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DIVIDEND POLICY, AGENCY COSTS, AND EARNED EQUITY

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Dividend Policy, Agency Costs, and Earned Equity

1. Introduction

Firms pay dividends because if they didn't their asset and capital structures would eventually become untenable as the earnings of successful firms outstrip their investment opportunities. To date no study has explored the impact on the balance sheets of long-time dividend payers of retaining the earnings they previously paid out. We do so and conservatively estimate that, had the 25 largest long-standing dividend-paying industrial firms in 2002 not paid dividends, they would have cash holdings of \$1.8 trillion (51% of total assets), up from \$160 billion (6% of assets), and \$1.2 trillion in excess of their collective \$600 billion in long term debt. Absent dividends, these firms would have huge cash balances and little or no leverage, vastly increasing managers' opportunities to adopt policies that benefit themselves at stockholders' expense. When managers' objectives differ from shareholders', using incentive contracts to control managerial opportunism is less effective than simply paying out excess cash (Jensen (1986)). And so, as stockholders observe earned equity (retained earnings) accumulate on the balance sheet, they will increasingly pressure managers to pay dividends to avoid the high cash/low debt financial structures and associated agency problems that would otherwise eventually result.

Managers acquire control over corporate resources either from outside contributions of debt or equity capital, or from earnings retentions. From an agency perspective, one advantage of contributed capital is that it comes with additional monitoring, since rational suppliers of outside capital will not be forthcoming with funds at attractive prices if they believe that managers' policies merit low valuations (Jensen and Meckling (1976), Easterbrook (1984)). Earned equity is not subject to the same ongoing, stringent discipline. Accordingly, potential agency problems are higher when a firm's capital is largely earned, since the more a firm is "self-financed" through retained earnings, the less it is subject to the ongoing discipline of capital markets. Looking forward, firms with a greater demonstrated ability to self-finance most likely are also firms with greater ability to fund projects internally that reduce stockholder wealth. Such potential wastage is limited by ongoing distributions that reduce the scale of resources under managerial control -- i.e., a regular stream of dividends reduces the threat of agency problems that

Scanning down each column in any given panel of table 8 shows that a firm at the 10th percentile for equity value ($NYE = 0.10$) has a much lower probability of paying dividends than a firm at the median, which in turn has a much lower probability than a firm at the 90th percentile. According to the bottom row, which reports the average change from the 10th to 90th percentiles, a one decile difference in equity value rank translates to an average probability difference of as much as 0.076 (when RE/TE is low) to a still substantial 0.043 (when RE/TE is high). These data show that the very largest firms exhibit a substantially higher probability of paying dividends than do firms that rank in the middle or at the low end of the NYSE equity value spectrum, after controlling for profitability, growth, the relative amount of earned equity, etc.

RE/TE differences are associated with substantial differences in the probability of paying dividends for all but the highest size deciles of NYSE firms, with smaller yet nontrivial increases for the latter firms. Our finding that the impact of RE/TE is less marked for the largest firms is a manifestation of the fact that the unconditional probability of paying dividends is quite high among this group. For firms with average current profitability and growth (panel B) whose equity value matches that of the median NYSE firm ($NYE = 0.50$), an increase from $RE/TE = 0.10$ to $RE/TE = 0.90$ increases the probability of paying dividends by 0.355 ($0.856 - 0.501$), which is a .044 increase for each increment of 0.10 in RE/TE . For the purpose of explaining whether a firm pays dividends or not, the economic impact of the amount of earned equity in its capital structure -- like that of its size -- is clearly substantial, and the impact of both earned equity and size are much greater than those of profitability and growth.

8. Conclusion

Why do firms pay dividends? The answer becomes apparent when one considers what their asset and capital structures would eventually look like if they did not, and the potential agency problems those asset and capital structures would engender. For the 25 largest long-standing dividend payers in 2002, we document that a decision to retain earnings instead of paying dividends would result in firms with little or no long-term debt and enormous cash balances that far outstrip any reasonable estimate of their attractive

investment opportunities. If, as agency theory assumes, large-scale retention facilitates non-value maximizing behavior by managers (Jensen (1986)), then dividends are valuable for these firms because they help avoid asset/capital structures that give managers wide discretion to make value-reducing investments. When the potential costs of excess retention are considered jointly with factors that encourage retention (e.g., flotation costs and personal taxes), the testable prediction is that firms avoid dividends when earned capital is low (relative to contributed capital) and pay them only after generating substantial earned equity (sufficient both to fund profitable projects and to sustain an ongoing stream of dividends). Our evidence uniformly and strongly supports this view of dividend policy.

For publicly traded industrials over 1973-2002, the proportion that pays dividends is high when the ratio of earned equity to total common equity (or to total assets) is high, and falls with declines in either ratio, becoming near zero when a firm has little or no earned equity. In a broad set of multivariate logit tests, we consistently observe a highly significant relation between the decision to pay dividends and the ratio of earned equity to total equity (and to total assets), controlling for firm size, current and recent profitability, growth, leverage, cash balances, and dividend history. The relation between earned equity and the decision to pay dividends is economically, as well as statistically significant, with the difference between high and low values of earned equity translating to a substantial difference in the probability of paying dividends for all but the largest NYSE firms (for which the probability difference is smaller, but still nontrivial, because the unconditional probability of paying dividends is high for very large firms). In fact, earned equity has an economically more important impact on the dividend decision than do profitability or growth, variables emphasized in the empirical payout literature. Overall, our evidence supports the hypothesis that firms pay dividends to mitigate the agency costs associated with the high cash, low debt capital structures that would eventually result if they didn't.