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Does geography matter? Firm location and corporate payout policy ☆

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ABSTRACT

We investigate the impact of geography on agency costs and firm dividend policies. We argue that remote firm location increases the cost of shareholder oversight of managerial investment decisions. We hypothesize that remotely located firms facing free cash flow problems precommit to higher dividends to mitigate agency conflicts. We find that remotely located firms pay higher dividends. As expected, the effect of geography on dividends is most pronounced for firms with severe free cash flow problems. Further, remotely located firms rely more on regular dividends instead of special dividends or share repurchases and decrease dividends less often.

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1. Introduction

This paper investigates the impact of geographic factors on corporate dividend behavior. In spite of technological advances, distance has been shown to affect information costs of analysts and investors. We argue that firm location influences shareholder ability to monitor and oversee management and, as a consequence, firm dividend policy. We hypothesize that decreased observability of managerial investment decisions at remotely located firms increases the potential for value destruction. To mitigate increased agency costs, firms precommit to higher dividends, particularly when they face high free cash flow and few growth opportunities. Empirically, we find that remote location predicts higher dividends and a preference for regular dividends over repurchases and special dividends, all else given. Consistent with the free cash flow argument, the relation between dividends and location is most pronounced for firms with high free cash flow and limited investment opportunities. Additional evidence suggests that the effect of remote location can be explained by distance to the shareholder base. Time-series properties of dividends are consistent with the greater importance of precommitment to dividends for remotely located firms.

This paper is related to existing literature on the relevance of geography. Lerner (1995) examines the subject of

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location in the context of venture capitalist oversight. He argues that the cost of providing oversight increases with distance and finds that geographic proximity is an important determinant of the likelihood of venture board membership. Other work shows that fund managers and analysts have an informational advantage with respect to local stocks and a preference for local stocks and stocks of big city firms (Loughran and Schultz, 2005; Bae, Stulz, and Tan, 2008; Malloy, 2005; Coval and Moskowitz, 1999, 2001; Ivkovic and Weisbenner, 2005). Acquirers prefer local targets and gain more from local acquisitions (Kedia, Panchapagesan, and Uysal, 2008; Kang and Kim, 2008). Firms located in industry clusters conserve cash for future acquisitions (Almazan, De Motta, Titman, and Uysal, 2010). Further, firms take into account the presence of local dividend clienteles (Becker, Ivkovic, and Weisbenner, 2011). Location also affects Chief Executive Officer (CEO) power and board composition (Francis, Hasan, John, and Waismann, 2007; Knyazeva, Knyazeva, and Masulis, 2010). Urban firms use more equity financing and higher quality underwriters (Loughran and Schultz, 2006). Moreover, corporate governance and financing policies are influenced by neighbor firms (John and Kadyrzhanova, 2008; Gao, Ng, and Wang, 2011). Finally, this paper is related to an extensive free cash flow literature (see, e.g., Jensen, 1986; Stulz, 1990; Smith and Watts, 1992; Lang and Litzenberger, 1989).

This paper contributes to existing literature by offering important new evidence on the role of geographic factors for firm dividend policies. We ask whether a firm's location away from shareholders limits observability of managerial investment decisions, thereby exacerbating agency costs and strengthening the need for dividend payouts in the presence of free cash flow. Our main hypothesis relates dividends, agency costs of free cash flow, and location.

Jensen (1986) describes the classic manager-shareholder agency conflict. When managerial investment decisions are unobservable, shareholders cannot prevent self-interested managers motivated by private benefits from using the firm's free cash flow to overinvest in inefficient projects. This agency conflict hinges on two conditions. First, the incentives of managers and shareholders diverge. Namely, shareholders only seek investments that maximize shareholder value, whereas self-interested managers derive utility from investment outlays and seek to expand investment even if shareholder value is destroyed in the process. The outlined overinvestment problem is more severe when the firm has few positive net present value (NPV) investment opportunities, yet significant cash flow is available to the manager. Second, incomplete contracting is in place: some friction prevents managerial investment decisions (for example, the quality of investment projects chosen by the manager) from being fully observable and verifiable to outsiders. As a result, shareholders are unable to contractually eliminate managerial overinvestment.

We argue that the observability of managerial actions to shareholders declines with distance, all else equal. Although technological advances have partly mitigated geographic barriers, the quality of projects chosen by the manager from the firm's opportunity set is largely soft information that is difficult to observe or verify over long distances. The decreased observability of managerial investment decisions at remotely located firms is expected to exacerbate the manager-shareholder agency conflict described above and facilitate overinvestment from the free cash flow. As a result, absent a constraint on managerial behavior, remotely located firms are expected to suffer from more overinvestment than centrally located firms with similar cash flows and investment opportunity sets.

Existing literature suggests that dividends can be used to disburse free cash flow, mitigating the manager-shareholder agency conflict. In the spirit of the Stulz (1990) model of precommitment through capital structure, it is possible to view the optimal level of dividends as a tradeoff between curtailing agency conflicts of overinvestment and leaving the manager enough funds to pursue positive-NPV investment projects. For firms with limited investment opportunities and high free cash flow, the optimal precommitment to dividends is expected to be larger as the overinvestment problem is more severe. Combining this argument about dividend precommitment with the above discussion of the implications of location for the observability of managerial actions, we expect remotely located firms with high free cash flow and scarce investment opportunities to adopt even larger dividend payouts. By comparison, shareholders of centrally located firms are expected to be in a better position to observe managerial investment decisions, resulting in a lower optimal level of precommitment to dividends, all else equal. Naturally, firms with good investment opportunities, for which agency costs of free cash flow are low and the downside of dividend payments in the form of forgone positive-NPV investment projects is high, would not need a costly dividend precommitment.

Differently from debt, which involves explicit contracting, dividends are an implicit commitment. To the extent that managers can influence future dividends, a relevant conceptual question is whether such implicit commitments are going to be upheld in equilibrium. Earlier papers have addressed the sustainability of dividend commitments. As a group, US managers are highly reluctant to cut dividends (see, e.g., Daniel, Denis, and Naveen, 2008; Servaes and Tufano, 2006). Related theory work shows that self-interested managers optimally uphold dividend commitments. For instance, in Myers (2000), managers pay dividends to convince shareholders to fund future firm projects. A manager's past failure to pay dividends can limit the firm's access to external equity financing in the event of a future shortfall (when the manager needs financing most).[1] It is important to emphasize that dividends, unlike investment decisions, are observable and verifiable. Thus, managers of high agency cost firms precommit to dividends to reassure shareholders that value loss from inefficient investments will be avoided; in turn, shareholders, who rationally

[1] This line of reasoning implicitly assumes that high free cash flow firms in general are not immune from cash shortfalls or external financing needs in some years, which seems plausible.

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