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Explaining dividend gap between R&D and non-R&D Indian companies in the post-reform period

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ABSTRACT

Short-termism or market myopia hypothesis, which posits a negative trade-off between dividend payments and research and development (R&D) investments of corporate firms, forms the basis of our paper. Factors influencing the dividend gap between R&D and non-R&D companies in India are explored and a semi-parametric decomposition (developed by Dinardo, Fortin and Lemieux (DFL, 1996)) conducted on cross-section data of listed companies for the years 2001 and 2010 to investigate the issue. The results reveal that profitability and market to book ratio are the factors which have played some roles to reduce the dividend gap in 2001. However, in 2010, all the characteristics have some role to play. In other words, if the R& D companies enjoyed characteristics similar to the non-R&D ones, then dividend gap between the two groups would have been less. However, the results are found to be sensitive to the ordering of the variables in the weighting function. Refuting the short-termism theory, our findings corroborate that decisions regarding dividend payments and investment in R&D are made simultaneously, which is in agreement with the simultaneous dividend theory.

1. Introduction

Short-termism or market myopia hypothesis – a much deliberated subject in financial economics – posits a negative trade-off between dividend payments and research and development

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(R&D) investments of corporate firms, implying consequentially a positive association between dividend payments and non-research and development (non-R&D) investment (Miles, 1993; Lasfer, 2002). The argument is that firm managers are myopic if they pay out more dividends in the short-term, which could otherwise finance investments in R&D. A gap is, therefore, expected to exist in dividend payments between R&D and non-R&D corporate firms. The idea of short-termism has evolved from a very old traditional financial debate, commonly known as 'irrelevance theory', developed by Miller and Modigliani (1961). The theory proposes that, under perfect capital market, firms' dividend and investment decisions are mutually separable or independent of each other. This theory is later extended to explain the relationship between dividends and investments in R& D.

According to the independent dividend theory, firms are concerned primarily with dividends (determined by exogenous factors such as signalling and agency costs) and investments in R& D are adjusted thereafter. Owing to asymmetric information between managers and investors, dividend payments are an indicator of the firm's quality and profits.

The agency cost theory suggests that investors force managers to pay dividends that could have been spent either on perquisites or unwise investments. It follows from the independent dividend theory that firms will cut their R&D investments to maintain their dividends if they are constrained by external financing sources. Such behaviour mostly occurs in the presence of information asymmetry between managers and shareholders, and managers try to convey information about their growth opportunities through dividend payments. Prioritizing dividends over R&D may derive from the concern that rewards from investments in R&D are lagged, and profits too decrease. Therefore, if firms follow an independent dividend policy, the relationship between investments in R&D and dividend payments is expected to be negative. Independent dividend policy is likely to be followed if the stock market investors are myopic.

An alternative theory – the simultaneous dividend theory – acknowledges the influence of exogenous factors on dividend payments, while paying equal attention to investments in R&D simultaneously. Both dividend payments and investments in R&D are considered as sources of value creation (Lasfer, 2002). This theory asserts a positive relationship between investments in R&D and dividend payments. The empirical works on this matter, however, give mixed results. The negative results are attributed to short-termism or market-myopia theory (Miles, 1993). Yet, there are some studies that give absolutely no relationship between the two (Lasfer, 2002).

During the recent years many researchers have chosen R&D investment over long term capital investment for several reasons as follows: (a) the exponents of economic growth theory and market myopia theory consider R&D investment as an important and crucial determinant. Broadly speaking, R&D investment of a company leads to technological innovation which in turn generate competitive advantage to R&D companies over non-R&D ones (Roussel et al., 1991). Market myopia theory exposes a trade-off between earnings and R&D investment. Some researchers supported the importance of R&D investment under market myopia theory (Stein, 1989; Bushee, 1998). Most of these studies have identified a negative trade-off between R&D investment and current earnings of the companies. In contrast, in the case of long term capital investment, only the depreciation component affects the earnings of the current year (Bushee, 1998; Lasfer, 2002). (b) R&D investment is a better proxy for long-term investment than capital investment. The reason behind this argument being that capital investment consists of two elements – new investment and depreciation of fixed assets over more or less 10 years. The managers of the corporate firms can regulate only the first component of capital investment. Thus, capital investment, as a whole, can never reflect the growth opportunities of the firm. However, R&D investment is solely controlled by managers of the firm. It can, thus, be well reflected in growth opportunities of the firm (Lasfer, 2002). But, one major limitation of choosing R&D investment over long term capital investment is the non-proprietary nature of R&D investment and non-collateral characteristics of R&D investment which produces a negative relationship between cash-flow and R&D investment (Himmelberg and Petersen, 1994).

India lags behind other developed countries in terms of technological innovation, despite its endowment of skilled human capital. The reason for this is low R&D investment at the firm-level, in India. Goldar and Renganathan (1997). Since the initiation of economic reforms in 1991, firms are expected