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Equity ownership segregation, shareholder preferences, and dividend policy in China

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ABSTRACT

We investigate how listed Chinese firms pay different types of dividend to satisfy shareholders, different dividend preferences shaped by institutional factors such as share tradability and asymmetrical taxation. We find that the cash dividend level is significantly and positively related to the proportion of non-publicly tradable shares and this relation is mainly driven by legal person shareholders' preferences for cash dividends. In contrast, the stock dividend level is significantly and positively associated with the proportion of publicly tradable shares. These findings provide an empirical rationale for the current reform on the segregation of equity ownership rights in China.

1. Introduction

There has been a sustained academic interest in examining the determinants of dividend policy (e.g., Basker & Wurgler, 2004; Faccio, Lang, & Young, 2001; Graham & Kumar, 2006). However, cash dividends and stock dividends are often studied separately.[1] One consequence of this segregation is that we have limited knowledge about how management and shareholders choose between cash dividends and stock dividends, why cash dividends paying companies do not issue stock dividends, why stock dividends paying companies do not issue cash dividends, and why some companies pay both cash dividends and stock dividends. Moreover, the statistically significant determinants identified by studying stock dividends or cash dividends separately may no longer be statistically significant when both are considered.

The literature has also paid little attention to shareholder preferences for stock dividends (Frankfuter & Lane, 1998). In contrast, shareholder preferences for cash dividends have attracted much more attention as can be seen from several theories such as clientele theory (Miller & Modigliani, 1961), 'bird-in-hand' theory (Gordon, 1963), self-control theory (Shefrin & Statman, 1984), and the more recent catering theory (Baker & Wurgler, 2004). However, these theories might have limited ability to explain shareholder preferences for stock dividends. Moreover, prior empirical studies focus on shareholder preferences for different levels of cash dividends rather than their preferences for cash dividends over stock dividends. As

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[1] Some studies of cash dividends effectively equate stock dividends to non-dividends as they perceive stock dividends as purely cosmetic events that do not increase revenues or reduce expenses except changing the size of the units in which ownership may be traded. However, many prior studies have found significant abnormal returns on the stock dividends announcement date and ex-date (e.g., Anderson, Rose, & Chan, 2004; Grinblatt, Masulis, & Titman, 1984), probably because stock dividends signal issuing companies' confidence in their future performance. In line with our approach to studying cash dividends and stock dividends together, a few studies have begun to investigate cash dividends and share repurchases simultaneously in a U.S. context (e.g., Lie, 2001).

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a result, there is little knowledge about why some shareholders in certain countries such as China, Netherlands, and South Korea prefer stock dividends and why those shareholders in prior studies who prefer a certain level of cash dividends do not prefer stock dividends.

In order to provide more comprehensive and robust empirical evidence, unlike prior studies, we examine the determinants of both cash dividends and stock dividends. In particular, we control for cash dividends when we examine stock dividends and similarly we control for stock dividends when we examine cash dividends. We also adopt a shareholder preferences perspective. That is, we examine how shareholders' different preferences affect companies' choice of paying out through cash dividends only, through stock dividends only, or through both cash and stock dividends.

Our study is set in a Chinese context where the payment of stock dividends is a significant feature of Chinese companies' dividend policy (Chen & Yuan, 2004). Indeed, about 34 percent of listed Chinese companies paid stock dividends while some 47 percent paid cash dividends from 1993 to 2006. These figures strongly reflect the segregation of ownership structure in listed Chinese firms. On the one hand, there exists a large proportion of non-publicly tradable shares (NPTS) held by government agencies, state-owned enterprises (SOE) and other institutions. They are twice the size of publicly tradable shares (PTS) that are held by private investors and foreign investors and can be traded publicly on the stock exchange. Unlike PTS holders, NPTS holders do not benefit from capital gains arising from share price changes in the secondary market and also tend to be large and thus have both powers and incentives to expropriate corporate wealth through cash dividend payments to support their non-profit making units (Lee & Xiao, 2002). On the other hand, unlike NPTS holders who do not enjoy capital gains, PTS owners would prefer stock dividends to cash dividends because the former can generate significant tax free capital gains and because it is difficult for the investors to use a cash dividend to mirror a stock dividend on the nascent stock market.

By considering both cash dividends and stock dividends, our study significantly enriches the literature on dividend policy determinants, especially the shareholder preferences-based studies. First, by including both cash dividends and stock dividends in our empirical models, we find that the two options have a significant and negative relation, suggesting a substitution effect. This also makes our results more robust because the size and significance level would be different for the coefficients of several important variables in our testing models if we only investigated either stock dividends or cash dividends. Second, we identify a new source of shareholder preferences – equity ownership rights. We find that shareholders' different preferences for different types of dividend can arise from the segregation of equity ownership rights resulting in differences in share tradability and tax. We find empirical evidence to support that the proportion of NPTS is positively associated with the level of cash dividends while the proportion of PTS is positively associated with the level of stock dividends. Methodologically, we complement panel regression models with a Multinomial Logit Model which allows us to model four dividend policy choices simultaneously, namely, cash dividends, stock dividends, cash and stock dividends, and no dividends.

Furthermore, as very little academic attention has been paid to dividend policy in Chinese companies, this study enhances investors and trading partners' (especially foreign ones) understanding of the investment environment in China, one of the largest economies and recipients of foreign direct investments. In particular, our results help understand the importance of the recently promulgated experimental reform for making NPTS publicly tradable (CSRC, 2005a). While some people still doubt the need to undertake such a reform, our results on NPTS holders' preferences for cash dividends induced by asymmetrical ownership arrangements hasten the need to reduce NPTS and alleviate inequality in shareholder rights.

Table 1
Stock dividends, cash dividends, and dividend yields in China: 1993–2006.

	1993	1994	1996	1998	2000	2002	2004	2006	Average 1993–2006
Panel A: stock dividend payment per share (1993–2006)									
Stock dividend-payers	173	149	302	278	156	166	278	392	237
As a percentage of total listed firms (%)	94.54	51.20	56.98	32.67	14.34	13.56	20.19	24.34	34.46
Average stock dividend (number of shares)	0.17	0.25	0.28	0.09	0.07	0.12	0.47	0.48	0.24
Total number of listed firms	183	291	530	851	1088	1224	1377	1434	915
Panel B: cash dividend payment per share and dividend yields (1993–2006)									
Cash and stock dividend-payer	45	69	58	50	66	69	81	92	66
As a percentage of total listed firms (%)	24.59	23.71	10.94	5.88	6.07	5.64	5.88	6.42	10.46
Cash dividend-payers	87	133	175	250	654	545	785	821	443
As a percentage of total listed firms (%)	47.54	45.70	33.02	29.38	60.11	44.53	57.01	57.25	46.62
Average cash dividend (RMB)	0.18	0.21	0.16	0.19	0.16	0.07	0.15	0.16	0.16
Average EPS (RMB)	0.47	0.38	0.29	0.20	0.21	0.09	0.24	0.24	0.25
Cash dividend payout rate (%)	0.39	0.56	0.56	0.98	0.76	0.78	62.50	66.67	19.76
P/E ratio	44.21	10.17	35.02	33.34	59.13	49.56	34.34	25.2	35.61
Cash dividend yield rate (%)	0.88	5.50	1.60	2.94	1.29	1.57	1.82	2.65	2.52
One year deposit rate (%)*	9.54	10.98	9.21	5.10	2.25	1.98	2.25	2.52	5.12

Data source: Genius database.
This table reports statistics of dividend payment in China from 1993 to 2006. All listed companies are included.