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Information content of unexpected dividends under a semi-mandatory dividend policy: An empirical study of China

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ABSTRACT

We examine the information content of unexpected dividend changes under China's unique semi-mandatory dividend policy, which requires firms to pay a minimum amount of cash dividends before they can undertake seasoned equity offerings (SEO). The cumulative abnormal returns (CARs) are significantly positive in response to unexpected dividend increase for non-SEO firms, but they are not significantly different from zero for SEO firms. For non-SEO firms, there is a significant positive relation between future earnings and unexpected dividend increases, but the relation is not significant for SEO firms. However, when considering additional refinancing costs for SEO firms caused by the mandatory dividend policy, higher dividend payments are associated with lower future earnings. Overall, our findings are consistent with both the dividend signaling theory and the negative effects of SEOs on a firm's value.

1. Introduction

In this paper, we investigate the information content of unexpected dividend changes in China, which is one of the most important emerging stock markets. Our motivation is to explore a unique semi-mandatory dividend setting in China, which allows public firms to undertake seasoned equity

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offerings (SEOs) only if they have paid dividends for the previous three years. Initially, the China Securities Regulatory Commission (CSRC) did not require firms to pay a minimum dividend before they can issue new equities. This rule changed in 2006, however, when the CSRC stipulated that issues of new shares had to be preceded by dividend payments equal to at least 20% of the issuing firm's net profits.[1] This setting is markedly different from that in the U.S., where firms can independently determine how much profit will be paid through dividends. It also differs from other mandatory dividend rules, such as those in Brazil (Martins & Novaes, 2012), Turkey (Adaoglu, 2000) and Greece (Dasilas & Leventis, 2011), where all firms must allocate a certain level of their earnings as dividends. The unique setting in China was considered a "semi-mandatory dividend institution" by Li, Wei., and Wu. (2010).

Such a semi-mandatory dividend rule suggests that unexpected dividend payments convey two important signals on dividend-paying firms: a positive signal of strong free cash flows in the near future, as predicted by traditional dividend-signaling theory (Bhattacharya, 1979; John & Williams, 1985; Miller & Rock, 1985); and a signal of a high likelihood of the issuance of SEOs, which is considered a negative signal of a firm's value by Myers and Majluf (1984). Furthermore, the positive signal of unexpected dividend increase will be offset by the negative signal of new equity; we thus do not expect that unexpected dividend payments in China always indicate a positive effect on stock prices as strong as that documented in countries such as the U.S., where firms do not have to pay dividends to obtain the right to issue new shares. Instead, we expect stock price reactions and firm future earnings' relation with unexpected dividend change to be conditional on whether firms undergo an SEO.

Non-SEO firms are not required to pay a dividend to shareholders. For the firms that increase their dividend payments, the traditional signaling theory applies. In particular, the theory is based on asymmetric information between a firm's investors and managers. Managers know more about their firms' financial condition than investors, and they need a tool to convey information about the firms' prospects. Dividends can play such a signaling role. An unexpected dividend increase shows that the firm's future cash flow is going to increase, which in turn could increase the stock prices. Thus, both abnormal stock returns and changes in future earnings should be positively related with unexpected earnings increases when non-SEO firms have increased their dividend payments.

Regarding an unexpected dividend decrease, according to the signaling theory, dividend reductions convey unfavorable information about future cash flows, and they often occur with a decrease in stock prices. However, this could be not the case for Chinese non-SEO firms when they announce dividend cuts for the following two reasons. First, dividends play a less important role in investors' income in China. In a stock market in which speculating is prevalent, Chinese investors have been found to prefer capital gains rather than dividend yields (Wang, Shi, & Fan, 2006). In fact, dividend income accounts for merely a fractional amount (4.7%) of investors' monthly total stock return.[2] Second, Chinese investors must pay a 20% tax on their dividends, but their capital gains on stocks are exempt from taxation. Under these circumstances, Chinese investors tend to treat dividends as a windfall: if dividends are paid, investors receive a bonus; if there are no dividends, there is no cause for concern. Hence, dividend-decreasing firms play the role of the "the lesser of the two evils"; that is, the future earnings of dividend-decreasing firms are perceived by investors to be (at least) greater than those of no-dividend firms. As a result, the perception for a dividend-decreasing firm may not be that bad, and the relation between an unexpected dividend decrease and future earnings might not be significantly negative for such firms.

Unlike non-SEO firms, SEO firms are subject to semi-mandatory dividend policy. According to the pecking order theory developed by Myers and Majluf (1984), corporate financing should follow the order of internal financing, debt financing and equity financing. Typically, the accounting costs of an equity offering are very high (Décamps, Mariotti, Rochet, & Villeneuve, 2011), amounting to 12.88% of gross earnings on average (Ross, Westerfield, & Jordan, 2010) in the U.S. Similarly, the issuance of seasoned equity also costs a substantial amount in China. As a result, firms should attempt to minimize their SEOs to reduce additional costs. Moreover, with the semi-mandatory dividend policy, when firms

[1] We provide a detailed description of China's dividend rules in Section 2.

[2] This observation is estimated based on the Chinese stock data from 2000 to 2014. The result appears to be reasonable because most listed Chinese firms implement a no-dividend policy.