Journal of Business Research xxx (2015) xxx–xxx

Contents lists available at ScienceDirect

Journal of Business Research

Effect of institutional ownership on dividends: An agency-theory-based analysis☆

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ARTICLE INFO

Article history:
Received 6 October 2014
Received in revised form 6 October 2015
Accepted 7 October 2015
Available online xxxx

JEL classification:
G23
G32
G35

Keywords:
Institutional investor
Agency theory
Monitoring
Long-term
Dividends

ABSTRACT

This study examines the effect of institutional ownership on dividend payouts through the lens of agency theory. We hypothesize that only institutions with certain traits are likely to monitor. Monitoring institutions will use dividend payouts as a tool to mitigate firms' agency problems, conditional on those firms' financial performance. We find that (1) there is a positive relation between lagged long-term institutional ownership with a large stake and the dividend payout ratio, (2) the positive relation is more salient in firms with high agency costs, and (3) the positive relation is more salient when external monitoring is weak. These findings support that (1) concentrated and long-term institutional investors play a monitoring role and (2) monitoring institutions use dividend payouts as a monitoring device. Our findings are robust to endogeneity tests, level and change models, alternative income-based dividend payout measures, alternative measures of long-term institutions, and sub-period analyses.

1. Introduction

This paper investigates the influence of monitoring institutional investors on firms' dividend payouts and explores whether this influence is related to agency costs. Whereas both institutional investors and dividends are documented to mitigate agency costs (Chen, Harford, and Li, 2007; John, Knyazeva and Knyazeva, 2011), our study focuses on whether and how institutional investors use dividend payouts as a tool to accomplish the task.

As major shareholders, institutional investors have power over corporate policies, especially when they have concentrated holdings (Hartzell and Starks, 2003) and long-term investment horizons (Gaspar, Massa, and Matos, 2005). Higher dividends can serve as an effective monitoring tool to mitigate the manager-shareholder agency conflict, especially at firms where such agency costs are high (John, Knyazeva, and Knyazeva, 2011). We therefore hypothesize that long-term institutions with large ownership stakes use dividend payouts as a monitoring device, especially at firms with high agency costs.

To test our hypotheses, we use the 10 largest long-term institutional shareholders of a firm (Top10LTOwners) as our proxy for institutions that are likely to monitor (monitoring institutions). The Top10LTOwners are likely to be more influential as they have large stakes (Chen, Harford, and Li, 2007), more sensitive to agency problems as they have concentrated holdings (Hartzell and Starks, 2003), and lower monitoring costs due to their long investment horizons (Harford, Kecskes, and Mansi, 2014). We proxy agency costs with positive free cash flow and low Tobin's Q, as firms with these characteristics are likely to be cash cows with poor investment opportunities (Jurkus, Park, and Woodard, 2011). We also proxy agency costs with high earnings management, as managers can use earnings management to serve their own interests at the expense of shareholders (Chung, Firth, and Kim, 2005). We use two proxies for information-quality-related external monitoring systems: (1) the Herfindahl–Hirschman index (HHI), which is a product market concentration index, and (2) quality of access to public information. Both proxies are related to external information transparency and influence managers' effort levels (Hart, 1983).

Our empirical findings from a large sample of U.S. firms over the 1995–2009 period provide supporting evidence for our hypotheses. A higher proportion of the Top10LTOwners is associated with a higher future dividend payout ratio. This relation is only salient in firms with high agency costs or weak external monitoring mechanisms. Our findings support the monitoring role of certain institutional investors and are consistent with an agency-theory-based interpretation: the presence of

☆ The authors appreciate the insights and guidance offered by Olubunmi Faleye (finance editor) and three anonymous referees. The remaining errors are our own.
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http://dx.doi.org/10.1016/j.jbusres.2015.10.088
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higher proportion of monitoring institutions leads to higher dividend payouts at firms with high agency costs or weak monitoring mechanisms.

Our study also contributes to the literature on the interaction between dividends and other monitoring mechanisms (Allen, Bernardo, and Welch, 2000; Grinstein and Michaely, 2005; Grullon and Michaely, 2012; Hoberg, Phillips, and Prabhala, 2014; Officer, 2011, and others) by providing further empirical evidence supporting the role of dividends as a tool to mitigate agency costs. We confirm the findings of Grinstein and Michaely (2005) that firms with high institutional holdings generally prefer lower dividend payouts. However, unlike Grinstein and Michaely (2005), we show that the Top10LTOwners are likely to monitor and have a different relation with dividend payouts from general institutional owners. When there are other strong external monitoring mechanisms, including product market competition and quality of access to public information, the Top10LTOwners do not influence dividend payouts. Our results are robust to measures of the proportion of shares owned by the Top10LTOwners, endogeneity tests, level and change models, sub-period analyses, and a number of dividend payout ratios that are calculated based on alternative measures of the firm's income.

We focus on dividend payments when examining the effect of institutional ownership on firms' payout policies in an agency theory framework. Dividends are stickier than repurchases, and dividend payout is a more credible monitoring device (Farre-Mensa, Michaely, and Schmalz, 2014). Managers state that they will pass up positive net present value projects before cutting dividends but do not make the same claim about repurchases (Brav, Graham, Harvey, and Michaely, 2005; John and Knyazeva, 2006). However, our results are robust to the inclusion of repurchases. Our results remain largely the same before and after the dividend tax law change in 2003, and after excluding pension funds from our sample. As pension funds face more favorable tax rates compared to other institutions, they are more likely to be subject to the clientele effect. So our findings suggest that a tax-related explanation is less likely.

2. Development of hypotheses

Agency theory predicts that manager–shareholder conflicts lead to agency costs, which hurt shareholder value (Jensen, 1986). Previous literature has proposed numerous mechanisms, including both dividends and institutional investors that mitigate agency costs. Through cash disbursement that reduces free cash flow at the firm, dividends can be used as a monitoring device that reduces agency costs, including managers' consumption of perks and overinvestment (Easterbrook, 1984; Grossman and Hart, 1980; Jensen, 1986). Through strengthened corporate governance, institutional investors with certain characteristics serve as monitors and mitigate agency costs. Such monitoring have been reflected by monitoring institutions' influences on executive compensation, earnings management, and mergers and acquisitions (Hartzell and Starks, 2003; Khan, Dharwadkar, and Brandes, 2005; Velury and Jenkins, 2006).

Institutional investors are only likely to monitor in a cost-efficient setting (Chen, Harford, and Li, 2007). A long investment horizon reduces institutional investors' monitoring costs, making them more likely to monitor (Harford, Kecskes, and Mansi, 2014). As long-term institutional investors are highly desirable to the firm, managers take them seriously (Beyer, Larcker, and Tayan, 2014; Gaspar, Massa, and Matos, 2005). Managers could please their shareholders by pre-committing to dividends. For example, John, Knyazeva, and Knyazeva (2011) show that rural firms have weaker governance mechanisms and pre-commit to higher dividend payouts to mitigate agency conflicts.

At the same time, a large stake increases the probability and effectiveness of monitoring, as institutions can gain access to the board through large holdings (Carleton, Nelson, and Weisbach, 1998). Concentrated long-term institutional investors can therefore vote on dividend policy to address their concerns on manager–shareholder conflicts.

Based on the above arguments, we believe that monitoring institutional investors are likely to be concentrated and long-term and propose the following joint hypothesis:

Hypothesis 1. *Top10LTOwners are likely to monitor and a higher proportion of Top10LTOwners is associated with greater future dividend payouts.*

Our Hypothesis 1 is closely related to the findings in Crane, Michenaud, and Weston (2014) with an important distinction. Whereas Crane, Michenaud, and Weston (2014) suggest that higher overall institutional ownership causes firms to pay more dividends and repurchase more shares, we argue that only concentrated long-term institutional ownership is positively associated with dividend payouts.

Following an agency-theory-based interpretation of dividends, *ceteris paribus*, monitoring institutions are more likely to intervene in firms with high agency costs as their benefits from doing so will be higher. Agency costs are likely to be high in firms with both free cash flow and poor investment opportunities, as the managers are more likely to have negative net present value projects at these firms (Chung, Firth, and Kim, 2005). As earnings management can also reflect agency costs, the extent of earnings management can serve as a proxy for the presence of an agency cost (Cornett, Marcus, and Tehranian, 2008). If the Top10LTOwners use dividend payouts as a monitoring device, we expect the disciplinary effect to be more salient in firms with high agency costs. We therefore propose the following hypotheses:

Hypothesis 2a. *The proportion of Top10LTOwners is positively associated with dividend payouts in firms with both positive free cash flow and poor investment opportunities.*

Hypothesis 2b. *The proportion of Top10LTOwners is positively associated with dividend payouts in firms with higher earnings management.*

Product market competition improves the quality of the information about managerial performance that shareholders can obtain and drives prices toward minimum average costs. Product market competition, therefore, monitors managers to increase firm efficiency (Giroud and Mueller, 2010; Hart, 1983; Holmstrom, 1982; Nalebuff and Stiglitz, 1983). Similar to product market competition, investors' access to public information is another important external monitoring mechanism as managers will be less inclined to discriminate their effort in a more transparent environment. We therefore propose the following hypotheses:

Hypothesis 3a. *Product market competition influences the relationship between the proportion of Top10LTOwners and dividend payouts.*

Hypothesis 3b. *The quality of investors' access to public information influences the relation between the proportion of Top10LTOwners and dividend payouts.*

3. Data and main results

3.1. Data

We use Thomson Reuters' 13F quarterly institutional common stock holdings data for the institutional ownership variables and the Compustat and Center for Research in Security Prices (CRSP) databases for the financial data. The 13F mandatory institutional reports are filed with the Securities and Exchange Commission (SEC) on a calendar quarter basis and are compiled by Thomson Reuters (formerly known as the 13F CDS/Spectrum database). The SEC's Form 13F requires all institutions with more than $100 million under management at the end of the year to report their long positions of equity. The reported positions are those in which the institution owns more than 10,000 shares or shares of over $200,000 in market value. Our sample includes all publicly traded U.S. firms in the CRSP and Compustat databases between 1995