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Corporate dividend policy in Thailand: Theory and evidence

Richard Fairchild [a,1], Yilmaz Guney [b], Yordying Thanatawee [c]

[a] School of Management, University of Bath, UK
[b] University of Hull, UK
[c] Graduate School of Commerce, Burapha University, Chonburi, Thailand

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ABSTRACT

This paper examines dividend changes in an emerging market: Thailand. We begin by considering the possible effects of the Thai corporate environment on dividend policy. We develop a theoretical model that considers the relationship between the strength of investor power and dividends in an agency cost/free cashflow framework. This allows us to consider the conditions for the outcome (positive relationship) or substitute (negative relationship) models, as discussed by La Porta et al. (2000). Our model also allows us to consider the expropriation hypothesis, in which the presence of large controlling shareholders may actually reduce outside investor power, leading to lower dividends. We then turn to our empirical analysis. Employing a large sample of companies that changed dividends in Thailand during the period 1996–2009, we test for the signaling, free cashflow and life-cycle hypotheses. A further contribution of our analysis is that we consider the impact of investor power and ownership on dividends in Thailand. Overall, we find little support for the signaling hypothesis, but we find considerable support for the free cashflow and life-cycle hypotheses. Our analysis of ownership variables suggests that increasing investor power (for example, high ownership concentration together with the presence of domestic institutional ownership) results in higher dividends, in support of the outcome model, rather than the substitution or expropriation models.

1. Introduction

Dividend policy is one of the most important research areas in finance. Many researchers have studied why firms pay a substantial portion of their earnings as dividends if, according to Miller and Modigliani's (1961) dividend irrelevance proposition, dividend policy does not change shareholders' wealth in a complete and perfect market. This is known as the 'dividend puzzle' (Black, 1976).

In the real world, however, the capital market is neither perfect nor complete. Many empirical studies (e.g., Asquith & Mullins, 1983, among others) show that the market reacts positively (negatively) to dividend increases (dividend cuts). The signaling and free cash flow hypotheses are two major theories that have been developed to explain corporate dividend policy. The signaling hypothesis (Bhattacharya, 1979; John & Williams, 1985; Miller & Rock, 1985) states that, under asymmetric information, managers pay dividends to convey signals to investors about the firm's future profitability. Alternatively, the free cash flow hypothesis (e.g., Easterbrook, 1984; Jensen, 1986) states that dividends help address agency problems between managers and outside investors. In Easterbrook's (1984) analysis, the monitoring role of dividends mitigates agency conflicts between managers and shareholders. The agency problem in Jensen's (1986) analysis arises from managers' incentives to consume private benefits, e.g., building their empires by investing free cash flows in negative net present value projects. Thus, dividends alleviate this problem by reducing the free cash flow available to managers.

A prediction of the signaling hypothesis, that there is a positive relationship between dividend changes and profitability changes, has been extensively examined, but the empirical evidence is inconclusive (for example, it is supported by Aharony & Dotan, 1994; Healy & Palepu, 1988; Nissim & Ziv, 2001 but not supported by Benartzi, Michaely, & Thaler, 1997; DeAngelo, DeAngelo, & Skinner, 1996[2]). Since the existing research on dividend policy is replete with evidence from the U.S. and developed markets, researchers have recently started looking at corporate dividend policy of firms in emerging markets, and have increasingly recognized that dividend policy may be affected by the international context in which it occurs (see, e.g., Aivazian, Booth, & Cleary, 2003; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000; Naceur, Goaied, & Belanes, 2006). Therefore, one contribution of this paper is to provide additional evidence from an emerging market (namely, Thailand) by testing whether profitability changes follow dividend changes in the same direction, as predicted by the signaling hypothesis.

Recently, scholars have developed the life-cycle theory of dividends (see, for example, DeAngelo, DeAngelo, & Stulz, 2006; Fama & French, 2001; Grullon, Michaely, & Swaminathan, 2002). This theory contends

E-mail address: mnsrf@bath.ac.uk (R. Fairchild).
[1] Tel.: +44 1225 383456.

[2] In an interesting study, Bozos, Nikolopoulos, and Ramganhi (2011) are the first to analyze dividend signaling under both stable and recessionary economic conditions. They find that dividends provide stronger signals in periods of economic adversity than in periods of growth and stability.

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that mature and established firms are more likely to pay dividends than young firms that have abundant growth opportunities with limited resources. A major contribution of this paper is that we test three dividend theories (that is, signaling, free cash-flow and life-cycle hypotheses)[3] in relation to dividend policy in Thailand. A further contribution is that we consider the effects of several corporate ownership variables on dividend policy in Thailand.

Thailand is characterized as a country with low shareholder and creditor protection, poor corporate governance and with incentives for tunneling of resources (Bertrand, Johnson, Samphantharak, & Schoar, 2008; Connelly, Limpaphayom, & Nagarajan, 2012; Gorkittisunthorn, Jumreornvong, & Limpaphayom, 2006; La Porta, Lopez-de-Silanes, & Shleifer, 1999; Limpaphayom & Polwitoon, 2004). In addition, the ownership structure of Thai firms is highly concentrated with inactive trading of shares (Aivazian et al., 2003; Claessens, Djankov, & Lang, 2000; Gorkittisunthorn et al., 2006; Limpaphayom & Ngamwutikul, 2004; Wiwattanakantang, 1999, 2001). These characteristics can increase the agency costs of free cash flows[4] and dividend payments are more likely to be used as a mechanism that help mitigate this agency problem. Moreover, Thai shareholders have significant cash flow and voting rights, compared to the peers in other nations and there is high degree of asymmetric information (Kim, Kitsabunnarat, & Nofsinger, 2004). Limpaphayom and Polwitoon (2004) highlight the presence of inactive bond markets and reliance on bank financing, stating that heavy reliance on short-term bank debt might be one of the key contributors of the 1997 financial crisis in Thailand. They suggest that bank equity ownership can mitigate the conflicts between lenders and borrowing firms. Similar to Gorkittisunthorn et al. (2006) and Wiwattanakantang (1999), Bertrand et al. (2008) find out the strong influence of founder families on corporate decision making. They report that rivalry among family members of large families leads to poor financial performance and inability to exercise effective veto power by controlling shareholders if family control is very significant. Relatedly, Connelly et al. (2012) state that one can observe a complex ownership structure in Thailand following the 1997 crisis, e.g., seemingly elusive power of controlling families through pyramidal ownership that is detrimental to firm value. Ownership concentration is high and rent-seeking is common in East Asia, hence the potential violation of minority shareholders. In other words, shareholder–manager conflicts in advanced countries take the form of large and small shareholders' conflicts in this region. Concentrated ownership increases the information asymmetries between insiders and outsider investors as well as the agency conflicts between two parties. Fan and Wong (2002) report that a typical firm in East Asia has low level of transparency and lacks quality of informativeness on accounting statements. They also find that among seven East Asian countries, Thailand has the most concentrated voting rights. A recent paper by Ekkayokkaya and Pengniti (2012) finds that the weak Thai legal environment can be improved by governance regulations (e.g., regulations can curb expropriation risk to outside investors) but this improvement may be limited if insiders have absolute control of the firm. They report that despite the major recent reforms, public enforcement of securities regulation is still vulnerable because of the business-owner politicians and shareholders with political links. Hence, this paper tests, in this unique environment, whether managers of Thai firms use dividend policy for signaling purposes or they are asked to employ dividends given the potentially high agency conflicts and weak corporate governance practices and legal protection.

Our major findings are as follows. We find little evidence that changes in dividends (either increases or decreases) precede future profitability in the same direction. Rather, we find that dividend changes are lagged results of past changes in profitability as well as the current financial performance. We also investigate the relationship between dividends and growth opportunities (some significant relationships), dividends and debt ratio (significant for dividend decreases only), dividends and cash flow (positive and significant for dividend increases), and dividends and current and past retained earnings ratio (significant in most cases). Furthermore, we find evidence of dividend stability in Thailand. The findings related to corporate ownership variables suggest that the presence of institutional and foreign investors tends to result in dividend increases. Also, for firms with higher ownership concentration, shareholders seem to prefer more dividend payments. Unlike individual shareholders, the institutional shareholders avoid dividend reductions. Overall, our findings lend some support to the free cash flow hypothesis[5] and the life-cycle hypothesis rather than the signaling hypothesis.

The paper proceeds as follows. Section 2 reviews the relevant literature. Section 3 develops our theoretical model analyzing the effects of investor power on dividends. In Section 4, we introduce the hypotheses arising from our literature review, and our theoretical model. In this section, we also describe the sample and variables. Section 5 provides the empirical results and Section 6 concludes.

2. Literature review

2.1. The signaling theory

The dominant explanation why firms pay dividends is the signaling hypothesis, which explains dividends as a means to signal the firm's future prospects. Lintner's (1956) survey evidence indicates that managers are reluctant to cut dividends because doing so has a negative impact on stock price, and they do not raise dividends if they are not confident that the firm's profitability will improve. This suggests that, if the signaling hypothesis is supported, dividend changes should be followed by profitability changes in the same direction.

Many researchers have attempted to test this implication of the signaling hypothesis, but the results are inconclusive. For example, Watts (1973) finds a positive link between dividend changes and future earnings changes of 310 U.S. firms during 1947–1966. However, the relationship is not strong, i.e., the average size of future earnings changes is very small. Healy and Palepu (1988) find that earnings of dividend-initiating firms increased rapidly in the past, and continued to increase for the two years following initiations. However, their analysis of 172 firms that omitted dividends indicates that earnings of these firms declined in the year of dividend omission but significantly improved in subsequent years, the findings in contrast with the signaling hypothesis.

Consistent with the signaling hypothesis, Aharony and Dotan's (1994) results indicate a positive relationship between unexpected changes in quarterly dividends and unexpected earnings in subsequent quarters and that firms that increased (decreased) dividends experience higher (lower) unexpected earnings in subsequent periods than do firms that did not change dividends. In contrast, DeAngelo et al. (1996) analyze a sample of 145 NYSE companies whose earnings decline after nine or more consecutive years of growth but find no evidence that dividend increases are associated with subsequent earnings surprises. In line with DeAngelo et al. (1996), Benartzi et al. (1997) investigate a large sample of 1025 firms and 7186 firm-year observations but still find insignificant earnings growth following dividend increases. In contrast with Benartzi et al. (1997), Nissim and Ziv (2001) find that dividend changes are positively related to earnings changes in each of the two years following the dividend change, and that dividend changes are positively related to the level of future profitability.

Grullon, Michaely, Benartzi, and Thaler (2005) subsequently employ a large sample of 2778 firms, 14,235 dividend increases, 947 dividend

[3] Indeed, Frankfurter and Wood's (2002) review of existing research identifies the lack of consensus over the motives behind dividend policy. Hence, it is important to test the various hypotheses identified in the literature.

[4] Gorkittisunthorn et al. (2006), for instance, emphasize weak legal protection and severe agency problems between controlling insiders and outside investors. Also, Connelly et al. (2012) argue that for firms in which family ownership is apparent in Thailand, the key agency conflict is between large and minority shareholders.

[5] For example, our examination of firms' investment behavior suggests that dividends help mitigate the overinvestment problem.