Journal of Corporate Finance 30 (2015) 85–97

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Equity-incentive compensation and payout policy in Europe

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ARTICLE INFO

Article history:
Received 15 November 2013
Received in revised form 28 October 2014
Accepted 29 October 2014
Available online 4 November 2014

JEL classification:
G35
G30

Keywords:
Executive compensation
Payout policy
Agency costs
Corporate governance

ABSTRACT

We examine the effects of executive compensation and investor protection on payout policy in Europe. We find a negative (positive) relationship between both option and restricted stock compensation and dividends (repurchases). However, when the incentive compensation is dividend protected, dividend payouts increase. Firms in weak investor protection countries pay higher dividends consistent with maintaining a reputation for distributing excess free cash flows. However, growth firms in weak investor protection countries reduce dividends (increase repurchases) in relation to increases in equity-incentive compensation. Our results are consistent with growth firms in weak investor protection countries using equity incentives as a substitute for dividends to reduce agency costs.

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1. Introduction

Existing literature shows that equity-incentive compensation affects the amount and form of payouts in the United States (see for example Fenn and Liang, 2001; Aboody and Kasznick, 2008; Brown et al., 2007). Using a sample of European firms, we examine whether this relation holds outside of the U.S. In particular, Eije and Megginson (2008) show that trends in payout policy in Europe are similar to U.S. trends. Additionally, while the use of equity-based compensation has traditionally been a U.S. phenomenon, European firms have recently increased their use of incentive compensation.[3] In this study, we explore how repurchases and dividends in Europe are related to these changes as well as country level investor protection, the use of dividend protection, and individual firm characteristics.

Europe provides a rich environment to explore the effect of compensation and investor protection on payouts as investor protection differs across countries, and investor protection affects the agency costs of free cash flow (La Porta et al. (1997, 1998), henceforth LLSV). For firms in weak protection countries, LLSV (2000) posit that dividends can serve to maintain a reputation for better treatment of minority shareholders. Pinkowitz et al. (2006) conclude that in countries with weak investor protection, higher dividend payouts reduce the agency costs of free cash flow. However, the relationship between investor protection and payouts may be altered by compensation if equity-incentive compensation also reduces agency costs. In countries with weaker investor protection, we postulate

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[3] See Conyon et al. (2013), Cheffins (2003) and Croci et al. (2012).

http://dx.doi.org/10.1016/j.jcorpfin.2014.10.019
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that equity-incentive compensation and dividends act as substitutes because both can reduce agency costs. Therefore, we expect firms from weak investor protection countries that have more equity-incentive compensation to pay lower dividends.

Growth opportunities may affect the interplay between investor protection, incentive compensation, and payouts. Firms with better growth options may pay out more to maintain a favorable reputation with minority shareholders for distributing excess free cash flows as they are more likely to require access to external capital markets, especially firms in countries with weak investor protection.[4] However, LLSV (1997, 1998) find that investors in weak investor protection countries are less willing to provide financing to firms, which is particularly problematic for high growth firms in countries with weak investor protections. These firms may prefer to pay fewer dividends and use retained earnings to invest in growth opportunities; yet paying fewer dividends conflicts with potentially using dividends to reduce the agency costs associated with weak investor protection. Durnev and Kim (2005) model that firms with a greater need for external financing and better investment opportunities institute better governance and that this relationship is stronger if the country-level legal environment is weaker. Similarly, to overcome weak investor protection, we hypothesize that high growth firms use more equity-incentive pay to align manager's interests to shareholders thereby reducing the need to pay higher dividends, and increasing financial flexibility.[5] We expect high growth firms that use more equity-incentive compensation to have lower (higher) dividend payouts (repurchases) and for this effect to be stronger in countries with weak investor protection.

While incentive compensation may reduce agency costs, the composition of incentive compensation would be expected to induce executives to favor a particular form of payout; for example, option and restricted stock compensation could have competing effects on the form of manager payout choice (Aboody and Kasznick, 2008; Brown et al., 2007; Fenn and Liang, 2001). Executive stock options incentivize management to reduce dividends because the value of non-dividend protected options is negatively related to dividend payments (Lambert et al., 1989).[6] For U.S. firms, Fenn and Liang (2001) find that options are associated with lower dividends and more repurchases, and suggest that repurchases can be used to offset option-induced reductions in dividends when a firm has a target payout policy.[7] While the primary effect of incentive compensation is to reduce agency costs, we also examine whether options and restricted stock have differing effects on payout policy in Europe compared to the U.S. Further, we examine the effect of dividend protection of options and restricted stock on payout policy.

Using a sample spanning 15 European countries over the period 2003–2012, we examine the association between payout policy and compensation as Europe increasingly adopts U.S.-like compensation policies. We find that incentive compensation is associated with a reduction in dividends paid and an increase in repurchases. When we decompose equity-incentive compensation into its components, we find similar effects of option and restricted stock incentive compensation on the form of payout in the general cross sectional analysis. This is in contrast to results in the U.S. which shows a negative relationship between options and dividends in the U.S. (Aboody and Kasznick, 2008), but a positive relationship between restricted stock grants and dividends. The negative relation between stock options and dividends in the U.S. is attributed to the fact that options are rarely dividend-protected while restricted stock is more likely to be dividend protected (Minnick and Rosenthal, 2014). We therefore consider the effect of dividend protection on the relationship between incentive compensation and payout policy. We hand collect dividend protection practices for our sample and find that dividend protection of options (restricted stock) is more (less) common in Europe than in the U.S. We find that dividend protected incentive compensation reduces the negative association between equity-based compensation and dividends and is insignificantly associated with repurchases. Importantly, the overall effect that incentive compensation is negatively (positively) associated with dividend payout holds.

Moreover we explore the effect of incentive pay on payouts when country-level investor protections or firm growth opportunities are considered. We find that firms in weak protection countries pay higher dividends. This positive relationship is consistent with firms in weak protection countries using dividends to establish a favorable reputation with minority shareholders for distributing excess free cash flow when they are likely to access capital markets. However, these firms reduce dividends at a greater rate with increases in incentive compensation, consistent with the idea that dividends and incentive-compensation both affect agency costs and may be substitutes. We explore the interplay between investor protection, growth opportunities, and incentive compensation and find that in weak protection countries, high growth firms with more incentive compensation reduce dividends at a faster rate than firms in strong investor protection countries. Our analysis of repurchases similarly finds that repurchases increase at a faster rate when more incentive compensation is used in weak protection countries. Considered together, our findings are consistent with growth firms as well as firms in weak investor protection countries using equity incentive compensation in lieu of dividends as a tool to reduce agency costs related to free cash flow. The equity-incentive compensation enables the firm to reduce dividend payouts and use repurchases to distribute excess free cash flow, thereby increasing financial flexibility.

Our research extends the literature that examines how compensation affects payout policy in the U.S. (see for examples Lambert et al., 1989; Fenn and Liang, 2001; Chetty and Saez, 2005; and Brown et al., 2007). While Eije and Megginson (2008) examine trends in payouts in Europe, they do not explore the role of compensation. In contemporaneous work, Cesari and Ozkan (2014) study seven European countries and find that dividends are negatively related to CEO option holdings and are not related to CEO equity ownership. In contrast, our research contributes to the literature by examining the role of equity-based compensation (both restricted stock and option compensation) on payout policy in Europe, as well as the effects of a company's dividend protection, growth prospects, and investor protection. Our research adds to several papers that examine agency issues and investor protection around payout policy.

[4] LLSV (2000) find some evidence that growth firms in weak protection countries pay greater dividends than mature firms.

[5] See e.g. Jagannathan et al. (2000) for a discussion of the importance of financial flexibility on the choice between dividends and repurchases.

[6] Dividend protection for options is the practice of compensating managers for dividend payouts, either by decreasing the exercise price of the option, or by adding accumulated dividends plus interest to the stock price upon exercise of the underlying options.

[7] Also see Grullon and Michaely (2002) for research related to the substitution of share repurchases for dividends.

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