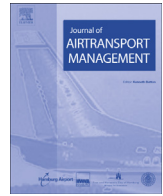




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Determinants of the payout decision in the airline industry

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ABSTRACT

Payouts play an important role in the relationship between shareholders and agents in terms of rewarding the decisions of shareholders. Previous studies have observed that payout decisions appear in different ways depending on an industry's financial and operating structures. Since the airline industry has been characterized as high debt dependency, this study presumes distinctive characteristics on payouts determinants and identifies them influencing dividend payments and share repurchases. The results indicate that firm size, cash holdings, financial leverage, and life-cycle influence dividends payments, whereas firm size, cash holdings and life-cycle stage affect share repurchase. The implications of the findings are discussed.

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1. Introduction

Corporations are responsible for compensating the decisions of their shareholder (Fama and French, 2001; Canina et al., 2001). Payouts, including dividends and share repurchases, are considered to be representative channels by which wealth is transferred to shareholders. In addition to this compensatory role, dividends and share repurchases are significant as signals to investors regarding a company's financial condition. Generally, investors are risk-averse and reluctant to invest in the stock of a firm that appears to be risky (DeAngelo et al., 2004). This antipathy to risk is derived from an information asymmetry regarding corporate financial conditions and status between the investors and company managers (Riley and Chow, 1992). That is, investors are likely to be reluctant to invest their wealth because the unbalanced information could increase financial insecurity. In this sense, to decrease the financial risk of their investments, it is meaningful for investors to ascertain the investment risk through the relevant alarm signals. In corporate finance, it is known that payouts function as an alert system by providing investors with information regarding a firm's performance and financial status. That is, payouts serve as crucial instruments to decrease the difference between unbalanced information levels (Dybvig and Zender, 1991; Frankfurter and Lane, 1992).

The importance of the role of dividends has been recognized in the literature; therefore, examination of fundamental factors that help predict dividends is a valuable subject for study (e.g. DeAngelo et al., 2008; Fama and French, 2001; Lie, 2005). Furthermore, previous studies have demonstrated that an idiosyncratic capital or operating structure of an industry influences payout determinants in different ways (Dempsey et al., 1993; Michel, 1979).

The airline industry, which is the primary focus of this study, is considered to have high debt dependency because airline operations have a highly cost-driven structure (Kang et al., 2010; Liu, 2009). Generally, airlines spend a substantial amount of their budgets for regular aircraft purchases and the repayment of the loans that such purchases require, with the result that airlines depend highly on debt financing to raise operation funding (Assaf, 2009; Suen, 2002; Liu, 2009). Therefore, an airline's value is underestimated relative to its stock market value because the firm's earnings are dissipated by the costs of capital, such as interest payments, and the risk of bankruptcy or takeover (Hofer et al., 2009). These financial characteristics cause firms to rely on external financing, which increases the cost of debt (Hofer et al., 2009; Myers, 1977). Since airlines are highly indebted, this unique capital structure may create a distinctive effect on payout prediction. Therefore, the question arises as to what financial/operating determinants could become strong predictors of payouts in airline industry.

Although previous studies have examined the effect of dividends on the financial performance and the value of firms (see

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Carter et al., 2006; Lee et al., 2013), scant efforts have been made to identify the relationship between financial/operating attributes and payouts in the airline industry. Therefore, this study examines how payout determinants appear as unique forms given the distinctive financial and operating characteristics of the airlines. This study uses logistic regression as an instrument of analysis because this method allows researchers to evaluate the likelihood that “payout will occur” (see Fama and French, 2001; Hoberg and Prabhala, 2009; Wooldridge, 2009) and to identify the financial and operating factors of payout-implementing airline firms.

2. Literature review

2.1. Theoretical foundation of payouts

2.1.1. Agency theory

According to the agency theory, agents have more reliable information than shareholders regarding the financial performance or status of firms. Thus, managers are more likely to behave in a manner that maximizes their own wealth instead of the wealth of shareholders (Jensen and Meckling, 1976). Therefore, agents are more likely to practice adverse selection using superior information to maximize their benefits instead of the wealth of their shareholders (Jensen, 1986; Fama, 1980). That is, agents take advantage of the information superiority, which often results in unwise investments and poor performance (Fama and MacBeth, 1973). Poor performance is dissatisfying to shareholders, who become suspicious and begin to monitor manager behavior. Valuable firm resources are dissipated by monitoring, and the resultant drain on resource exacerbates the impending destruction of firm value. Dybvig and Zender (1991) and Frankfurter and Lane (1992) suggested solutions for this agency problem. They argued that payouts function as crucial instruments to decrease the difference between imbalanced information levels by transferring the cash flow from the side of the agents to the side of the shareholders. Because free cash flow on the side of the managers is a proxy of information asymmetry, the payout policy decreases the likelihood of adverse selection by managers (Moh'd et al., 1995).

2.2. Empirical evidence of payouts

In this study, the fundamental variables commonly used in previous payout studies are employed as main variables: (a) firm size, (b) cash holdings, (c) debts, (d) life-cycle stage, (e) return on assets (ROA), (f) investment opportunities, and (g) previous payouts. Also, economic conditions and airline-specific variables are inserted in the study model as control variables to acquire more robust estimation by controlling external effect.

2.2.1. Firm size and payouts

One aspect of payout policy is firm size. Previous dividend studies have demonstrated that larger firms are likely to implement payouts consistently because larger firms possess extra resources that enable firms to withstand undesired business conditions, such as an economic crisis and political instability (Chay and Suh, 2009; Eije and Megginson, 2008). Because airline firms are sensitive to economic crises and political instability at the destinations to which they provide service, firm size functions as an instrument to protect firms from undesired outside effects (Liu, 2009; Assaf, 2009; Fama and French, 2001). Moreover, Lee et al. (2013) demonstrated the relationship between firm size and payout in airline context, showing that a larger firm performs better than a smaller firm, thereby often paying out dividends. Thus, the research suggests the following research hypotheses:

H1a. Airlines with greater assets are more likely to pay dividends.

H1b. Airlines with greater assets are more likely to repurchase shares.

2.2.2. Cash holdings and payouts

A second aspect of the payout decision is cash holdings. Most dividends are dependent on the amount of cash, which implies that managers at firms with more cash holdings have a higher probability of determining a payout (Espen Eckbo and Verma, 1994; Jensen, 1986; Jiang et al., 2013). Numerous empirical studies have verified this positive relationship between cash holdings and payout. For example, Kalchva and Lins (2007) investigated approximately 5000 firms from 31 countries and verified the positive relationship. In addition, Carter et al. (2006) found evidence for this relationship in the airline industry, contending that the highly cost-driven nature of the airline business, which results from aircraft purchases, and a large portion of the labor cost cause cash-flow uncertainty at airlines. Therefore, airlines are likely to retain substantial cash holdings that increase the likelihood of payouts by these airlines. Considering the empirical evidence, this study proposes the following additional research hypotheses:

H2a. Airline firms with more abundant cash holdings are more likely to pay dividends.

H2b. Airline firms with more abundant cash holdings are more likely to repurchase shares.

2.2.3. Debt and payouts

The third determinant of payout decisions is debt. Debt often plays an important role in predicting payouts when an industry highly depends on debt. If a firm is highly dependent on debt, the firm must repay debt to minimize debt cost, which decreases the amount of resources available for stockholder payouts. This negative association between debt and payouts has been demonstrated in the literature. For example, Deshmukh et al. (2013) found that debt decreases the likelihood of payouts in case of US companies across various industries between 1980 and 1994. Lie (2005) also confirmed this relationship, arguing that debt decreases the resources available to firms to pay their shareholders by influencing free cash flow. Because the airline industry is known to be highly debt dependent, the chances of payouts by airline firms are decreased because of their debt covenant (Suen, 2002; Liu, 2009; DeAngelo et al., 2008). Based on these empirical indications, this study proposes two research hypotheses as follows:

H3a. Airline firms with more debt are less likely to pay dividends.

H3b. Airline firms with more debt are less likely to repurchase shares.

2.2.4. Life-cycle stage and payouts

Life-cycle stage is regarded as another factor in the payout decisions. Previous research demonstrates that mature firms will most likely possess more retained earnings (DeAngelo et al., 2006). The additional retained earnings enable firms to allocate more resources for payouts. That is, mature firms are more likely to issue payouts. Kim and Jang (2010) verified the positive association between the life-cycle stage and payouts. In addition, regarding the airline industry, Rakowski and Bejou (1992) asserted that mature airlines are competitive in the market. These more competitive firms can demonstrate a sounder financial condition, which increases their likelihood to implement shareholder payouts. Thus, this study proposes the following research questions:

H4a. Mature airline firms are more likely to pay dividends.

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