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Dividends and share repurchases in the European Union ☆

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ABSTRACT

We examine cash dividends and share repurchases from 1989 to 2005 in the 15 nations that were members of the European Union before May 2004. As in the United States, the fraction of European firms paying dividends declines, while total real dividends paid increase and share repurchases surge. We also show that financial reporting frequency is associated with higher payout, and that privatized companies account for almost one-quarter of total cash dividends and share repurchases. Our regression analyses indicate that increasing fractions of retained earnings to equity do not increase the likelihood of cash payouts, whereas company age does.

1. Introduction

Dividends are both pervasive and perplexing. They are pervasive in that companies have been paying regular cash dividends since the dawn of the modern limited liability company over three centuries ago, and publicly traded companies in all market economies have been paying out large fractions of their earnings ever since.[1] Dividends are perplexing (especially to financial economists) because it is not obvious why investors should demand cash dividends. Since the seminal paper by Miller and Modigliani (1961), a vast literature has examined the payout policies of U.S. companies, and much of the recent research has studied both cash dividends and share

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[1] Dewing (1953, p. 93) notes that an act of Parliament in 1697 formalized the restriction that cash dividends could only be paid out of a company's profits, not its capital, clearly indicating that dividends were important even then. A similar provision appeared in the Massachusetts Land Bank's charter, granted in 1739.

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repurchases.[2] However, relatively little research has yet been published examining the payout polices of non-U.S. companies.

This study examines cash dividend payments and share repurchases, over the period 1989–2005, of companies headquartered in nations that were members of the European Union before May 2004. Besides being the world's second largest economy, the EU during this era provides an ideal laboratory for studying payout policies, for four reasons. First, it is a grouping of 15 mostly sovereign and highly developed nations that over our study period is becoming increasingly unified economically and politically, but whose corporate governance systems, taxation regimes, and financial markets remain largely segmented. Second, while most of the EU countries have commercial codes based on civil law, two key nations (Britain and Ireland) have common law codes. Third, there is significant cross-sectional and time-series variation in the taxation of dividends and share repurchases over the study period, which allows us to directly examine how tax preferences influence payout probabilities and amounts. Finally, a large majority of the EU nations adopt a new common currency, the euro, after 1999, but three member countries—including the nation with the largest number of listed firms (Britain)—retain their own currencies throughout the study period.

Despite the EU's global importance, very little published research has examined cash dividend payments or share repurchases on a continent-wide basis. Denis and Osobov (2008) examine the dividend policies, but not repurchases, of companies headquartered in three European countries in their sample of six large economies, while LaPorta, López-de-Silanes, Shleifer, and Vishny (2000) include European firms in their global study of dividend policies. Pinkowitz, Stulz, and Williamson (2006) similarly include many European companies in their examination of how cash holdings and dividend payments are valued in 35 countries with varying corporate governance regimes. The only other recent studies we find are single-country analyses. This relative dearth of continental research primarily results from difficulties in obtaining comprehensive data prior to the 1999 adoption of the euro.

We ask and answer a series of basic questions about European payout policies. Are EU dividend payout ratios and likelihood to repurchase shares higher or lower than in the United States, and are these ratios the same for different European countries? Do European companies show the same declining propensity to pay dividends as Fama and French (2001) show for U.S. listed firms? Have share repurchases become as, or more, important than cash dividends among European firms, as Skinner (2008) shows has occurred in the United States, and are EU repurchases driven by the same firm-specific factors as cash dividends? Are dividends and earnings also concentrating in EU firms, as DeAngelo, DeAngelo, and Skinner (2004) show is happening in American companies? Are cash payouts as highly correlated with the fraction of retained earnings (versus contributed equity) in the equity capital structures of European firms as DeAngelo, DeAngelo, and Stulz (2006) find for U.S. dividend-paying firms? Are total payouts becoming more responsive to earnings in companies that regularly pay cash dividends and repurchase shares, as Skinner (2008) finds for the United States? Finally, do the patterns observed in Europe support any of the competing theories explaining dividend payments—especially the agency cost model, which is the current mainstream favorite, or the catering theory proposed by Baker and Wurgler (2004a)?

We find that dividend and share repurchase policies of EU companies are similar in many ways to those of American firms. For example, the fraction of European firms paying dividends has also declined in recent years, while total real dividends paid have increased. The total value of share repurchases has also surged in Europe, and now accounts for over half of the total value of cash dividends—although only one-fourth as many European companies repurchase shares as pay cash dividends. Additionally, dividends are also concentrating among European firms and, while the overall propensity of all EU firms to pay cash dividends has declined continuously with time, the propensity to repurchase shares has steadily increased. We find that company characteristics like size, market-to-book, and profitability that explain the likelihood to pay dividends or repurchase shares in the United States also influence the likelihood that EU firms will distribute cash to investors. While fewer European than American firms repurchase shares, dividend payments and repurchases are also complements in Europe and repurchases are significantly more sensitive to earnings in the most recent sub-period (2001–2005).

In addition to showing how American and EU firms are similar, we also make several new contributions by either reporting differences between Europe and America or by examining factors not considered in the U.S. context. Most critically, we show that large-scale share repurchases started much later in Europe than in the United States, but have grown even more rapidly over the past decade. Additionally, this is the first academic study to examine the relationship between financial reporting frequency and corporate payout policies. We find that the average reporting frequency of EU companies has steadily increased over 1989–2005, from 1.2 to 2.4 times per year, and is associated with higher amounts of cash dividends

[2] The theoretical and empirical literature from the first 40 years of modern dividend policy research is summarized in Allen and Michaely (2003). More recently, Koch and Sun (2004) show that investors interpret dividend changes as credible signals of the sustainability of past earnings changes, Morck and Yeung (2005) explore how American tax policy relating to inter-corporate dividend payments has promoted dispersed stock ownership in the United States, Grinstein and Michaely (2005) examine how corporate payout policy (dividends and repurchases) impacts institutional share ownership, and Brav, Graham, Harvey, and Michaely (2005) present survey evidence on the factors that drive managerial decisions regarding dividend payments and share repurchases. Intriguingly, DeAngelo and DeAngelo (2006) reexamine the original M&M dividend irrelevance theorem—which has served for four decades as the theoretical touchstone for payout research—and find that it does not hold, even in frictionless markets. In DeAngelo and DeAngelo (2007), these same authors advocate an alternative method of teaching dividend policy to students that does not begin with an irrelevance assumption.