained earnings and the firm's ability to internally finance its future investments and hence force managers to access external capital markets to finance new projects thereby increasing the probability of financial distress. External financial markets play a disciplining and monitoring role that presumably reduces managers' incentives to engage in empire-building activities (Jensen 1986).

5. Model Specification

The study used the following three-step procedure developed by Rapp, Schmid & Urban, 2012 to test the relationship between financial flexibility and payout policy:

1. In the equation below, annual cumulative abnormal returns are regressed on changes in firm characteristics. Firm characteristics are its growth opportunities measured by a firm's Tobin's, profitability measured by operating cash flow, costs of holding cash and individual and corporate tax rates, costs of external financing measured by the volatility of a firm's total shareholder returns and the reversibility of capital measured by a firm's tangibility. Cumulative abnormal returns were calculated based on Fama and French (1993) three factor asset pricing model using Kenya specific factors.

$$r_{i,t} - R_{i,t} = \gamma_0 + \gamma_1 \frac{\Delta C_{i,t}}{M_{i,t-1}} + \gamma_2 \frac{\Delta E_{i,t}}{M_{i,t-1}} + \gamma_3 \frac{\Delta NA_{i,t}}{M_{i,t-1}} + \gamma_4 \frac{\Delta RD_{i,t}}{M_{i,t-1}} + \gamma_5 \frac{\Delta I_{i,t}}{M_{i,t-1}} + \gamma_6 \frac{\Delta D_{i,t}}{M_{i,t-1}} + \gamma_7 \frac{C_{i,t-1}}{M_{i,t-1}} + \gamma_8 L_{i,t} + \gamma_9 \frac{NF_{i,t}}{M_{i,t-1}} + \gamma_{10} TobQ_{i,t} + \gamma_{11} \frac{OCF_{i,t}}{M_{i,t-1}} + \gamma_{12} T_{i,t} + \gamma_{13} PV_{i,t} + \gamma_{14} Tang_{i,t} + \gamma_{15} \frac{C_{i,t-1}}{M_{i,t-1}} \cdot \frac{\Delta C_{i,t}}{M_{i,t-1}} + \gamma_{16} L_{i,t} \cdot \frac{\Delta C_{i,t}}{M_{i,t-1}} + \gamma_{17} TobQ_{i,t} \cdot \frac{\Delta C_{i,t}}{M_{i,t-1}} + \gamma_{18} \frac{OCF_{i,t}}{M_{i,t-1}} \cdot \frac{\Delta C_{i,t}}{M_{i,t-1}} + \gamma_{19} T_{i,t} \cdot \frac{\Delta C_{i,t}}{M_{i,t-1}} + \gamma_{20} PV_{i,t} \cdot \frac{\Delta C_{i,t}}{M_{i,t-1}} + \gamma_{21} Tang_{i,t} \cdot \frac{\Delta C_{i,t}}{M_{i,t-1}} + \epsilon_{i,t} \quad \text{(Eq. 1)}$$

where $r_{i,t} - R_{i,t}$ is the cumulative abnormal return (above benchmark return) of firm *i* in year *t*. The independent variables are firm-specific factors. All independent variables except leverage, Tobin's Q, stock price volatility, and tangibility are divided by the lagged market capitalization of the firm, $M_{i,t-1}$. $C_{i,t}$ is cash and short-term investments. $E_{i,t}$ is earnings before interest, taxes, depreciation, and amortization (EBITDA). $NA_{i,t}$ is total assets minus cash. $RD_{i,t}$, is research and development expense (to zero if there is no research and development expense). $I_{i,t}$ is interest expense. $D_{i,t}$ is cash dividends. $NF_{i,t}$ is net cash flow from financing. Δ denotes the one-year absolute change of a variable. $L_{i,t}$ is leverage defined as total debt divided by the sum of total debt and market capitalization. The additional factors in the equation above, which were taken from the original model by Faulkender andWang (2006), are supposed to control for other determinants of abnormal returns; namely, a firm's financial structure ($I_{i,t}$, $D_{i,t}$, $L_{i,t}$, and $NF_{i,t}$), its investment policy ($RD_{i,t}$ and $NA_{i,t}$), and its profitability ($E_{i,t}$).

2. Based on the regression coefficients for $\frac{\Delta C_{i,t}}{M_{i,t-1}}$ and the interaction terms, I calculate the value of financial flexibility of firm *i* in year *t*, $\text{VOFF}_{i,t}$, as follows:

$$\text{VOFF}_{i,t} = \gamma_1 + \gamma_{15}\frac{C_{i,t-1}}{M_{i,t-1}} + \gamma_{16}L_{i,t} + \gamma_{17}\text{TobQ}_{i,t} + \gamma_{18}\frac{\text{OCF}_{i,t}}{M_{i,t-1}} + \gamma_{19}\text{T}_{i,t} + \gamma_{20}\text{PV}_{i,t} + \gamma_{21}\text{Tang}_{i,t} \quad \text{(Eq. 2)}$$

3. Finally, various payout variables are regressed on the value of financial flexibility in order to analyze the influence of financial flexibility considerations on payout decisions.

6. Data

The population of the study consisted of all firms except banking, utility and insurance firms listed on the Nairobi Stock Exchange (NSE) as at 31st December 2012, a total of forty firms. Accounting and financial ratios data were obtained from the NSE handbook for the period 2008-2012 and NSE Monthly Statistical Bulletins. Firms which were not listed for the entire period of the study were removed from the list. I used firm-year observations. The final sample consisted of 180 firm-year observations over the five year period, which represents 100% of the total expected 180 firm- year observations. In order to generate annual cumulative abnormal returns, the dependent variable in the financial flexibility regression (equation 1), I used the Fama and French (1993) three factor model based on monthly total shareholder returns obtained from NSE Monthly Statistical Bulletins.

Analyzed data is presented using tables that provide a clear picture of the research findings at a glance. First the value of financial was calculated and then OLS regressions were used to determine the relationship between financial flexibility and dividend policy.

In order to calculate cumulative abnormal returns, $r_{i,t} - R_{i,t}$ a Fama and French (1993) three factor model is used. As inputs to this model, I obtained company return data, risk-free interest rates (in Kenya it is called the central bank interest rate), the Fama and French (1993) factors (beta, market capitalization and book-to-market equity). Monthly company return data for the 2008-2012 period was obtained from NSE Monthly Statistical Bulletins. Firms which neither were listed for the entire period of the study nor had missing returns during any year were removed from the list. Data on shareholder returns were obtained from NSE handbook for the period 2008-2012 and validated with company announcements. I then calculated cumulative annual doing monthly time-series regressions. For each month, excess stock returns (stock return minus central bank rate) are regressed on the excess market return. Based on the regression coefficients, monthly abnormal returns are calculated. Using these monthly abnormal returns, yearly cumulative abnormal returns are calculated as the sum over 12 monthly abnormal returns for a given company.

Summary statistics for the period 2008-2012 are provided in Table I below. Group A refers to financial flexibility regressions, while Group B refers to payout regressions.

Table I: Summary Statistics

Variable	N	Value
Group A: Financial Flexibility Regressions		
$r_{i,t} - R_{i,t}$	773	0.0079
$\Delta C_{i,t}$	1,054	0.0016
$\Delta E_{i,t}$	1,021	0.0085
$\Delta NA_{i,t}$	1,054	0.0368
$\Delta RD_{i,t}$	1,057	0.0000
$\Delta I_{i,t}$	1,003	0.0000
$\Delta D_{i,t}$	971	0.0000
$C_{i,t-1}$	1,056	0.1243
$L_{i,t}$	1,145	0.1628
$NF_{i,t}$	990	-0.0080
$TobQ_{i,t}$	1,146	1.0547
$OCF_{i,t}$	991	0.0661
$T_{i,t}$	1,299	0.5561
$PV_{i,t}$	977	0.0959
$Tang_{i,t}$	1,238	0.7946
Group B: Payout Regressions		
$PayerD_{i,t}$	1,165	0.9500
$DI_{i,t}$	1,165	0.1099
$RE_{i,t}$	1,166	0.2174
$TE_{i,t}$	1,275	0.4307
$ROA_{i,t}$	1,274	0.0253
$SGR_{i,t}$	1,177	0.0750
$Logsize_{i,t}$	1,276	4.5515
$Cash_{i,t}$	1,274	0.0976

Where: $r_{i,t} - R_{i,t}$ is the cumulative abnormal return obtained from a Fama and French (1993) model. $C_{i,t}$ is cash and near cash assets to lagged market capitalization. $E_{i,t}$ is EBITDA to lagged market capitalization. $NA_{i,t}$ is total assets minus cash and near cash assets to lagged market capitalization. $RD_{i,t}$ is research and development expense to lagged market capitalization. $I_{i,t}$ is interest expense to lagged market capitalization. $D_{i,t}$ is cash dividends to lagged market capitalization. $L_{i,t}$ is leverage calculated as total debt divided by the sum of total debt and market capitalization. $NF_{i,t}$ is net cash flow from financing activities to lagged market capitalization. $TobQ_{i,t}$ is Tobin's Q defined as market capitalization of common equity divided by total assets. $OCF_{i,t}$ is cash flow from operating activities to lagged market capitalization. $T_{i,t}$ measures the relative taxation of interest at the corporate and individual level. $PV_{i,t}$ is the one-year volatility of monthly total shareholder returns. $Tang_{i,t}$ is tangibility, defined as tangible assets divided by total assets. $PayerD_{i,t}$ is a dummy variable that is set to one if firm i pays cash dividends in year t and zero otherwise. $DI_{i,t}$ is the ratio of cash dividends to net income. $RE_{i,t}$ is retained earnings divided by total assets. $TE_{i,t}$ is total common equity divided by total assets. $ROA_{i,t}$ is net income divided by total assets. $SGR_{i,t}$ is logarithmic sales growth where sales is denominated in millions of kenya shillings (KES). $Logsize_{i,t}$ is the natural logarithm of total assets in millions of KES. $Cash_{i,t}$ is cash and near cash assets scaled by total assets. Δ denotes the one-year absolute change of a variable. All factors and dependent variable were trimmed at the 1% tails to reduce the impact of outliers.

7. Results

Pooled ordinary least squares (OLS) regression results with yearly cumulative abnormal returns ($r_{i,t} - R_{i,t}$) as the dependent variable for the period 2008-2012 period is shown below in Table II.

Table II: Regression Results

Variable	Regression result
Intercept	0.006
$\Delta C_{i,t}$	0.374
$\Delta E_{i,t}$	0.197
$\Delta NA_{i,t}$	0.040
$\Delta RD_{i,t}$	0.115
$\Delta I_{i,t}$	-0.790
$\Delta D_{i,t}$	1.553
$C_{i,t-1}$	0.088
$L_{i,t}$	-0.247
$NF_{i,t}$	0.0749
$TobQ_{i,t}$	0.006
$OCF_{i,t}$	0.282
$T_{i,t}$	-.008
$PV_{i,t}$	0.815
$Tang_{i,t}$	0.006
$C_{i,t-1}$. $\Delta C_{i,t}$	-0.113
$L_{i,t}$. $\Delta C_{i,t}$	-0.144
$TobQ_{i,t}$. $\Delta C_{i,t}$	0.092
$OCF_{i,t}$. $\Delta C_{i,t}$	-0.094
$T_{i,t}$. $\Delta C_{i,t}$	-0.115
$PV_{i,t}$. $\Delta C_{i,t}$	1.119
$Tang_{i,t}$. $\Delta C_{i,t}$	-0.256
R^2	0.168
Adjusted R^2	0.167
N	312

Results of Table III below enable us to understand the relationship between financial flexibility and dividend policy. It presents means of several variables for $VOFF_{i,t}$ annual deciles for the period 2008-2012.

Table III: Means of Variables for $VOFF_{i,t}$

VOFF decile	1	2	3	4	4	6	7	8	9	10
$PayerD_{i,t}$	0.5248	0.5404	0.5099	0.4729	0.4369	0.3999	0.3573	0.3040	0.2448	0.1734
$D_{i,t}$	0.3014	0.2853	0.2542	0.2376	0.2189	0.1965	0.1686	0.1420	0.1119	0.0799
$RE_{i,t}$	0.1974	0.2232	0.1787	0.0999	0.1007	0.0841	-0.0056	-0.1503	-0.3911	-1.1544
$C_{i,t-1}$	0.4400	0.2494	0.1964	0.1598	0.1297	0.1204	0.1104	0.1058	0.1031	0.0944
$L_{i,t}$	0.3319	0.2412	0.2221	0.2151	0.1924	0.1657	0.1440	0.1158	0.0837	0.0487
$TobQ_{i,t}$	0.5481	0.5860	0.6563	0.7090	0.7616	0.8349	0.9260	1.0648	1.3406	2.5692
$OCF_{i,t}$	0.1709	0.1122	0.1082	0.1016	0.0918	0.0834	0.0727	0.0599	0.0452	0.0174
$T_{i,t}$	1.2118	1.1394	1.0494	0.8537	0.7205	0.6624	0.6325	0.6213	0.6119	0.6153
$PV_{i,t}$	0.0728	0.0766	0.0858	0.0883	0.0903	0.0955	0.1020	0.1111	0.1268	0.1577
$Tang_{i,t}$	0.6094	0.6064	0.6007	0.5898	0.5758	0.5565	0.5319	0.5092	0.4995	0.5121

Table IV below shows the relationship between financial flexibility and dividends by presenting the pooled regression results with the dependent variable being either the dividend dummy, $PayerD_{i,t}$ or the ratio of dividends to net income, $DI_{i,t}$. $VOFF_{i,t}$ is the sole explanatory variable.

Table IV: Relationship between Financial Flexibility and Dividends

	$PayerD_{i,t}$	$DI_{i,t}$
Variable		
Intercept	1.0242	0.306
$VOFF_{i,t}$	-2.2595	-0.6215
Pseudo R^2	0.1079	0.0771
N	808	808

8. Discussion

8.1 Approximation of the Value of Financial Flexibility

Refer to Table II. The coefficient for $\Delta C_{i,t}$ is positive and significant at the 1% level. According to the negative and significant coefficients for $C_{i,t-1}.\Delta C_{i,t}$ and $L_{i,t}.\Delta C_{i,t,}$ firms with higher lagged cash holdings and a higher leverage have a lower value of financial flexibility. The value of financial flexibility is also higher in firms with more growth opportunities ($TobQ_{i,t} . \Delta C_{i,t}$). In addition, firms with higher profitability, estimated by $OCF_{i,t} . \Delta C_{i,t}$, have a lower value of financial flexibility. In addition, the negative and significant coefficient for $T_{i,t} . \Delta C_{i,t}$ indicates that the value of financial flexibility decreases as the opportunity costs of holding cash in the firm increase. The value of financial flexibility is higher for firms with high external financial costs, as indicated by the positive coefficient for the stock price volatility, $PV_{i,t} . \Delta C_{i,t}$. Finally, firms with a better reversibility of capital, measured by $Tang_{i,t,}$ have a lower value of financial flexibility, because a firm should, in general, be able to sell tangible assets more easily than intangible assets in the case of unexpected cash needs.

8.2 Impact of Financial Flexibility on Dividend Policy

Refer to Table III. Both the likelihood and the amounts of dividends decrease with a higher value of financial flexibility, which is in line with the financial flexibility perspective of payout policy (Hypothesis H_2). For instance, the mean likelihood of a dividend payment is 0.5248 in the lowest financial flexibility decile, while it is only 0.1734 in the highest decile. Similarly, $DI_{i,t}$ decreases from 0.3014 in the first decile to 0.0799 in the highest decile, suggesting that firms with a low value of financial flexibility pay out almost 30% of their net income via dividends, while firms with a high value of financial flexibility pay only 8% of their net income by means of dividends.

8.3 Dividends

Refer to Table IV. Under $PayerR_{i,t}$, $VOFF_{i,t}$ is the sole explanatory variable. Its coefficient amounts to-2.2595 and it is significantly different from zero at the 1% level. Thus, firms with a higher value financial flexibility are less likely to pay dividends, which is in line with the financial flexibility perspective of payout policy (Hypothesis H_1).

9. Conclusion

The purpose of this study was to determine the relationship between a firm's financial flexibility and its dividend policy. The population of the study consisted of all firms except banking, utility and insurance firms listed on the Nairobi Stock Exchange (NSE) as at 31st December 2012. Firms which were not listed for the entire period of the study were removed from the list.

The study found out that there exists a relationship between the financial flexibility and dividend policy and that a firm's value of financial flexibility has a strong impact on its payout policy. Further, it was found out that the probability and amount of dividends decrease as the value of financial flexibility increases. Firms with high values of financial flexibility are less likely to payout dividend compared to firms with low values of financial flexibility.

These findings have several implications. First, both academics and managers should factor in financial flexibility in dividend policy decisions. Second, the value of financial flexibility affects the behaviour of firms. For that reason, capital markets should come up with mechanisms that ensure that growth is not hindered in firms with high value of financial flexibility.

Future research may involve investigation into the effect of financial flexibility on investment, capital structure and working capital activities.

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