Corporate Governance and Dividend Policy

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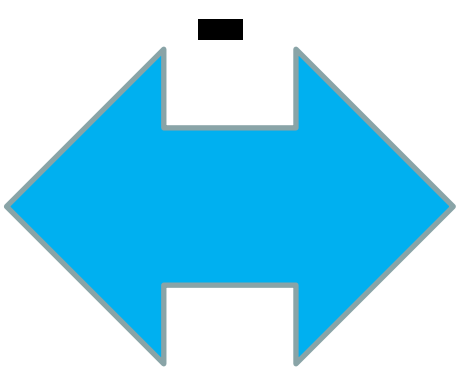
A Quick Summary

Substitute

Corporate Governance



Dividend Payout

Complement

Relation between the Two

Substitutes: **Good Governance discourages Dividend Payout**

Hu and Kumar (2004, JFQA), John, Knyazeva, and Knyazeva (2015, JCF), Hoberg and Prabhala (2009, RFS), Officer (2011, JCF)

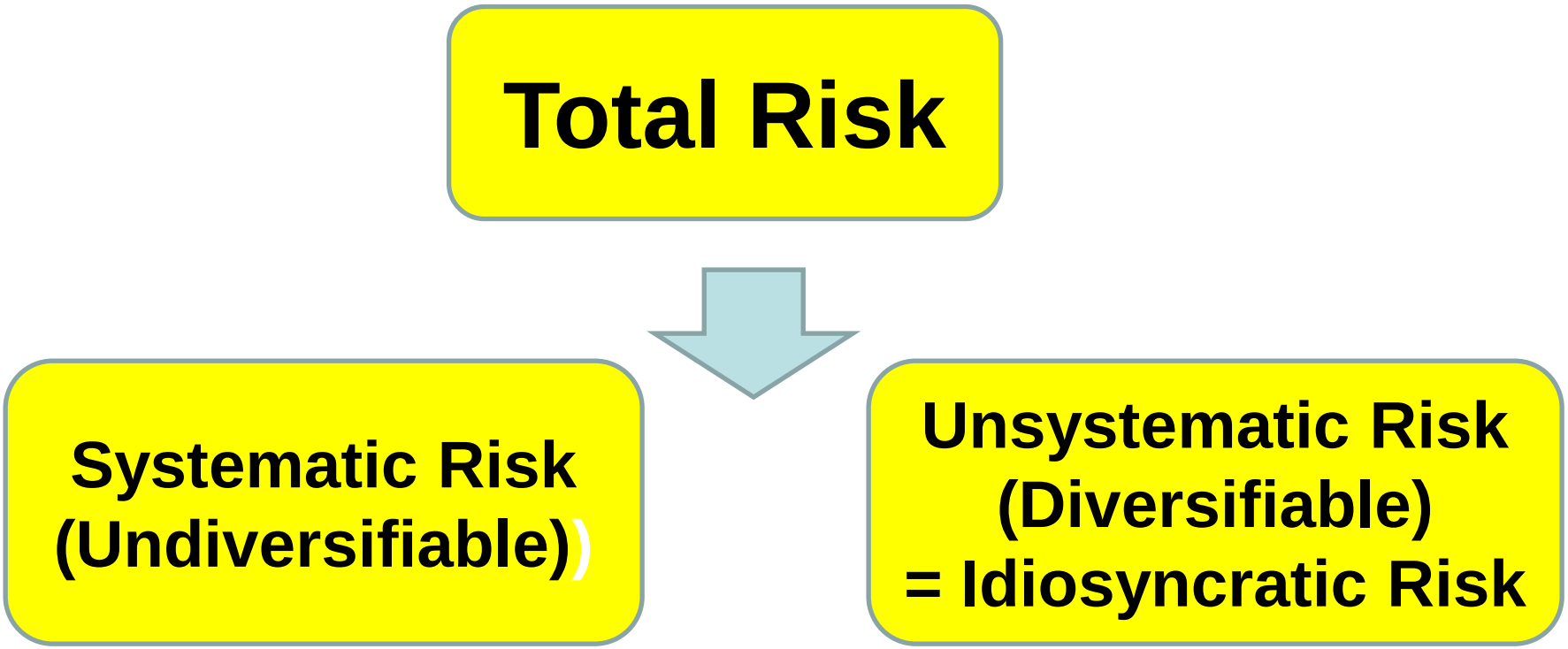
Complements: **Good governance encourages Dividend Payout**

La Porta, López-de-Silanes, Shleifer, and Vishny (2000, JOF), Michaely and Roberts (2012, RFS), and Grullon and Michaely (2014, JOF)

Our Finding:

They can be either Substitutes or Complements depending on level of Idiosyncratic Risk

Decomposition of Total Risk



Finance Literature

In reality, markets are not frictionless and IR matters

Negative relation between IR and Stock Returns: Ang, Hodrick, Xing, and Zhang (2006, JOF; 2009, JFE)

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Why Idiosyncratic Risk?

IR is highlighted in two areas of finance research

1. **Short Sale Literature**
2. **Investment Literature**

Short Sale Literature

Securities are short-sale constrained

Investors disagree on their value

Overpriced & Negative Returns

Miller (1977, JOF) and Boehme, Danielson and Sorescu (2006, JFQA)

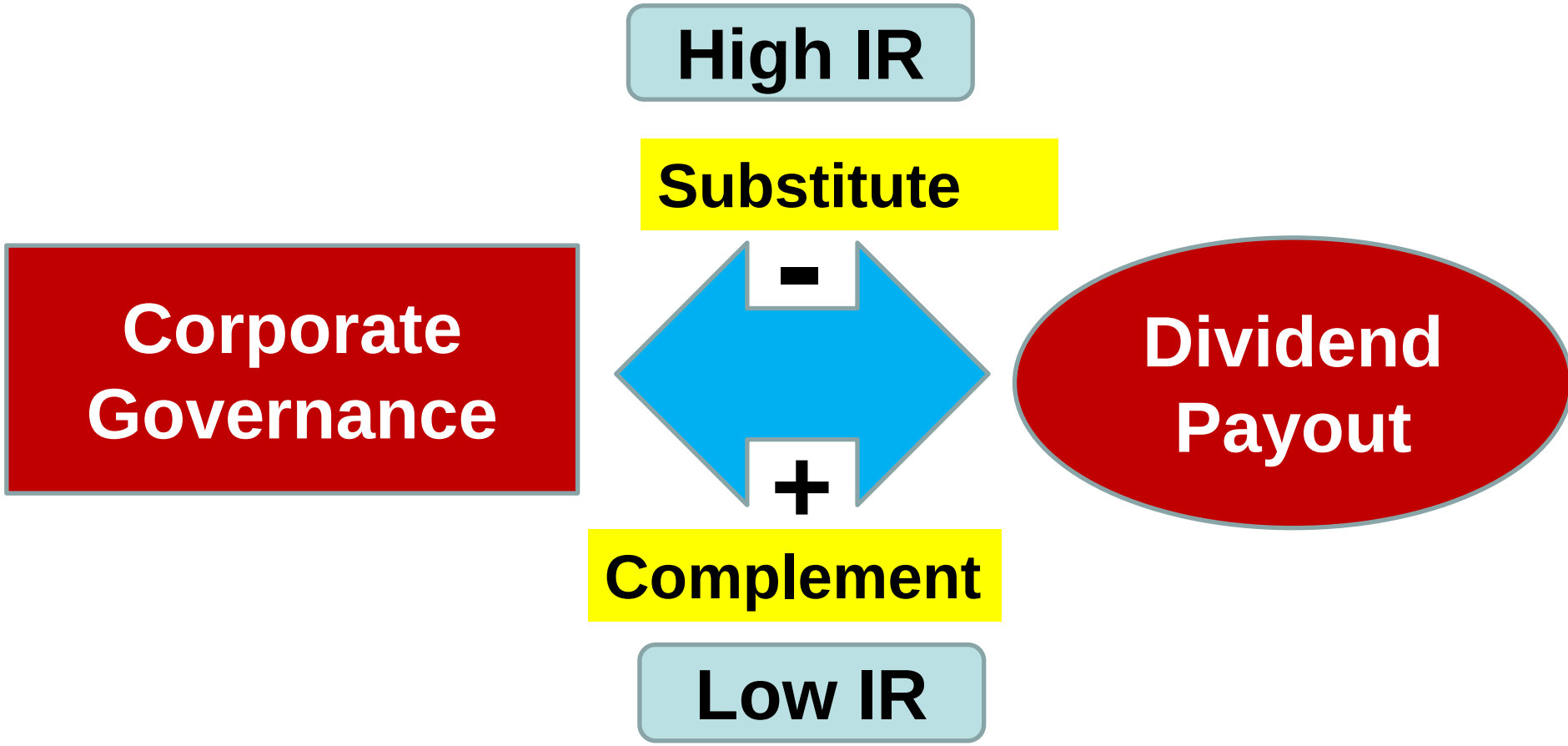
IR : Proxy for Divergence of Investor Opinion

Investment Literature

High IR	• **Underinvestment** • **Discourage Payout**
Low IR	• **Overinvestment** • **Encourage Payout**

DeMarzo, Fishman, He, and Wang (2012, JOF), Panousi and Papanikolaou (2012, JOF), and Hoberg and Prabhala (2009, RFS)

A Complete Picture



Data (I)

COMPUSTAT: Financial Statement Data

CRSP: Stock Price Data

Risk Metrics/Institutional Shareholder Services:
Industry Corporate Governance Quotient (ICGQ) & Board Independence Data (2003-2009)

64 Variables: Comprehensive & Multidimensioal

ExecuComp: CEO Age; CEO Inside Debt; CEO Leverage

Data (II)

Study Period: 1982-2013

Sample: Approx. 5,000 firms from 2003 to 2009
(Much broader than S&P1500 firms);
Over 16,830 firm-years observations

Extended Study Period:

BCF Index (Bebchuk, Cohen, and Ferrell; RFS, 2009) (1989-2013)

Anti-Takeover Index (Cremer and Nair; JOF, 2005)(1989- 2013)

State-Level Governance Index (John, Li, and Pang, 2017, MS; Karpoff and Wittry, JOF, 2018)(1982-2013)

Summary Statistics

	Low IR			High IR		
	Dividend Non-Payer	Dividend Payer	Diff Test	Dividend Non-Payer	Dividend Payer	Diff Test
Corporate Governance (ICGQ)	60.75	66.49	***	48.69	51.74	***
IR	0.02	0.02	***	0.05	0.04	***
Market to Book	1.98	1.84	***	2.11	1.60	***
Profitability	0.05	0.08	***	-0.10	0.04	***
Asset Growth	0.15	0.08	***	0.14	0.06	***
BV Asset	2,599	9,358	***	623	1,387	***
Product Fluidity	7.07	5.12	***	7.78	5.12	***
Number of Firms	5,115	4,876		8,904	1,091	***

. Significant at the 1% level

Summary Statistics (I)

Dividend Payers

- Better governance
- Lower IR
- Higher profitability
- Larger size
- Lower growth rate

Than Non-Payers

Summary Statistics (II)

Low IR Firms have

- Better governance
- Higher profitability
- Larger size

Than High IR Firms

- Asset Growth: Unclear

Logit Regressions

Payer = f (ICGQ, IR, ICGQ*IR, Controls)

Dependent Variable:

One if the firm is dividend payer
Zero if the firm is non-payer

Independent Variables: ICGQ, IR, and ICGQ*IR

Controls: Firm Size; Profitability; Asset Growth; Systematic Risk; Market-Book; RE/TE; NYSE Percentile

Additional Controls: RD/TA; Negative Earnings; Product Fluidity

Main Hypothesis:

Coefficient of Interaction < 0

Propensity to Pay Dividends

Dependent Variable	Payer Indicator			
	(1)	(2)	(3)	(4)
ICGQ	0.002 ***	-0.001	0.006 ***	0.006 ***
	(0.002)	(0.278)	(0.006)	(0.002)
IR		-50.961 ***	-38.569 ***	-33.935 ***
		(<.001)	(<.001)	(<.001)
ICGQ*IR			-0.253 ***	-0.267 ***
			(<.001)	(<.001)
Controls		Yes	Yes	Yes
Additional Controls				Yes
Fixed Effects	Yes	Yes	Yes	Yes
R^2	0.214	0.298	0.299	0.325
Observations	19,986	19,986	19,986	19,986

Controls: Syst Risk; M-B; Asset Growth;Profitability; NYSE Percentile; RE/TE;TE/TA
Additional Controls: RD/TA; Negative Earnings; Product Fluidity

Negative Coefficient of Interaction between CG and IR

- When IR is high, good governance firms are less likely to pay dividends: Substitutes
- When IR is low, good governance firms are more likely to pay dividends: Complements
- Results:

Dependent Variable:	Payer Indicator
Estimated Coefficient	
Baseline Model:	-0.253*** (-0.001)
Quintile Regression:	-0.044*** (-0.001)

Economic Significance: Quintile Regression

- **Highest IR quintile:**
  Governance weakest → strongest:
  Probability of Payout: 29.08% decline

- **Lowest IR quintile:**
  Governance weakest → strongest:
  Probability of Payout: 24.27% increase

Risk of Underinvestment

	Coefficient of ICGQ*IR	
	Low	High
CEO Age (Serfling; JCF, 2014)	0.071	-0.536 ***
CEO Personal Leverage (Sundaram and Yermack; JOF, 2007 and Wei and Yermack; RFS, 2011)	0.106	-0.727**

Risk of Overinvestment

	Coefficient of ICGQ*IR	
	Low	High
Free Cash Flow 1 (Lehn and Poulsen; JOF, 1989)	-0.125	-0.668 ***
Free Cash Flow 2 (Leuz, Triantis, and Wang; JAE, 2008)	-0.093	-0.731***

Robustness Tests with Alternative Governance Measures

- **ICGQ is replaced with Other Governance Measures**
  - **Pay-Performance Sensitivity (Delta): Core, Guay, and Larcker (2003): Alignment of management and sharehodlers interests**
  - **Inversed E (entrenchment) Index compiled by Bebchuk, Cohen, and Farrell's (RFS, 2009)**
  - **Big Four Auditor**
  - **Log (# of Institutional Shareholders)**

Robustness Tests with Alternative Governance Measures

Dependent Variable	Payer Indicator			
Governance Proxy	Pay-Performance Sensitivity	Inversed BCF Index	Big 4 Auditor	Log(# of institutional investors)
	(1)	(2)	(3)	(4)
Governance	0.043 ***	0.060 *	-0.202 ***	0.080 ***
	(0.002)	(<.001)	(0.006)	(0.004)
Idiosyncratic Risk	-56.331 ***	-33.574 ***	-51.575 ***	-38.048 ***
	(<.001)	(<.001)	(<.001)	(<.001)
Gov.*Idio. Risk	-3.375 ***	-6.471 ***	4.455 *	-4.735 ***
	(0.001)	(<.001)	(0.071)	(<.001)
Other controls	Y	Y	Y	Y
Fixed effects	Ind&Year	Ind&Year	Ind&Year	Ind&Year
# observations	20,363	24,972	79,891	84,518
R^2	0.313	0.310	0.346	0.374

Robustness Tests with Alternative Governance Measures (I)

Dependent Variable	Payer Indicator			
Governance Proxy	Pay-Performance Sensitivity	Inversed BCF Index	Big 4 Auditor	Log(# of institutional investors)
	(1)	(2)	(3)	(4)
Governance	0.043 ***	0.060 *	-0.202 ***	0.080 ***
	(0.002)	(<.001)	(0.006)	(0.004)
Idiosyncratic Risk	-56.331 ***	-33.574 ***	-51.575 ***	-38.048 ***
	(<.001)	(<.001)	(<.001)	(<.001)
Gov.*Idio. Risk	-3.375 ***	-6.471 ***	4.455 *	-4.735 ***
	(0.001)	(<.001)	(0.071)	(<.001)
Other controls	Y	Y	Y	Y
Fixed effects	Ind&Year	Ind&Year	Ind&Year	Ind&Year
# observations	20,363	24,972	79,891	84,518
R^2	0.313	0.310	0.346	0.374

Robustness Tests: Post-SOX Years (2003-2013)

Dependent Variable	Payer Indicator			
Governance Proxy	Pay-Performance Sensitivity	Inversed BCF Index	Big 4 Auditor	Log(# of institutional investors)
	(1)	(2)	(3)	(4)
Governance	0.090 ***	0.211 ***	0.148	0.156 ***
	(0.008)	(<.001)	(0.260)	(0.001)
Idiosyncratic Risk	-76.474 ***	-40.139 ***	-46.464 ***	-9.722 **
	(<.001)	(<.001)	(<.001)	(0.020)
Gov.*Idio. Risk	-6.663 ***	-13.651 ***	-13.431 ***	-13.178 ***
	(0.008)	(<.001)	(0.004)	(<.001)
Other controls	Y	Y	Y	Y
Fixed effects	Ind&Year	Ind&Year	Ind&Year	Ind&Year
# observations	11,690	11,507	27,937	21,023
R^2	0.277	0.263	0.297	0.296

Repurchase and Total Payout

- **Our results hold for repurchase decision**
  - **IR and the interaction terms remain significant but with a smaller magnitude**
  - **Magnitude is stronger for large repurchase payers**

Major Findings

- **The relation between corporate governance and dividend payout depends on idiosyncratic risk**
  - **Good governance firms are LESS likely to pay, initiate, and omit/cut when IR is HIGH.**
  - **Good governance firms are MORE likely to pay, initiate, and omit/cut when IR is LOW.**
  - **The results are robust using different governance measures**
- **Similar results are also found in repurchase and dividend initiation decisions**

Thank You for Your Attention