



# Dividend payout policies: Evidence from Latin America

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## ABSTRACT

This paper examines dividend payout policies for firms in six Latin American countries from 1995 to 2013. As predicted by the pecking order and trade-off models, the dividend payout is positively linked to profitability and negatively related to past indebtedness and investment opportunities. We also find that the target dividend payout ratio is positively related to governance indicators at the country level. In addition, the speed to which firms adjust their dividends to changes in earnings is lower in high governance countries in the region. Thus, firms smooth dividends more in countries with higher governance scores. We do not find evidence supporting the lifecycle theory nor illiquidity effects on dividends levels.

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## 1. Introduction

Means to give firm shareholders their money back, have always been (and always will be) a contentious issue. The financial literature has studied the ways, dividends and repurchases, and the motivations behind giving back cash to shareholders. Floyd et al., (2015), for example, study how payout policies evolve over the last 30 years in the United States, arguing that signaling and agency costs are extant reasons to explain those policies. Both explanations arise from the two main models the financial literature has posited to explain capital structure decisions: the pecking order model and the trade-off model. Although initially conceived to explain capital structure choices, both models also offer predictions on how firms decide to pay dividends to their shareholders (Fama and French, 2002).

In the pecking order framework, Myers (1984) posits that asymmetric information leads managers to issue risky securities when they are overpriced. As a result, investors demand a premium on new and existing shares, once new issues are announced. In anticipation managers can forego profitable investments if they require additional risky capital. To avoid this problem, minimizing asymmetric information costs, managers prefer to finance new projects with retained earnings, then with low risk debt, risky debt, and as a last option they issue equity. The pecking order model does not explain why firms pay dividends; however, once dividends are paid, firms with less profitable assets in place, large current and expected investments, and high leverage find dividends less attractive, given the financing costs attached to the issue of new risky securities.

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Higher stability of income can also be associated with a lower likelihood of foregoing attractive investments or the need of issuing risky securities. Thus, to lower the possibility of not taking advantage of investment opportunities when cash flow is low, firms with volatile income pay less dividends. The following associations, controlling for additional interactions, are expected: (1) more profitable firms pay more dividends; (2) firms with more leverage and more investment opportunities pay less dividends; and (3) firms with more volatile income pay less dividends

The other main venue in explaining capital structure decisions is the trade-off model. Under this model firms make capital structure decisions weighing different and opposing forces. In this setting, firms weigh bankruptcy costs and tax considerations when determining a target or optimal level of debt. Firms with higher leverage, more volatile income, and larger expected investment outlays are likely to set a lower leverage level to minimize distress costs. Given the fiscal benefits of interest payments, one also would expect a more intense use of debt by the most profitable firms.

The pecking order and trade-off models make similar predictions in terms of dividends. Firms set dividends as to minimize potential bankruptcy costs (bearing in mind the differential fiscal treatment of dividends versus interest payments). Thus, firms with less volatile earnings, lower leverage, and lower expected investment opportunities are more prone to pay higher dividends. Conversely, firms with unprofitable assets in place are likely to have a low dividend payout ratio.

Under the trade-off model, agency cost considerations can also account for leverage and dividend decisions. [Easterbrook \(1984\)](#) analyzes the effect of a consistent dividend policy in an environment characterized by agency problems within the firm. One agency cost firms face is the one related to supervising management<sup>1</sup>, a cost which shareholders must assume since the interests of shareholders and managers are not always aligned. A second agency cost refers to risk aversion by management (given its human capital investment in the firm) that prompts management to take low risk projects which in many cases may not be the most beneficial for shareholders.

Dividends can reduce these two agency costs since they can force companies to use financial markets more frequently and in the process expose the company to a higher degree of monitoring by investors and investment bankers that ends up reducing monitoring costs initially borne by all investors. Likewise, according to [Easterbrook \(1984\)](#), dividends can serve to adjust the level of risk taken by management to a point more in line with shareholder's preference (higher level). In this sense, paying a dividend increases the debt-to-equity ratio benefiting shareholders and sets free an efficient mechanism<sup>2</sup> which results in a reduction in the firm's agency costs.

[Jensen \(1986\)](#) points out the potential cost of agency that large free cash flow, under managerial control, could pose on the firm value. Without restrictions in the use of the free cash flow, managers can waste the free cash flow in negative net present value projects. Larger dividends reduce those agency costs forcing managers to take better decisions before wasting resources of the firm. [Iturriaga and Crisóstomo \(2010\)](#) confirm the role of dividends in Brazil as a disciplining mechanism to control managers that may feel inclined to pursue value-destroying projects.

[La Porta et al. \(2000\)](#) discusses two versions of the agency theory of dividends. By and large, agency theory considers dividends as a mechanism to mitigate conflicts between corporate insiders and outside shareholders.

A first version referred to as the "outcome model" states that dividends are a result of an effective legal protection system of shareholders. In this sense one would expect a positive relationship between the level of dividends and the level of investor protection across countries. The latter, since investors in more protected countries can extract more dividends from companies they invest in.

A second version of the agency theory of dividends ("substitute model") considers dividends and investor protection as substitutes. In this version, dividends become an instrument to strengthen the reputation of companies. This reputation is important since firms may occasionally need to get funding in financial markets. Under this model one would expect an indirect relationship between dividends payments and the level of investor protection across countries, since it is likely that companies in low investor protection countries care more about their reputation and as a means to protect it use dividends more intensely than companies in high investor protection countries.

In addition to pecking order and trade off explanations on how firms pay dividends, [DeAngelo et al. \(2006\)](#) propose a lifecycle theory of dividends as an alternative to these two often used models. They claim that young firms tend to be less prone to pay dividends since they are likely to be in a capital infusion phase, and thus most of its capital is contributed (e.g., by new shareholders), not earned. On the other hand, as firms mature (and most of its capital is earned not contributed) these older firms are more inclined to pay dividends as they run out of investment opportunities.

[DeAngelo et al. \(2006\)](#) find supportive empirical evidence of a lifecycle explanation of dividends because they document a positive and highly significant relationship between the earned over contributed capital ratio (proxied by retained earnings over total equity, or over total assets) and the propensity to pay dividends, even after controlling for firm size, growth, and profitability.

[Brockman and Unlu \(2011\)](#) extend the evidence of a lifecycle theory of dividends in an international study of payout policies. The ratio of retained earnings to equity had a positive influence in the likelihood that a firm pays dividends implying that young firms (usually with a low ratio of retained earnings to contributed capital) tend to pay lower dividends than older firms. Not only age considerations play a role in explaining dividend policy; Brockman and Unlu document that

<sup>1</sup> For example, audit costs to avoid manipulation of financial statements and possibly, expropriation by managers.

<sup>2</sup> That increases the probability of using the market for capital with the consequent reduction of monitoring costs of management's actions.

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