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Exploratory analyses of dividend reinvestment plans and some comparisons

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Abstract

In this paper, we explore salient features of dividend reinvestment plans (DRIPs), analyze their financial peculiarities and search for the differences between firms that offer DRIPs and those that do not. As more than 1200 firms currently offer the plan, an understanding of why these plans differ in a variety of cost/benefit structures and, perhaps more importantly, what separates these firms from No-DRIP firms is crucial for both investors and adaptors of the plan. Our research suggests that—out of 17 financial and accounting variables—DRIP firms differ from No-DRIP firms in only three variables. In spite of this, we conclude that there is much to learn about the motivation for DRIPs.

JEL classification: G30; G32; G35
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1. Introduction

The purpose of this paper and the research it proposes is to expand the corporate, academic finance literature dealing with the effects of dividend reinvestment plans (DRIPs) on the dividend policy formulation of firms. In recent years, DRIPs have become much more prevalent—both as an investment strategy or tool for the individual investor and as a source

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of new equity for corporations—since their emergence in the late 1960s and are currently offered by approximately 1200 firms. According to Baker and Seippel (1981) and others, firms view these programs as a means of raising equity capital and improving shareholder goodwill, and investors see them as a means of dollar-cost averaging.

DRIPs are set-up to allow current shareholders to purchase additional shares by buying directly from the firm and thereby bypass the broker and his associated fees (Carlson, 1992). In addition, approximately 50 companies now allow open enrollment in their DRIPs. Through these plans, investors can make initial investments and all subsequent investments without paying broker fees (Burns, 1994). Although the plans appear to be beneficial to both the shareholders and the firm, there are some problems that could be considered deterrents. As Schneid (1981) points out, one such problem is that "plan terminations and arbitrage trading may tend to exert a negative impact on market price."

Because of the popularity of DRIPs with individual investors and personal investment analysts, most of the information about DRIPs has been in the laymen finance literature. These articles focus of course on the relationship of DRIPs to personal finance issues rather than corporate or academic finance issues and implications. Furthermore, most of the corporate and academic literature on DRIPs concentrates on their association with utilities. Consequently, it pays scant attention, if any, to other industries (predominantly the financial services industry, which now accounts for the largest percentage of DRIPs offered), much less the entire universe of DRIPs.

Despite their apparent advantages, not all firms offer DRIPs. This seems to suggest that firm-specific factors might be the driving force for the introduction of such plans, and perhaps, that firm characteristics may be instrumental in the specifics of the plan offered. Because of the thinness of the academic literature, there is a void that calls to be filled by exploring these issues of specificity and characteristics. Accordingly, the analyses of how firms that offer DRIPs differ from firms that do not is the objective of this paper and our research. This objective necessarily involves the study of DRIP characteristics as well. Naturally, our research agenda is exploratory because the lack of well-justified hypotheses precludes it from being confirmatory.

Section 1 is a brief overview of DRIPs. In Section 2, we review the literature. Section 3 is the statistical part of the paper where we discuss the data, explain the variables of the study, describe the models we use and the results of our tests. Finally, in Section 4, we suggest avenues for future research and also offer some brief conclusion.

1.1. DRIPs: an overview

DRIPs are by no means new. Mutual funds and closed-end investment companies have been providing DRIPs for their shareholders since the early 1940s (Finnerty, 1989). Lehman Corporation, an investment company, was the first firm to offer market DRIPs.[1] DRIPs were first made available to noninvestment companies through an SEC regulation revision in 1968. Allegheny Power Systems was the first industrial corporation to implement a DRIP.

[1] Davey (1976), and Saporoschenko (1996) examine three types of DRIPs: (1) market DRIPs, which are set-up as a service to shareholders and provide no "new" cash to the firm; (2) treasury DRIPs, which are designed to sell shares from treasury stock; and (3) combination DRIPs (market and treasury).