



Signaling, corporate governance, and the equilibrium dividend policy[☆]



Omar A. Esqueda*

Tarleton State University, Department of Accounting, Finance, and Economics, 1333 West Washington Street, Stephenville, TX 76402, USA

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ABSTRACT

The well-documented information content of dividends is contingent on the firm's corporate governance. Using cross-listing events, we find that firms reach a new equilibrium dividend policy after a shift in the level of shareholder protection and the direction of the dividend adjustment depends on the pre-cross-listing locus of control. Exchange-traded cross-listings can afford to decrease dividend payouts as they substitute dividends with better corporate governance. However, dividend distributions and the likelihood to pay dividends increase when cross-listings are controlled by insiders, supporting the signaling hypothesis. The cross-listing level and ownership structure convey useful information regarding future shifts in dividend payouts.

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1. Introduction

Information asymmetry between corporate insiders and outside shareholders drives widely-held firms to signal their prospects to the financial markets, commonly, through dividend policy. For example, Watts (1973), Black (1976), Miller and Rock (1985), Ambarish, John, & Williams (1987), Noe and Rebello (1996), La Porta, Lopez-de-Silanes, Shleifer, & Vishny (2000), Aivazian, Booth, & Cleary (2003), Asem and Alam (2015) confirm that dividend policy conveys relevant information about the firm. However, interpreting the signals sent by firms is not straightforward as the information content of dividends is contingent on the firms' corporate governance, in other words, a similar shift in dividend policy may have different connotations for firms with differing levels of shareholder protection (Noe & Rebello, 1996). In addition, evaluating the information conveyed in dividend payouts becomes more

challenging as dividends are known to mitigate agency problems (Aivazian et al. (2003); Easterbrook, 1984; Jensen, 1986; La Porta et al., 2000; Mitton, 2004; Rozeff, 1982); hence, dividend policy is endogenous with potential agency problems.

This paper examines the implication of the signaling hypothesis and shareholder protection in the discovery of the equilibrium dividend policy. We employ cross-listing events as the trigger for improvements in firm-level corporate governance as documented by Doidge, Karolyi, & Stulz (2004). This study sheds light on the link between signaling and corporate governance and their effect on payout policy. Moreover, we contribute to the cross-listing literature reconciling existing research on the association between cross-listings and dividend policy.

Cross-listings offer a unique opportunity to study the effects of firm characteristics on dividend policy as cross-listing events trigger fundamental changes in firms' capital barriers, agency problems, liquidity, and investor recognition (Karolyi, 2006). La Porta et al. (2000), O'Connor (2006), and Petrsek (2012) have linked shifts in dividend policy to simultaneous improvements in agency costs as implied by the bonding hypothesis, with inconclusive results. In this context, previously tested payout policy models assume homogenous changes in agency costs by cross-listing level. We argue that an equilibrium payout policy is contingent on the firm's pre-cross-listing locus of control; thereby, control is endogenous with the post-cross-listing shifts in dividend policy. Noe and Rebello (1996) state that increments in

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* Tel.: +254 968 9908; fax: +254 968 9665.

E-mail address: esqueda@tarleton.edu

dividend payout release positive (negative) signals when the firm is management-controlled (shareholder-controlled). We endeavor to test the bonding hypothesis, the signaling hypothesis, and the liquidity hypothesis of dividends in the context of cross-listing events.

The bonding hypothesis (Coffee, 1999, 2002; Stulz, 1999) indicates that cross-listed firms bond themselves to a stock market with stricter rules, hence improving corporate governance. After firms cross-list on U.S. exchanges, firm value increases thereby supporting a “firm-level” bonding hypothesis (Doidge et al., 2004). Payout policy might be affected as firms’ agency costs change and managers act upon this change. La Porta et al. (2000) develop two dividend policy models based on the bonding hypothesis of cross-listings: the outcome model and the substitute model of dividends. The outcome model states that increased corporate payouts are the result of improved corporate governance and pressure by minority shareholders. Hence, improved shareholder protection after cross-listing implies a higher payout ratio. On the other hand, the substitute model of dividends suggests that firms substitute the monitoring mechanism inherent in dividend payments with a corresponding increase in shareholder protection.

Dividend payment shows information about the expected future cash flows of the firm (Watts, 1973). Hence, newly cross-listed firms are expected to use payout policies to signal changes in firms’ agency costs. Miller and Rock (1985) recognize that information asymmetry significantly affects the equilibrium level of dividend payouts. Noe and Rebello (1996) state that under information asymmetry, the locus of control is a decisive factor of optimal financial policies. Emerging-market cross-listings are an interesting sample to test this hypothesis as a significantly large proportion of firms from emerging countries tends to be controlled by insiders. When these firms cross-list in the United States, a decrease in information asymmetry is anticipated. Hence, dividend policy signals sent by insider-controlled and management-controlled firms might differ. Insider-controlled firms tolerate higher dividends only if they are pressured from minority shareholders to do so; therefore, an increase in dividend payments signals improvements in corporate governance. Conversely, shareholder-controlled firms are able to send positive signals by reducing payouts as they substitute dividends with improved corporate governance (Noe & Rebello, 1996). Unlike previous studies, we posit that both the outcome model of dividends (insider-controlled firms) and the substitute model of dividends (non-insider-controlled firms) could be supported simultaneously.

Mitton (2004) suggests that firms with stronger corporate governance have a higher dividend payout after cross-listing, consistent with the outcome model of dividends. If Mitton’s argument holds, cross-listed firms are expected to increase their dividend payout, consistent with the signaling hypothesis and the outcome model of dividends. We additionally hypothesize that firms with previously low levels of investor protection will have greater dividend increases as managers signal improvements in corporate governance by increasing/initiating dividends.¹ Despite the vast amount of research on dividend policy, there is scant evidence on whether there is a shift in dividend policy following a cross-listing event and if so, to what extent.

The market segmentation hypothesis suggests that capital barriers are reduced when firms become available to foreign investors thereby decreasing the cost of equity capital (Alexander, Eun, & Janakiraman, 1988; Errunza & Losq, 1985; Hail & Leuz, 2009).

¹ We do not attempt to isolate the individual influence of signaling and agency theories on dividend policy. e.g., Aivazian et al. (2003) indicate that dividend policy serves as both a signaling mechanism and control for managerial opportunism among U.S. firms.

Table 1
Description of ADR levels.

ADR type	Capital-raising	Description
Level 1	No	This level is traded in the U.S. only over the counter (OTC). OTC-ADRs can use either the OTCBB or the Pink Sheets quotation systems. However, this ADR level cannot raise capital in the U.S.
Level 2	No	ADRs Level 2 are U.S. exchange-traded but are considered non-capital-raising in U.S. equity markets.
Level 3	Yes	This ADR level is traded in U.S. exchanges and is allowed to raise capital (issue new shares) in U.S. equity markets.
Level 4	Yes	ADRs Level 4 are available in the U.S. only through private offerings for qualified institutional buyers (QIB). This ADR level, also known as PORTAL or Rule 144-A, can raise capital in the U.S. only from QIB.

Nevertheless, the magnitude of the decrease in capital barriers also depends on whether the firm is registered to raise capital (ADRs levels 3 and 4) or not (ADRs levels 1 and 2). We present a detailed description of each cross-listing level in Table 1. Moreover, this hypothesis suggests that dividend payout decreases when firms experience a lower cost of equity capital (Bekaert & Harvey, 2000). Relevant payout policy theories put forward contradictory outcomes as can be seen in the above findings. The association between cross-listing events and dividend policy under varying levels of shareholder protection is not straightforward and warrants further attention. In the context of variations in the dividend policy of cross-listed firms, we test the bonding hypothesis, the signaling hypothesis, and the market segmentation hypothesis to identify the main determinant of dividend policy.²

This manuscript contributes to the literature in several distinct ways. First, we find that following a cross-listing event, the discovery of the new payout policy equilibrium moves in an opposite direction for insider-controlled versus non-insider-controlled firms, thus supporting the signaling hypothesis of dividends. Second, our findings reconcile prior conflicting evidence on the outcome and the substitute model of dividends, thereby supporting the bonding hypothesis. Third, we control for a set of relevant variables that have been omitted in previous research and include a set of firm-level ownership structure variables to proxy for shareholder protection. Fourth, we test the market segmentation hypothesis to clarify shifts in payout policy after cross-listing. Finally, in addition to the panel model with a continuous dividend payout variable, we use pooled logit models that allow for binary dependent variables to test the likelihood of firms being dividend payers.

2. Literature review and hypothesis development

Existing dividend literature corroborates a positive market reaction for firms that announce dividend increases/initiations as investors pay a premium for firms that return cash to shareholders.³ When managers decide it is appropriate to return wealth to shareholders, they choose between dividends and share repurchases. However, share repurchases are trivial in emerging markets.

² Additionally, Petrusek (2012) states that an increase in dividend payments following capital-raising cross-listing events lends support to the liquidity hypothesis of dividends. This hypothesis predicts that capital-raising firms can increase dividends as they are allowed to raise equity capital in the U.S. if necessary.

³ See Allen and Michaely (2003) survey for an extensive review of dividend policy literature.

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