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A macro-analysis of financial decisions: An examination of special dividend announcements

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ABSTRACT

This paper investigates macro-level explanations for why firms pay special dividends. We find both the business cycle and market condition affect the propensity and abnormal returns of special dividends. Firms are more likely to announce special dividends in market or economic downturns than upturns. They tend to use additional cash for business growth in expansions and distribute it to reduce agency costs in contractions. The signaling effect of special dividends is stronger and companies with these announcements are better performers in recessions than in expansions. This research sheds light on and enhances the understanding of why firms disburse extra cash dividends at the aggregate level.

1. Introduction

Why do corporate events happen in waves? It is one of the unsolved puzzles in corporate finance (Brealey & Myers, 1996; Brealey, Myers, & Allen, 2011; Myers, 2001, 2003). Previous studies examine equity offerings, mergers and acquisitions, and share repurchases and find that these events are driven by market conditions. In particular, firms issue equities (Baker & Wurgler, 2000; Lowry, 2003), or use their stocks to acquire targets (Dong, Hirshleifer, Richardson, & Teoh, 2006; Rhodes-Kropf, Robinson, & Viswanathan, 2005) when the market is overvalued, but repurchase their shares (Baker & Wurgler, 2002) when the market is undervalued. This is known as the Market Driven Theory. On the contrary, according to the Neoclassical Efficiency Hypothesis, Dittmar and Dittmar (2008) and DeAngelo, DeAngelo, and Stulz (2010) report that firms initiate share repurchases or announce seasonal equity offerings in relation to their corporate lifecycle stages. Given the debate in the explanation for the timing patterns of corporate events, this study focuses on special dividend announcements to examine why firms pay extra or special dividends from the macro perspective.

Special dividends are one-time cash distributions that firms pay out to their shareholders when they have surplus funds. By announcing special dividends, firms can reduce agency costs, especially when there are no potential or less favorable investment opportunities (Jensen, 1986; Lang & Litzenberger, 1989; Lie, 2000). The distinction between special dividends and share repurchase is price valuation. If managers believe the current share price is not undervalued, they would distribute excess funds to shareholders through special dividends rather than buyback their shares (Howe, He, & Kao, 1992). Compared to regular cash dividends, these one-off announcements are usually viewed as a temporary performance shock; otherwise, firms would increase the level of normal dividends payout (Baker, Mukherjee, & Powell, 2005; Brickley, 1983). Since special dividends are viewed as relatively 'non-recurring" events (Lie, 2000) and they are less related to price valuation, it is interesting to investigate whether and why these announcements happen in waves.

Using a broad sample of the US-listed firms for the period between 1926 and 2012, this research finds that the aggregate special dividend activities come into view as wave patterns. Companies prefer to pay special dividends in bear markets than in bull markets. Both short-term and long-term abnormal returns of these announcements are larger in market downturns than in upturns. The probability and excess returns of firms initiating special dividends increase when investor sentiment decreases. These results show a counter-cyclical effect in special dividend distributions. In addition, we find that the likelihood and abnormal returns of special dividend announcements are negatively correlated to business cycle variables. Both the likelihood and returns are also higher in economic contractions than in expansions. These results

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are consistent with the Agency Theory or Free Cash Flow Hypothesis (Jensen, 1986; Lie, 2000) and further confirm that companies are more likely to keep additional cash and use it for business growth in expansions, but disburse it as special dividends to shareholders in recessions. The market reacts more positively to these announcements as they can mitigate agency problems, prevent managers' waste from daily unnecessary expenses and negative net present value (NPV) projects, as well as increase investor protection and enhance their loyalty to the firms in economic contractions. The positive effect of special dividends payments outweighs the negative effect of the lack of investment opportunities for companies in market downturns. Corporations having sufficient funds or being willing to disburse the extra cash back to their shareholders in tough times are better performers than their counterparts in good times.

We find both market-timing opportunities and the business cycle stages explain the aggregate special dividend activities. However, the relative importance of the business cycle in explaining the propensity and abnormal returns of firms paying special dividends is substantially larger than market-timing opportunities. Hence, the dominant macro-determinant for the decisions on and excess returns of special dividend announcements is the business cycle, which are more consistent with the Neoclassical Efficiency Hypothesis.

This study makes several contributions to the literature. First, it aids in the understanding of patterns in and determinants of special dividend announcements. Most of the existing studies on these announcements focus on using cross-sectional variations in firms' characteristics to explain their decisions on special dividend payments. However, little research has paid attention to investigate the aggregate patterns of these announcements to understand why many firms choose to pay special dividends many times in some periods, but only a few times in others. The findings of this study shed light on why special dividend distributions occur in waves. They directly tie cycles of these activities to the condition of the market and the stage of the economy.

Second, this research is related to much previous research. Apart from the literature on the market overvaluation and investor sentiment driving corporate events of mergers and acquisitions, IPOs, and SEOs (see Baker & Wurgler, 2000, 2006, 2007; Dong et al., 2006; Lowry, 2003; Rhodes-Kropf & Viswanathan, 2004; Rhodes-Kropf et al., 2005), this study is related to the research that uses the business cycle to explain the aggregate patterns and returns of share repurchase and equity offering announcements (see Dittmar & Dittmar, 2008). This study nests both market sentiment as well as business cycle variables into the examination of the events, special dividend distributions. The results assist in resolving the puzzle of how the market-timing and economic cycle factors play a part in the propensity and excess returns of corporate announcements. The findings of this research also complement the outcomes of Harford (2005), Massa, Rehman, and Vermaelen (2007) and Lee, Chen, and Chang (2013), suggesting that industry factors, such as technology shocks and concentration ratio, cause the waves of mergers and acquisitions or share repurchases. The nature of this paper fits in and adds to the literature examining the trends in corporate events.

Third, this study provides an empirical result to the owners of companies as to whether distributing special dividends is a good way to reduce agency costs, especially during market and economic downturns. Since the abnormal returns generated from these announcements are higher in market declines and recessions than in market upturns and expansions, special dividends are confirmed to be a useful tool to alleviate firms' agency problems and increase shareholder wealth in contractions or market downturns. Such findings are in line with the Agency Theory by Jensen (1986), Lang and Litzenberger (1989), and Lie (2000). Finally, this research fills a gap in the literature by using an 87-year time series of US data to investigate the macro-explanations for the decisions to announce special dividends. As far as it can be ascertained, this is the longest and most updated sample period to examine these events.

The remainder of this paper is organized as follows. Section 2 discusses the hypotheses along with the related literature. Section 3 decribes the data used in the research. Section 4 presents and discusses the empirical results. Section 5 provides concluding remarks.

2. Literature review and hypothesis development

2.1. Literature review

Special dividends are firms' assets distributions, normally in the form of cash, to their shareholders after an exceptionally strong earnings increases. They are also referred to as one-time cash distributions or extra dividends. Brickley (1983) reports that the market reaction to regular dividend increases is greater than the reaction to special dividend announcements. He shows that firms with either one of the events experience an increase in earnings in the year of the announcements, but only the firms that raise the level of normal dividends experience earnings increases in the following years. Howe et al. (1992) suggest that managers would not increase their level of regular dividend payment unless they are certain that the current free cash flows or earnings increases will be continued. In this way, firms can avoid the pressure of the cash payments if earnings are reversed in the future. Therefore, special dividends are more recognized as temporary cash shocks or "nonrecurring" excess funds, compared to "recurring" excess funds for normal dividend increases (Lie, 2000).

In general, the main criteria for companies to choose share repurchases over special dividends is to take advantage of price undervaluation. If managers believe that their share prices are undervalued relative to the intrinsic value, they would carry out open market repurchases at the point where repurchase price is equal to current market price (Barclay & Smith, 1988). Share repurchases reduce the number of shares outstanding in the market and increase earnings per share without a change in net profits. Baker et al. (2005) use a survey method to ask US firms listed on the NASDAQ, NYSE, and AMEX from 1994 to 2001. 34.6% of the respondents agree that market undervaluation is the primary motive for share buybacks. The degree of market reaction to repurchases depends on the magnitude of stock undervaluation (Ikenberry, Lakonishok, & Vermaelen, 1995). Chhachhi and Davidson (1997) and Ofer and Thakor (1987) state that the price response to share repurchases is usually greater than special dividends.

There are several reasons that companies initiate special dividends using firm characteristic analysis. First, the Signaling Hypothesis asserts that special dividend distributions send a positive signal to the market about firms' unexpected cash and earnings increases (Brickley, 1983). However, these unexpected increases in earnings are only temporary as they decrease significantly after the special dividends are declared (Crutchley, Hudson, Jensen, & Marshall, 2003; Howe et al., 1992). Second, the Free Cash Flow or Excess Funds Hypothesis suggests that firms announce cash dividends when they have excess funds. By paying extra cash back to their shareholders, corporations can alleviate agency problems and enhance ownership loyalty (Bradford, Chen, & Zhu, 2013; Jensen, 1986; Lie, 2000; Su, Fung, Huang, & Shen, 2014). Balasingham, Dempsey, and Mahamuni (2009) also report that firms with high growth opportunities use extra cash dividends to signal their earnings performance, whereas firms with low growth opportunities pay special dividends to reduce the principal-agent conflict of interests in UK. Third, special dividend distributions can help corporations to defend takeover threats. In particular, share price increases after special dividend announcements so that firm's value and cost of the bid are enlarged; target companies become less attractive and harder to overthrow (Denis, 1990). During the period 1980 to 1987, Denis (1990) finds that shareholders' wealth in target firms increases following special dividend payments, which is different from using share repurchases as a takeover defence. Collier (1965) also reports that special dividends can at least delay some hostile mergers and acquisitions. Beladi, Chao, and Hu (2016a) find a Christmas Effect of special dividend payments, whereby