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# Reputation building and the lifecycle model of dividends

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ABSTRACT

We analyze the relationship between corporate dividend policy and firm lifecycle in a low-disclosure regime, where domestic firms have an incentive to use dividends to build capital market reputation among external investors. We use a range of lifecycle indicators from the extant literature and find that, as predicted by the lifecycle model, dividend payouts increase along the lifecycle until peaking in the mature stage. Furthermore, dividends are positively related to growth opportunities. In all lifecycle stages, firms with relatively larger growth opportunities pay relatively larger dividends. We find that firms in low-disclosure regimes, engage in reputation-building behaviour, not just in the early stages of their lifecycle but also in the mature stage.

## 1. Introduction

The lifecycle model of dividends postulates that a firm's dividend payout policy is a function of their lifecycle stage. Early empirical studies of dividend policy, though not explicitly focusing on the lifecycle model, identified key characteristics of dividend-paying firms that are consistent with the prediction of the lifecycle model. For example, studies by Fama and French (2001) and Grullon et al. (2005) offer indirect support for this model as they find dividend initiators exhibit mature tendencies; they are large, profitable, and have positive free cash flow for distribution to shareholders. Furthermore, Brockman and Unlu (2009) show that dividend-paying growth firms pay smaller dividends compared to dividend-paying mature firms.

DeAngelo et al. (2006) explicitly test the dividend-lifecycle relationship by employing a single lifecycle measure, namely the ratio of retained to total equity, RE/TE. They argue that as firms mature this ratio increases for two reasons. First, as firms grow and become profitable RE increases. Second, their reliance on contributed equity falls as their investment opportunity set diminishes, and this coupled with growing profitability means that firms can substitute retained for external equity. Based on a sample of U.S. firms, DeAngelo et al. (2006) present empirical evidence that corporate dividend payouts follow a distinct lifecycle pattern, with a positive monotonic relationship between RE/TE and the likelihood of paying a dividend. Mature firms with large RE/TE are most likely to pay a dividend. Subsequent studies show that this also applies to other developed markets (Denis and Osobov, 2008); and to the dividend amount and not just to the likelihood of paying a dividend (Brockman and Unlu, 2009).

A connected strand of literature relates corporate dividend policy to country-level institutions and disclosure standards. Beck et al. (2006) show that country-level institutional development is inversely related to financing obstacles, prompting firms to implement their own strategies to overcome these obstacles. Brockman and Unlu (2011) test the lifecycle-inclusive disclosure standards versions of the agency outcome and substitution models of dividends (La Porta et al., 2000) and find that the 'dividend-payout-disclosure standards' relationship is u-shaped. The probability of paying a dividend is highest when disclosure standards are either weak or strong. Where disclosure standards are weak, the costs of debt and equity capital are often prohibitively high (see Botosan, 1997; and Sengupta, 1998 for the link between disclosure quality and the cost of capital). In such countries, growth firms respond by

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establishing a history of paying large dividends to foster trust with outside investors and build capital market reputation.[1] This reduces financing constraints and allows them to grow (Gan et al., 2013).[2] Where disclosure standards are strong, the cost of capital is lower implying that firms have less need to engage in reputation-building strategies. Therefore, we should not be surprised that the lifecycle model of dividends receives empirical support in countries with high disclosure standards, e.g. DeAngelo et al. (2006) and Denis and Osobov (2008) among others. Interestingly, Brockman and Unlu (2011) report similar findings for low-disclosure regimes. They find that the likelihood of paying a dividend increases with RE/TE but do not address the issue of whether or not the dividend amount varies over the firm lifecycle. Shao et al. (2013) show that RE/TE is positively and statistically significantly related to being a dividend payer but statistically indistinguishable from zero using dividends-to-sales (the dividend amount), in countries where creditor rights are weak. It remains an unanswered question if the magnitude of dividends differs between mature and growth firms in countries with low-disclosure requirements, where dividends may be used to establish capital market reputation. Arguably it is the size of the dividend that provides the strongest signal of a firm's intent to protect prospective shareholders, thus incentivising firms with greater growth potential to pay larger dividends.[3]

In this paper, we build on these two strands of the literature to address two issues. Firstly, we test the lifecycle model of dividends using data from Korea, a country with low-disclosure standards relative to developed markets, focusing on both the likelihood of paying a dividend and the dividend amount. Secondly, we try to reconcile the dividend-lifecycle relationship with the reputation-building strategies pursued by firms in countries with weak institutions. Ignoring reputation-building motives, the extant literature suggests that mature companies pay larger dividends than growth companies. However, where these motives are strong, early-stage firms may potentially pay comparable or larger dividends than their more-established counterparts. In addition to the RE/TE ratio, we employ a range of lifecycle measures such as firm age, size- and industry-adjusted age, multiclass linear discriminant analysis, and the composite proxy developed by Dickinson (2011). To the best of our knowledge, no study of the lifecycle model of dividends to date has used this wide range of lifecycle indicators. Using more than one lifecycle proxy ensures that our findings are not driven by one specific lifecycle measure and allows us to assess the interpretation of some of these measures in a low-disclosure regime.

Korea, over our sample period, provides an ideal setting in which to test the lifecycle model of dividends given the potential interaction of corporate dividend policy and reputation-building strategies in this newly liberalised financial market.[4] Though Korea officially opened up its stock market to foreign investors in 1992, restrictive ownership limits of 3% for an individual and 10% for aggregate foreign holding were initially applied. These restrictions were gradually unwound and finally abolished in May 1998. Foreign ownership grew substantially over our sample period. In 1996, 11.5% of outstanding shares were in foreign ownership and these accounted for 13% of market capitalisation and by the sample end of 2004, the corresponding numbers were 22% and 42% respectively (Kim and Yi, 2015; Table 2).

Operating within a newly-liberalised and emerging market, indigenous firms had a strong incentive to engage in reputation-building strategies to reassure foreign investors as to their commitment to protect minority stakeholders and to overcome country-level barriers to investment. As a country, Korea has relatively low-disclosure standards. Its score of 68 places it in the bottom tercile of the CIFAR disclosure distribution.[5] Furthermore, Korea's civil law origin provides relatively weak protection of minority shareholders with La Porta et al. (1998) showing that its Rule of Law and Efficiency of Judicial System scores (5.35 and 6 respectively) are well below the average for common-law countries (6.46 and 8.15 respectively) and far removed from the U.S. market (who scores 10 on each measure). However, Korean firms appear to invest relatively little in voluntary programs aimed at boosting their corporate governance (see for example, Black et al., 2014),[6] opening up the possibility that Korean firms may use alternative bonding mechanisms (e.g. large dividend payouts) and/or combine dividends with governance to build reputation capital (see John et al., 2015).

Our results produce a number of interesting findings. Firstly, Korean firms engage in reputation-building behaviour. Firms with relatively larger growth opportunities tend to pay larger dividends, in contrast to the findings for firms in more developed, high-disclosure regimes. Secondly, reputation building through dividend payout policy is not the sole preserve of early-stage firms, but is also a characteristic of mature firms. Mature firms with relatively higher growth opportunities continue to pay higher dividends to signal to potential investors that they are committed to protecting external providers of capital. Overall, the evidence is consistent with the predictions of the lifecycle model of dividends, with dividends increasing over the lifecycle and peaking during the mature stage. This story emerges due to both growth- and mature-stage firms pursuing reputation-building strategies.

[1] Using dividend payouts to build external financing capacity is also highlighted by Masters et al. (2016). Using a sample of publicly-traded U.S. firms, they show that contrary to conventional wisdom, financially constrained firms pay dividends, and increase their dividend immediately prior to a SEO announcement.

[2] The notion that firms can build capital market reputation using dividend payout is not new. Campbell and Turner (2011) find evidence in support of the agency substitution model of dividends in Victorian Britain.

[3] Using large dividends to build reputation involves a trade-off for corporate insiders. Since expropriation risk is higher in countries with weak legal protection/disclosure standards, insiders forgo large private gains by paying large dividends rather than retaining the funds. However, if this form of reputation building is effective in reducing firm-level financing constraints, corporate insiders gain as the value of their (legal) cash flow rights increases as firms fund growth opportunities. Outside investors are prepared to fund these growth opportunities as the dividend signal is deemed both costly (for insiders) and credible. The larger the dividend the more costly it is for corporate insiders, hence the larger the signal sent to outside investors. Doidge et al. (2004) model this trade-off for firms who cross-list in the U.S. and use Level 2/3 ADRs (or an ordinary listing) as a bonding device.

[4] Korea has been the focus of a number of influential single-country studies due to the quality of the data available (Black et al., 2006); and the variation of firm governance and business structures within the country (Baek et al., 2004; Bae and Goyal, 2010).

[5] The CIFAR disclosure index captures the accounting disclosure standards in a given country by examining annual reports for the inclusion or exclusion of 85 key items.

[6] Doidge et al. (2007) show that firms with seemingly large incentives to undertake firm-specific improvements in governance may choose not to do so where financial and/or economic development is weak.