



Dividend policy and the earned/contributed capital mix: a test of the life-cycle theory[☆]

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Abstract

Consistent with a life-cycle theory of dividends, the fraction of publicly traded industrial firms that pay dividends is high when retained earnings are a large portion of total equity (and of total assets) and falls to near zero when most equity is contributed rather than earned. We observe a highly significant relation between the decision to pay dividends and the earned/contributed capital mix, controlling for profitability, growth, firm size, total equity, cash balances, and dividend history, a relation that also holds for dividend initiations and omissions. In our regressions, the mix of earned/contributed capital has a quantitatively greater impact than measures of profitability and growth opportunities. We document a massive increase in firms with negative retained earnings (from 11.8% of industrials in 1978 to 50.2% in 2002). Controlling for the earned/contributed capital mix, firms with negative retained earnings show virtually no change in their propensity to pay dividends from the mid-1970s to 2002, while those whose earned equity makes them reasonable candidates to pay dividends have a propensity reduction that is twice the overall reduction in Fama and French [2000, *Journal of Financial Economics* 76, 549–582]. Finally, our simulations show that, if well-established

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firms had not paid dividends, their cash balances would be enormous and their long-term debt trivial, thus granting extreme discretion to managers of these mature firms.

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1. Introduction

Dividends tend to be paid by mature, established firms, plausibly reflecting a financial life cycle in which young firms face relatively abundant investment opportunities with limited resources so that retention dominates distribution, whereas mature firms are better candidates to pay dividends because they have higher profitability and fewer attractive investment opportunities. Fama and French (2001), Grullon et al. (2002), and DeAngelo and DeAngelo (2006) all advance life-cycle explanations for dividends that rely, implicitly or explicitly, on the trade-off between the advantages (e.g., flotation cost savings) and the costs of retention (e.g., agency costs of free cash flow). The trade-off between retention and distribution evolves over time as profits accumulate and investment opportunities decline, so that paying dividends becomes increasingly desirable as firms mature. The literature offers only a rough empirical idea of the characteristics that differentiate firms that pay dividends from those that do not. Most notably, Fama and French (2001) find that firms with current high-profitability and low-growth rates tend to pay dividends, while low-profit/high-growth firms tend to retain profits.

We test the life-cycle theory by assessing whether the probability a firm pays dividends is positively related to its mix of earned and contributed capital, i.e., whether firms with relatively high retained earnings as a proportion of total equity (RE/TE) and of total assets (RE/TA) are more likely to pay dividends. The earned/contributed capital mix is a logical proxy for the life-cycle stage at which a firm currently finds itself because it measures the extent to which the firm is self-financing or reliant on external capital. Firms with low RE/TE (RE/TA) tend to be in the capital infusion stage, whereas firms with high RE/TE (RE/TA) tend to be more mature with ample cumulative profits that make them largely self-financing, hence good candidates to pay dividends. The proportion of equity capital that is earned is conceptually distinct from (and in our sample uncorrelated with) current or short-term profitability, which is widely recognized since at least Lintner (1956) to affect dividend decisions. It is also a better measure of a firm's life-cycle stage (hence suitability to pay dividends) than its cash balances, because the *source* of the cash impacts the dividend decision. For example, high cash holdings can reflect the proceeds of a recent equity offering for a firm whose low RE/TE and RE/TA show it to be in the infusion instead of the distribution stage.

Our evidence uniformly and strongly indicates that the probability a firm pays dividends increases with the relative amount of earned equity in its capital structure. For publicly traded industrials over 1973–2002, the proportion of firms that pay dividends is high when the ratio of earned to total common equity (RE/TE) is high and falls with declines in this ratio, reaching near-zero levels for firms with negligible retained earnings. Similarly, the proportion of dividend payers is high when earned equity is a large fraction of total assets

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