ELSEVIER
Pacific-Basin Finance Journal 10 (2002) 443–473
PACIFIC-BASIN FINANCE JOURNAL
www.elsevier.com/locate/econbase

Dividend policy, cash flow, and investment in Japan

Hideaki Kiyoshi Kato [a,*,1], Uri Loewenstein [b], Wenyuh Tsay [c]

[a] *Graduate School of Business Sciences, University of Tsukuba, 3-29-1, Otsuka, Bunkyo, Tokyo 112-0012, Japan*
[b] *Eccles School of Business, University of Utah, Salt Lake City, UT 84112, USA*
[c] *College of Business Administration, California State University at San Marcos, San Marcos, CA 92096, USA*

Abstract

This study provides evidence in support of the cash flow information (CFI) hypothesis focusing on the Japanese firms. Dividend changes indeed convey information about the firm's cash flows. Although the free cash flow hypothesis is to some degree supported by the evidence in firms' investment behavior, dividend policy is not used by Japanese firms to control the overinvestment problem. In addition, the dividend clientele effect does not appear significant around dividend announcements in Japan. Given the specific institutional features of the Japanese market, we find that investment spending is very sensitive to liquidity constraints for nonkeiretsu firms, but not so for keiretsu firms.

JEL classification: G32; G35
Keywords: Japan; Dividend; Invesment decision; Free cash flow

1. Introduction

Dividend announcements have been the focus of extensive research in the U.S. markets. Hypotheses based on the information asymmetry and the overinvestment of free cash flow provide common interpretation of stock price reactions to dividend announcements. Announcements of dividend changes are usually associated with significant excess returns consistent in various ways with these nonmutually exclusive hypotheses. The purpose of this study is to test these hypotheses in Japan. Moreover, this research also provides general evidence about the relation between firms' cash flows and dividend changes. That is, how

* Corresponding author. Tel.: +81-3-3942-6881; fax: +81-3-3942-6829.
E-mail address: hkato@gssm.otsuka.tsukuba.ac.jp (H.K. Kato).
[1] Formerly Kiyoshi Kato.

0927-538X/02/$ - see front matter © 2002 Elsevier Science B.V. All rights reserved.
PII: S0927-538X(02)00068-9

dividends are financed and whether the careful management of dividends is regarded as important by corporate Japan. Finally, it makes a contribution to the investment literature by studying the general investment behavior of Japanese firms.

One popular hypothesis, the cash flow information hypothesis, suggests that management uses dividends to convey inside information about the firm's cash flow not available to other market participants. An announcement of a dividend increase (decrease) is a declaration by the management of their knowledge of favorable (unfavorable) future prospects for the firm. Larger changes in the dividend imply greater changes in the firm's cash flow. Therefore, the magnitude of the market reaction is positively related to the size of the dividend change (e.g., Asquith and Mullins, 1983; Denis et al., 1994).

The alternative hypothesis, the free cash flow hypothesis, implies that dividends are paid out to stockholders in order to prevent managers from building unnecessary empires in their own narrow interests. Entrenched managers have the tendency to invest free cash flow in size-increasing but nonprofitable projects. Stockholders would prefer to see an increase in dividend that would reduce the free cash flow available to the managers. As a result, stock prices react favorably to announcements of dividend increases and unfavorably to dividend decreases by overinvestors (Lang and Litzenberger, 1989).

Most of the empirical studies that intend to distinguish between these competing hypotheses focus on the examination of the cumulative excess returns around dividend announcements. Clearly, either hypothesis is consistent with positive stock price reaction to an announcement of a dividend increase and a negative reaction to a dividend cut. Surprisingly, however, when the various studies, which are all carried out using U.S. data, separate the firms by their growth potential, some find results consistent with the information hypothesis (Denis et al., 1994; Yoon and Starks, 1995), while others conclude that the results are consistent with the free cash flows hypothesis (Lang and Litzenberger, 1989).[2] Moreover, in an attempt to distinguish between the hypotheses, these studies take one step further and examine the revisions of analysts' earning forecasts after the announcements of dividend changes. Unfortunately, these tests do not help in finding the elusive consensus either. Denis et al. (1994) and Yoon and Starks (1995) find significant revisions of analysts' earning forecasts following dividend announcements, whereas Lang and Litzenberger (1989) obtain evidence of insignificant revisions.

There is clearly a need for a fresh look at these mixed results. Examining dividend announcements in Japan can shed light on this debate. This approach is especially promising because the institutional features of the Japanese market differ substantially from those of the U.S. market.

One unique institutional feature in Japan is the industrial organization of the firms. Most companies are affiliated with business groups or *keiretsu*, and engage in extensive

[2] In addition to the debate between these two hypotheses, the dividend clientele hypothesis proposes that the level of dividend yield also affects the magnitude of the market reaction to the dividend announcements. This clientele effect results from the investors' preference for dividend income due to their tax status. These clienteles are concerned with the level of dividend payout. As suggested by Bajaj and Vijh (1990), if the marginal investors in high-yield stocks have a preference for dividend, the announcements of dividend changes by higher-yield firms should lead to greater market reaction to the announcements. As a result, the magnitude of the excess returns around dividend announcements is positively related to the level of dividend yield.