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Payout initiation by IPO firms: The choice between dividends and share repurchases

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ABSTRACT

This study evaluates the economics of the choice of form of payout initiation mechanism adopted by IPO firms. Our results suggest that IPO firms demonstrate a preference for repurchases over dividends as the specific form of payout initiation mechanism. We however, find that while the market views post-IPO payout initiations favorably, it is indifferent to the specific form of payout mechanism adopted. Further, we find that dividends and repurchases represent distinct payout mechanisms adopted by IPO firms with fundamentally different characteristics and motivation to initiate payouts during the post-IPO phase. Our results suggest that while dividend initiations are primarily driven by life cycle and catering theory considerations, signaling theory provides the more likely explanation for payout initiations through share repurchases.
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1. Introduction

Initial public offering (IPO) firms typically go public on the promise of growth thereby conditioning investors to expect capital gains rather than dividends or share repurchases during the post-IPO phase. In fact, the offering prospectuses of most IPO issuers usually indicate that the firm is unlikely to be in a position to pay dividends in the foreseeable future. Since IPO firms are typically young, growth oriented companies that are pursuing innovative products and technologies, they are expected to

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invest substantially in areas such as R&D, capital expenditures, and advertising during the post-IPO phase in an effort to gain market share and achieve technological dominance in their rapidly evolving product markets and industries. At the time of going public, these firms are often cash flow negative and are likely to continue to need substantial external financing during the post-IPO phase to sustain their high growth rates as well as help finance acquisitions. Further, even if IPO issuing firms are profitable at the time of going public, they are likely to favor earnings retention over distribution to ensure availability of financing for their growth projects and thereby reduce their reliance on external capital markets, which are often unpredictable and can go through periods when financing constraints are high.

Despite the expectation that IPO firms are unlikely to be in a position to initiate cash flow payouts, extant empirical evidence suggests that a small but economically significant proportion of IPO firms tends to pay dividends during the early post-IPO phase. For instance, Michaely and Shaw (1994) report that approximately 22% of IPO firms start paying dividends within the first 3 years of going public. Similarly, Fama and French (2001) report that 25% of new lists that survive eventually start paying dividends. One potential explanation for payout initiations by IPO firms is based on the life cycle theory of dividends, which suggests that a firm's tradeoff between earnings retention versus distribution evolves over time and at a certain stage of development when profits accumulate and availability of profitable investment opportunities decline, the desirability of dividends over retention increases (DeAngelo, DeAngelo, & Stulz, 2006; Fama & French, 2001; Grullon, Michaely & Swaminathan, 2002). An alternative explanation for cash flow payouts by IPO firms can be inferred from the catering theory which argues that firms tend to pay dividends when investors desire them as reflected by the dividend premiums offered (Baker & Wurgler, 2004). As such, catering theory implies that even if IPO firms have not reached a stage in their life cycle where payouts become desirable, they might initiate distributions to satisfy investor demand. Consistent with both the life cycle and catering theories, a survey of financial executives revealed that managers attribute an increase in earnings and/or demand by institutional investors as the primary motivation for firms to initiate payouts (Brav, Graham, Harvey, & Michaely, 2005).

While an extensive body of corporate finance literature has focused on the payout policies of established firms, relatively little is known regarding payout behavior of newly public firms. Further, the limited research on payout policies of IPO firms has largely focused either on the valuation effects of dividend initiations or on the identification of factors influencing the occurrence and timing of dividend initiations (Bulan, Subramanian, & Tanlu, 2007; Desmukh, 2003; Kale, Kini, & Payne, 2006; Lipson, Maquieira, & Megginson, 1998). For instance, Kale et al. (2006) identify the determinants of dividend initiations as well as evaluate factors influencing the level and timing of payout initiations by IPO firms. The authors conclude that the determinants of dividend initiation identified in their study are consistent with the predictions of several major theories of dividends such as signaling, tax, transaction costs, clientele, agency, catering, and residual income. The above-described literature on payout policies of IPO firms has however, largely focused on dividends and not evaluated share repurchases as an alternative form of payout initiation mechanism available to IPO firms.

In the context of established firms, researchers have provided compelling empirical evidence to indicate that over the past two decades a significant shift has occurred in the corporate payout behavior of U.S. firms with share repurchases emerging as an economically significant phenomenon and overtaking dividends as a percentage of total payouts (Brav et al., 2005; Fama & French, 2001; Grullon & Michaely, 2002; Jagannathan, Stephens, & Weisbach, 2000; Skinner, 2008). For instance, Grullon and Michaely (2002) point out that that during the 1985–2000 period, a majority of firms initiated cash payouts through repurchases rather than dividends. The emergence of repurchases as an economically significant phenomenon has generated a vigorous debate in the corporate finance literature as to whether dividends and repurchases are substitutes or alternatively whether they represent two distinct forms of payout mechanisms adopted by different types of firms at different stages in their evolution. For instance, support for the substitution hypothesis is based on evidence suggesting a direct correspondence between the increasing propensities for the adoption of repurchases with a declining trend to pay dividends, as well as on indications that both dividends and repurchases are linked to earnings (Grullon & Michaely, 2002; Skinner, 2008). On the other hand, researchers have argued that managers tend to use dividends to pay out permanent cash flows, while repurchases are used to

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