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The role of cross-listing, foreign ownership and state ownership in dividend policy in an emerging market

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ABSTRACT

In this paper, we investigate if dividend policy is influenced by ownership type. Within the dividend literature, dividends have a signaling role regarding agency costs, such that dividends may diminish insider conflicts (reduce free cash flow) or may be used to extract cash from firms (tunneling effect) – which could be predominant in emerging markets. We expect firms with foreign ownership and those that are listed in overseas markets to have different dividend policies and practices than those that are not, and firms with more state ownership and less individual ownership to be more likely to pay cash dividends and less likely to pay stock dividends. Using firms from an emerging economy (China), we examine whether these effects exist in corporate dividend policy and practice. We find that both foreign ownership and cross-listing have significant negative effects on cash dividends, consistent with the signaling effect and the notion of reduced tunneling activities for firms with the ability to raise capital from outside of China. Consistent with the tunneling effect, we find that firms with higher state ownership tend to pay higher cash dividends and lower stock dividends, while the opposite is true for public (individual) ownership. Further analysis shows that foreign ownership mediates the effect of state ownership on dividend policy. Our results have significant implications for researchers, investors, policy makers and regulators in emerging markets.

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1. Introduction

Corporate dividend policy has attracted the interest of researchers of capital markets and corporate behavior for almost half a century. Today, corporate governance and ownership structure issues continue to be of major interest to researchers, practitioners and policy makers, in particular following accounting scandals such as Enron and WorldCom in 2002 and the corresponding legislative reforms such as the Sarbanes–Oxley Act in the United States. Empirical research on corporate governance is based on the theoretical framework of agency theory (e.g., Jensen and Meckling, 1976; Fama and Jensen, 1983), which provides a framework to explain how to create an effective monitoring and incentive scheme under uncertainty and incomplete information. Following this line of research, the literature has argued that dividends can be used to prevent insiders from diverting retained earnings for their own benefit. In countries with strong investor protection, dividends are found to play a useful role in reducing agency problems, whereas they play a less important role in countries with weak investor protection (La Porta et al., 2000). China is a civil law country with weak investor protection and according to the La Porta et al. (2000) model, lower dividend payout ratios are expected. However, along with dynamic changes, extremely high payout ratios have been observed in China (Chen et al., 2009). In this paper, we shed light on such a dilemma by focusing on whether corporate ownership structure has an influence on corporate dividend policies.

Corporate ownership structure could be associated with dividend policy and practice in that dividends signal the extent of conflicts between majority shareholders and minority shareholders (e.g. Jensen et al., 1992). While empirical studies have documented the significant role of ownership variables in determining dividend policies (Thomsen, 2005; Mancinelli and Ozkan, 2006; Khan, 2006; Szilagyi and Renneboog, 2007), the results are quite mixed. For instance, Szilagyi and Renneboog (2007) find a positive relationship between stakeholders' ownership and dividends for Dutch firms, while Thomsen (2005) and Khan (2006) find a negative relationship for UK firms.

In addition, the potential impact of foreign stockholder ownership has been largely neglected, especially in emerging markets where the ownership structures and institutional background are significantly different from those of developed economies. In a recent study, Ferguson et al. (2002) show that the disclosure policies and disclosure behavior of Chinese firms issuing cross-listed shares on the Stock Exchange of Hong Kong (H-shares on SEHK) were very different from other SEHK-listed firms and state-owned firms incorporated in Hong Kong (Red-chip shares), which they attribute to signaling incentives and cost-benefit concerns. Such differences might also exist for dividend policies and practices. If dividends play a signaling role, then the fact that firms are listed overseas may have a significant influence on their dividend policies and practices compared to those that are not. Therefore, in an emerging market setting, we investigate whether there are significant differences in dividend policies and practices between firms with cross-listed shares and/or foreign ownership and those without.

Other motivations of our study come from the unique institutional setting of public firms in China. The literature has documented several possible motivations for public firms to pay dividends, such as to signal firms' future prospects to investors (e.g., Bhattacharya, 1979; John and Williams, 1985), restrain agency problems by forcing firms to external capital markets with additional monitoring (Rozeff, 1982; Easterbrook, 1984), reduce management's opportunity to invest the firm's free cash flow in projects that benefit management at shareholders' expense (Jensen, 1986) or projects that benefit controlling shareholders at minority shareholders' expense (Faccio et al., 2001) and to minimize taxes (Wilkinson et al., 2001).

However, in contrast to the earlier hypothesis that dividend payments are a vehicle to constrain the agency behavior of managers (e.g., Jensen, 1986), cash dividends are preferred by majority shareholders in emerging markets (Chen et al., 2009). This may occur because the firms listed in emerging markets are mostly equity carve-outs, a term used to indicate that these firms were originally part of assets or subsidiaries of state-owned enterprises and were chosen to be listed because they were relatively attractive to investors. Earlier literature has documented that Chinese firms with a controlling state shareholder are more likely to pay cash dividends and state shareholders are more likely to surrender the exercise of stock subscription rights (Wei et al., 2004).[1]

[1] Rights offerings are the offering to existing shareholders of rights to subscribe to common stocks.