

Does Dividend Policy Enhance Shareholder Value?

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We approach dividend policy from the perspective of an interactive game between corporate managers and shareholders. While dividend policy in Japan has been extensively discussed in connection with hostile takeover defenses, we look at the more basic issue of how dividend policy might affect shareholder value. Recent theories suggest that dividend policy decisions carry concealed messages from management that may influence share prices. We review the literature and explore ways for shareholders to assess dividend policy.

1. Introduction

Ahead of the new Corporation Law that takes effect in 2006, companies are busily studying rational defense strategies to prepare against the anticipated increase in hostile takeovers. While dividend policy is often discussed in connection with takeover defenses,¹ in this paper we examine dividend policy at a more fundamental level to see how it can enhance shareholder value.²

However, difficulties arise in trying to link dividend policy directly to shareholder value. First, in measuring shareholder value, suppose we simply use the share price. Despite the clarity, standard theory would lead us to only one conclusion—that dividend policy has no effect on share price—leaving little room to discuss why dividend policy matters.

Thus to better understand the implications

¹ Under the new Company Law, dividends are separated from earnings appropriation, and distributions no longer need be made annually at fiscal yearend. Moreover, the distribution limit will change from earnings available for dividends (*haito-kano rieki*) to a distributable amount (*joyokin no bunpai-kano gaku*) that essentially refers to the retained earnings account. Practically, however, the changes are not significant enough to affect our dividend policy discussion.

² Since the interests of shareholders may sometimes conflict with other stakeholders, shareholder value may not completely fit with the broader concept of corporate value. However, we simplify the discussion by assuming that corporate value is approximately equivalent to shareholder value.

of dividend policy, in this paper we shift the focus to the message concealed in management's choice of dividend policy. The stock market is constantly digesting information on corporate management and reflecting it in the share price. If new information is concealed in management's announcement of a change in dividend policy, the share price is likely to respond accordingly. Understanding these messages is a key consideration in determining the appropriate dividend policy.

2. Defining Dividend Policy

Dividend policy refers to management's long-term decision on how to deploy cash flows from business activities—that is, how much to invest in the business, and how much to return to shareholders. We focus on the return to shareholders, and specifically on whether it takes the form of cash dividends or share repurchases.³

Clearly, the dividend policy decision is a complex one involving many factors. For example, consider the case of a company that is planning to expand operations. One option is to accumulate funds internally by reducing current dividends. In this case, dividend policy should be compared to alternative financing

³ While the term "total payback policy" might be more descriptive than dividend policy, we use the more widely recognized term.

Figure 1 Comparison of Cash Dividend and Share Repurchase

	Cash dividend	Share repurchase
Recipient	All shareholders	Sellers only
Ex-dividend price drop	Yes	No
Tax liability	Taxed as ordinary income	Taxed as capital gains

methods such as new borrowing or capital increases. Dividend policy may also come under review when a company enters a new growth stage. For instance, when a company shifts from a high-risk, high-growth stage to a mature stage with strong cash flow but limited growth options, it may choose to return cash to shareholders to avoid accumulating excess funds.

Moreover, companies also must decide on the form of distributions made to shareholders. Broadly speaking, the two options are cash dividends and share repurchases, and their main characteristics are compared in Figure 1. But to identify the decisive factors in selecting the form of payback to shareholders, we must look for more fundamental differences.

3. Status of Return to Shareholders

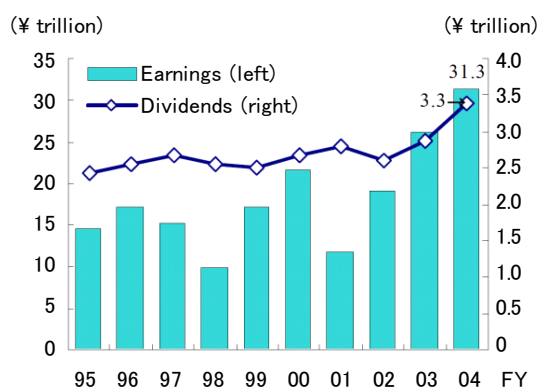
Before entering a theoretical discussion, we first look briefly at the current status of the return to shareholders in Japan. The following data is from the *2005 Survey of Corporate*

Initiatives to Improve Shareholder Value by the Life Insurance Association of Japan.

First, over the past decade, ordinary earnings have been rather volatile compared to dividends, indicating a weak correlation between the two (Figure 2). But since fiscal 2001, both have moved upward together. In addition, share repurchases—not shown here—have recently grown in size to equal cash dividends. In addition, companies have increasingly emphasized the return to shareholders. As a result, the correlation between dividends and earnings may have grown more than expected in recent years.

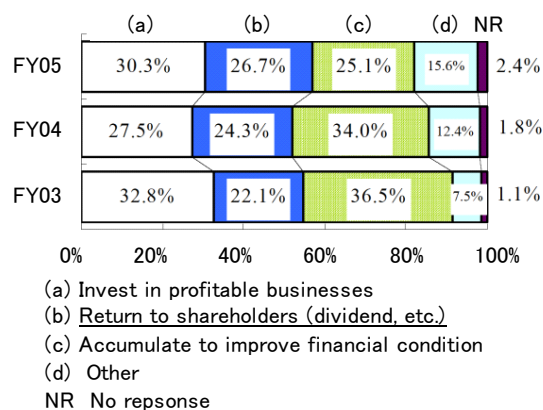
Second, the preferences of companies and investors do not coincide, as shown in Figure 4. Interestingly, most companies (60.6%) prefer a stable dividend, while most investors (66.7%) prefer dividends that reflect recent business performance. Two questions arise: (1) How do we explain the difference? (2) Which style better enhances shareholder value?

Figure 2 Earnings and Dividends



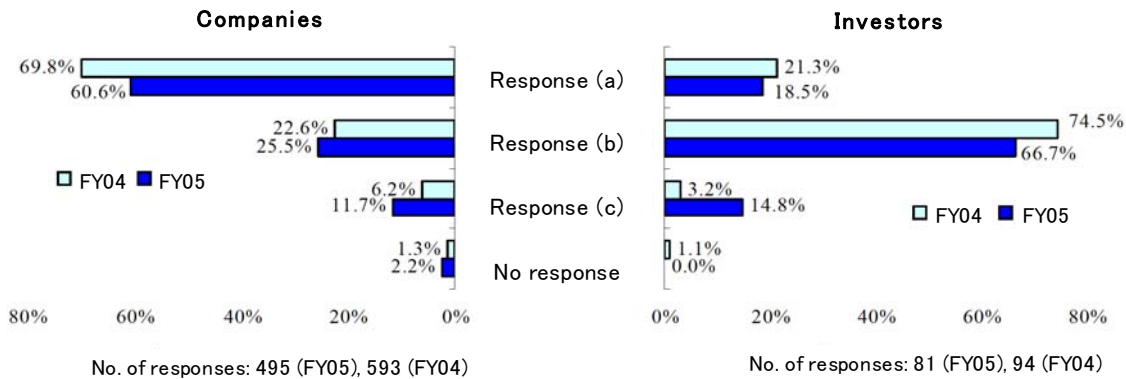
Note: Survey covers publicly traded companies in Japan for which continuous data is available for the period.
Source: LIAJ (2005)

Figure 3 Allocation of Earnings



Source: LIAJ (2005)

Figure 4 Dividend Policy Preferences—Companies and Investors



- (a) Maintain stable dividend
- (b) Tie dividend to latest results
- (c) Other

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4. Miller-Modigliani Dividend Irrelevance Proposition

Our theoretical discussions starts with the dividend irrelevance proposition by Nobel laureates Miller and Modigliani. The proposition states that dividend policy affects only the allocation between ordinary income and capital gains, and has no effect on the total gain to shareholders. The proposition rests on several assumptions—capital markets are perfect, there is no asymmetry of information, no tax or transaction costs, no changes to the business composition or capital structure, and managers seek to maximize shareholder value. Under these simplified conditions, the logical conclusion is that changes in dividend policy have no economic implications.

We illustrate this point with the example in Figure 5. The company, which holds no debt and has ¥90 billion in business assets, is going to pay out ¥10 billion in cash to shareholders. Since total assets are ¥100 billion and 100 million shares have been issued, the initial share price is ¥1,000. If the company pays out a cash dividend of ¥10 billion, the ex-dividend share price will drop to ¥900. But shareholders are not worse off because they have received ¥100 in cash.

Suppose the company then makes a public offering at ¥900 per share, raising ¥10 billion

and restoring total assets to ¥100 billion. Total outstanding shares have increased, but the share price remains at ¥900, and new and current shareholders are neither better nor worse off than before.⁴ If a share repurchase is done instead of the cash dividend, certain details may change, but the economic outcome for shareholders remains unchanged.

Thus under these simplified conditions, dividend policy affects only the allocation between income gains and capital gains, and has no effect on the total value received by shareholders. Moreover, even if the company could freely increase capital so as to boost dividends, the higher dividend would still be meaningless to shareholders.⁵ Thus standard theory shows that dividend policy has little if any economic effect.

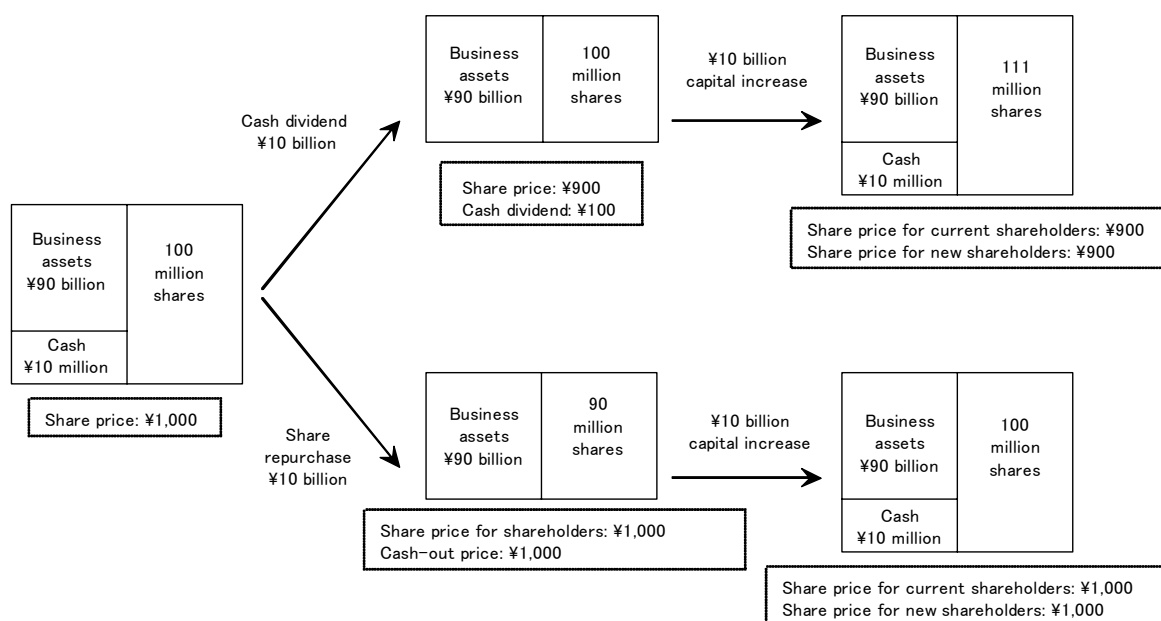
But in the real world, shareholders traditionally seek higher dividends, while companies regard dividend policy with caution. Do their respective behaviors have meaning? If not, why have these tendencies persisted over the years?⁶ Moreover, announcements of

⁴ However, adding new shareholders will dilute voting rights.

⁵ A capital increase may strengthen monitoring by shareholders, alleviating the agency problem (Eastbrook 1984).

⁶ The lack of a clear reason for dividend payouts has been called the “dividend puzzle.” We only note here that the high dividend tax rate should render them less

Figure 5 Example of the Dividend Irrelevance Proposition



dividend hikes and share repurchases are often favorably received by the market, seemingly contradicting the MM dividend irrelevance proposition.⁷ Why do not dividend policy and actual share prices always conform to standard theory?

This inconsistency may arise because the assumptions oversimplify the situation. In the real world, asymmetry of information exists between managers and investors, and the release of private information concealed in the dividend policy announcement will cause the share price to respond accordingly. Moreover, managers do not necessarily seek to maximize shareholder value at all times. Should they do anything to damage shareholder value, it will quickly be reflected in the share price.

To address such matters not covered by the MM proposition, we discuss two hypotheses below—the signaling hypothesis and free cash flow hypothesis—and show that dividend policy can indeed affect share price. Moreover, through dividend policy, we also examine what types of communication can be established between shareholders and management.

attractive to shareholders. However, this view lacks adequate empirical support.

⁷ For example, see Makita (2005).

5. Signaling Hypothesis

Let us first consider cash dividends. Since investors cannot be as informed or knowledgeable of the company as management (due to information asymmetries), they assume that management can better predict future earnings. In addition, investors tend to applaud dividend increases and frown on dividend cuts. On the other hand, managers tend to appease shareholders by maintaining dividends even when performance declines.⁸ Under these conditions, a dividend increase implies two commitments from management—first, that the higher dividend will be maintained over the long term, and second, that earnings will grow to sustain the dividend.

Thus investors perceive a dividend increase as a signal that management confidently predicts earnings will grow, which causes the share price to rise. Conversely, when a dividend is cut for no apparent reason, it signals to investors that management predicts

⁸ Ever since Linter's (1956) classic study, researchers have noted how managers set dividends in line with sustainable future earnings, and avoid dividend cuts as much as possible.

earnings will deteriorate to the point that dividends cannot be sustained, sending the share price downward. In this way, dividend changes serve as a signal of predicted earnings, thereby impacting share prices.

Investors also respond to share repurchase announcements as signals. Due to information asymmetries, investors predict that a share repurchase generally means that shares are currently undervalued, while the issuance of new shares means that shares are overvalued. Thus when a share repurchase is announced, it signals to investors that the share is currently valued below fair value, causing the share price to rise.⁹

As we have discussed, the signaling hypothesis is based on information asymmetries between managers and investors. Investors interpret changes in dividend policy (cash dividends and share repurchases) as signals regarding information not yet made public, causing share prices to react.

6. Free Cash Flow Hypothesis

When companies generate cash flow from business activities in each period, they can either invest it in the business, or build up cash holdings.¹⁰ In the latter case, managers enjoy considerable discretion, and may not necessarily try to maximize shareholder value. It may use the cash to serve other stakeholders, particularly itself. The large financial slack may induce managers to neglect their duties or invest in unproductive projects.

This problem of free cash flow is part of the larger agency problem that arises from the conflict of interest between management and investors. The problem is particularly serious at companies with large cash flow, excess funds, and limited growth options. If the market suspects that the financial slack is being squandered, it will discount the share

⁹ This is also known as the undervaluation hypothesis or market timing hypothesis.

¹⁰ This hypothesis is widely known as the Jensen free cash flow hypothesis (Jensen 1986).

price accordingly.¹¹

To remove the discount on its share price, the company must convince the market that the financial slack is being deployed effectively. The best way to do this is by returning capital to shareholders, either by increasing the dividend or repurchasing shares. Recently, cash-rich companies with discounted share prices are being targeted by aggressive investment funds.

7. Implications for Shareholders

The two hypotheses described above offer some implications for shareholders regarding dividend policy. Both hypotheses suggest that dividend hikes and share repurchases tend to boost share prices, which explains why shareholders have traditionally welcomed dividend hikes and spurned dividend cuts. But the two hypotheses differ in the meaning they give to dividends and repurchases (Figure 6).

Under the signaling hypothesis, a cash dividend contains private information from management regarding predicted earnings, while a share repurchase contains private information regarding current valuation. As a result, investors can glean new information from dividend policy changes, and the share price responds accordingly.

On the other hand, under the cash flow hypothesis, both a dividend increase and share repurchase help alleviate the agency problem. Here as well, management is signaling its commitment to deploy the financial slack prudently. The effect of reducing cash holdings is particularly pronounced at companies with a large financial slack and limited growth opportunities.

Thus the form that management chooses to

¹¹ While we use the term “excess funds” for simplicity, it includes not only cash but investments in securities and real estate, shareholdings in subsidiaries, affiliates and other companies that do not produce synergies, and other funds with little or no connection to the main business.

return cash to shareholders may depend on what information it seeks to convey to the market. If management confidently predicts earnings growth but believes this information is not fully reflected in the share price, the likely action is a dividend increase.¹² On the other hand, if management believes that the current share price is fundamentally undervalued and takeover concerns are mounting, the likely action is a share repurchase. Companies with excess funds, strong cash flow, and deeply discounted share prices are particularly vulnerable to hostile takeovers. To remove the discount, a large dividend increase or massive share repurchase is effective because either action demonstrates to the market that management is aggressively tackling the agency problem.

8. Improving Shareholder Value

Dividend policy can provide shareholders insight on management's views on earnings trends and current share prices, as well as its stance on financial slack. This information is vital in valuing the company and assessing the management. Our discussion also offers several implications regarding shareholder demands for dividends.

First, shareholders must act in a way that does not diminish the information value of dividend policy. A dividend increase is management's way of demonstrating confidence in future earnings growth, and at the same time recognizing that shareholders will not tolerate a dividend cut. Shareholders

can enhance the information value of dividend policy by reacting predictably—that is, applauding a dividend increase, and condemning a decrease.

But as we noted earlier, there is a growing demand among investors today for a fixed dividend payout ratio. Fixing the ratio means that investors must consent to a dividend cut when earnings drop. As such, dividend policy would no longer represent management's commitment to an earnings baseline for the long term, and thus would lose some of its information value.

However, we do not mean to deny the payout ratio's importance, nor to assert the dividend level's primacy. Instead, the issue is one of time horizon. The payout ratio target should be a long-term priority, while dividend stability should be a short-term priority. Surveys suggest that managers observe this distinction when deciding dividend policy.¹³

Secondly, shareholder demands for higher dividends may prove to be effective at many companies. Critics point out that dividends are excessively low, and attribute this to the low payout ratio compared to U.S. companies. But another reason may be shareholder complacency. Managers vigorously seek to keep dividends at a minimal level because they know that dividend cuts are not tolerated, and that dividend increases will commit them to expanding baseline earnings. Thus unless shareholders strongly insist on higher dividends, managers are likely to set the

Figure 6 Implications of Payout Method

	Signaling hypothesis (signaling effect)	Free cash flow hypothesis (cash reduction effect)
Cash dividend	<p>Increase conveys private information that earnings will rise --positive effect on share price</p> <p>Decrease conveys private information that earnings will fall --negative effect on share price</p>	<p>Increase alleviates agency problem --positive effect on share price</p> <p>Decrease aggravates agency problem --negative effect on share price</p> <p>(Effect depends on extent of excess funds and growth limitations)</p>
Share repurchase	<p>Repurchase implies shares are undervalued --positive effect on share price</p>	<p>Like dividend increase, alleviates agency problem --positive effect on share price</p>

payout ratio target considerably below the achievable long-term level.

The low payout ratio causes the financial slack to grow, exacerbating the cash flow problem.¹⁴ Moreover, should the company respond by increasing dividends, the action loses some information value because we cannot tell whether management has upgraded the earnings outlook, or is simply remedying a low return to shareholders.

Third, the desirable dividend policy will vary by company. Seeking a uniform dividend policy for all companies would overburden some and under-burden others, and also risks being incompatible with maximizing shareholder value at most companies.

For example, companies that enjoy a large stable cash flow, or have a large financial slack but conceal its uses, are likely to have serious free cash flow problems and heavily discounted share prices. These companies should consider a dividend increase or share repurchase on a massive scale. On the other hand, companies with good growth prospects rarely have free cash flow problems, and should be left to decide their own dividend policy, while shareholders should concentrate on analyzing the signals.

In this paper, we have discussed how shareholders might approach dividend policy as an interactive game with management. But much remains unknown about how dividend policy can maximize shareholder value. The discussion on dividend policy needs to be pursued further so that its significance, impact, and optimization methods are better understood by both investors and management.

¹⁴ The pecking order hypothesis seeks to explain why management prefers to build financial slack. Asymmetry of information between investors and management makes external financing more difficult to obtain. Thus management prepares for future financial risks and business opportunities by accumulating internal funds whose use is not restricted.

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