DIVIDEND POLICY AND FAMILY RELATIONS

Área de investigación: Finanzas

Humberto Valencia-Herrera
EGADE Business School
Instituto Tecnológico y de Estudios Superiores de Monterrey
México
humberto.valencia@itesm.mx

Felipe Javier Ruiz Rivera
EGADE Business School
Instituto Tecnológico y de Estudios Superiores de Monterrey
México

XX CONGRESO INTERNACIONAL DE CONTADURÍA ADMINISTRACIÓN E INFORMÁTICA

ANFECA
Asociación Nacional de Facultades y Escuelas de Contaduría y Administración

alafec

Octubre 7, 8 y 9 de 2015 Ciudad Universitaria México, D.F.

Dividend policy and Family Relations

Resumen

El artículo revisa la relación que existe entre grupos familiares, inversionistas institucionales y el pago de dividendos tanto a nivel de pago promedio como de su riesgo usando un modelo de ecuaciones estructurales. Encontramos una relación inversa entre la presencia de inversionistas institucionales y el control de las familias. El control de la familia esta inversamente relacionado con la razón de pago de dividendos. La presencia de inversionistas institucionales está relacionada con la volatilidad en el pago de dividendos. El pago de dividendos esta inversamente relacionado con su volatilidad. Estas relaciones se observan en el contexto de México, que es una economía emergente, que proviene de la tradición de régimen legal de ley civil, donde muchas de las empresas que cotizan en bolsa tienen relaciones familiares.

Abstract

The article reviews the relation among family groups, institutional investors, and payment of dividends, both at the average and at the risk level using a structural equation model. It is observed an inverse relationship between the presence of institutional investors and the family control. Family control is inversely related with the dividend payout ratio. The existence of institutional investors is related with the payout ratio volatility. The dividend payout ratio is inversely related with its volatility. These relationships are observed for public companies in México, an emergent economy which comes from the civil law tradition, in which the members of the board and upper management of many public companies have family links.

Keywords: Dividend policy, corporate control, family control

Introducción

Dividend policy differs in countries with civil law (La Porta 2000). Family relations of the CEO with other board members can change the corporate government of the organization and many policies, including the dividend one. Arguments used include more and better surveillance of the organization and alignment of the objectives of management with the main shareholders because family controls act as substitute for corporate controls and dividend policy.

Other aspect that has not been so deeply analyze is how dividend policy volatility is related with internal control of the organization, in particular family ties of the CEO with the main shareholders or the presence of institutional investors. These forms of organization effect on only the level of the dividend policy, but also its volatility.

The article explores these issues using a structural equation approach.

The article is organized as follows. This section is an introduction. The second section reviews the literature of different theories that explain the main relations. The third section discusses the methodology, variables and data. The forth section makes an analysis of the main results. The fifth and final section is the conclusions and recommendations.

Literature review

Like the rest of the French-origin countries, Mexico has highly concentrated ownership. With the exception of Chile, which has strong shareholder rights, all Latin American countries in the sample have higher ownership concentration than the world mean. After Greece and Colombia (68%), Mexico has the third-largest ownership concentration level in the world (67%). In sum, these data indicate that Mexico has unusually high ownership concentration, possibly as an adaptation to weak legal protection (Chong, A., Guillen, J. and Lopez-de-Silanes, F. , 2009)

According to the model in La Porta et al. (2001), improved valuations, as a result of better corporate governance, results from the investors' higher confidence that controlling shareholders will not expropriate the cash flows of the firm. Investors are thus more willing to provide capital to firms at lower cost, which is reflected in higher valuation multiples for those firms with better governance practices.

Chong, Guillen and Lopez-de-Silanes (2009) found that those firms that have started to use the available differentiating tools to improve their corporate governance in Mexico are rewarded by the market with lower costs of capital and they provide better returns to their investors. Gompers, Ishii, and Metrick

(2003), Klapper and Love (2002) found a positive effect of governance on operating performance for other countries.

There is a negative relationship between the dividend policy and insider ownership. The relation can be explained by the free cash flow hypothesis. According with Jensen (1986), higher dividend payments reduces the discretionarily of management and the agency conflicts inside the firm. This justifies a negative relationship between these two variables, because they are substitutes.

In addition, according with Rozeff (1982) when the insiders have a high percentage of the capital of a company, they will prefer to pay lower dividends to benefit from the lower taxes to the capital gains. In addition, there is the hypothesis that in countries with weak corporate governance and in companies in which management and directors have a higher proportion of ownership, there is an expropriation of the minority shareholders, who are paid lower dividends. These relations confirm a hypothesis of a negative relationship between dividend policy and inside ownership.

According with Minguez Vera (2007), there is a negative relationship between dividend policy and business enterprise. A company which pays its shareholders with capital has a higher investment risk than a company which pays its shareholders with dividends.

Kale and Nole (1990) propose a model in which the business risk is negatively related with the dividend payments. Business with higher risk will have higher floatation costs when emitting new equity, therefore, they will prefer to paid lower dividends.

An alternative theory will be that a firm with high dividend policy will be subject more to the business risk than a company with a low dividend policy. Therefore, high dividend firms will have more business risk than firms with a low dividend policy.

With respect to the risk on the insider ownership, there are two different hypotheses. Demsetz (1983) and Demetz and Lehn (1985) argue that companies which faces more risk are more difficult externally to control. Therefore, it is important the ownership concentration of board members and management to complement the ownership of externals. However, Demsetz and Lehn (1985) also argue that a high risk can result in disincentives for insiders to have a higher ownership in the company because higher return variability can result in abrupt changes in personal wealth. Some other authors, such as Chen and Steiner (1999) argue that there is a non-linear relationship. With low risk, there is a positive relationship based on a reduction of the agency conflicts between

shareholders and management. However, if risk is high, the opposite relation dominates.

The effect of the inside ownership on the business risk shows two possible inverse effects. The alignment between the interest of insiders and management can result in more risky policies, because higher risk can result in the transfer of wealth from lenders to shareholders (Chen and Steiner 1999). In addition, higher ownership can be used by the insiders to impose their decisions in the company, Adams, Almeida y Ferreira (2005). On the other hand, Treynor and Black (1976) postulate that companies control by insiders will have less return variability because the risk aversion of management, which have a non-diversify human capital and financing portfolio. They will be interested in reducing the business risk.

Most of the evidence between these variables is based in countries with common law, which is different to the civil law, which includes the Mexican case. According with La Porta, López de Silanes, Schleifer y Vishny (2002), some of the differences between these systems are that in countries with common law the ownership structure is more disperse and there is more participation of institutional investors, more protection to the shareholders, and a higher weight on external control mechanisms.

There are different theories that explain the main relations that the model considers. The free cash flow theory in volatility relates de volatility of the dividend payout policy with the systematic risk. The substitution effect of the governance control with dividend policy analyses the substitution effect on management of the discipline actions from the governance control and the dividend policy. The signal theory by family groups explains smoothing of the dividend payout policy when there is family control as a signal to the market. The free cash flow theory in volatility also states differences in the volatility of the payout policy with the business risk, that is, if the volatility of the payout policy changes with the sector. Debt can also act as a substitute for the payout policy to discipline management. The presence of institutional investors acts as a complement to a higher payout policy to discipline management.

Free cash flow theory in volatility

The volatility observed in the dividend payout policy can be related with the systematic risk of the firm. In particular, the standard deviation of the payout ratio can reflect the systematic risk measured by the firm beta or the risk premium.

Substitution of governance control with dividend policy:

The substitution theory states that firms substitute corporate control from familiar relationships in management with a dividend payout policy to discipline management. The payout ratio is lower in firms directed by a CEO

who is also a member of the controlling family. The family company have a control group which manage the firm can reduce the payment of dividends because it has a better internal control. Almazan, Hastzelly & Starks (2005).

An alternate theory is that the family group that controls the firm expropriates other shareholders. For example Bena and Hanousek (2006) found it in Czech firms; however the presence of institutional investors improves the control of the firm. Almazan, Hartzelly and Starks (2005), Manos (2002) and Rozef(1982) found that the presence of institutional investors improves the control of the firm.

Signal theory by family groups.

Family control firms will send a signal to the market smoothing the dividend payout policy. The volatility in the payout policy will be smaller if the firm is family controlled. On the contrary, a public firm will reflect in its payout policy more of the market reality. Therefore, its payout policy will have more volatility.

The free cash flow theory: Dependency with the sector

The business risk is related to the sector in which the company operates. The free cash flow theory in volatility states that the volatility of the payout policy will be related with the business risk, therefore, with the sector in which the company operates.

Substitution effect of debt and payout policy

It is suggested that debt can act as a substitute to the payout policy to discipline management.

Complement effect of institutional investors and payout policy

The presence of institutional investors is a substitute of internal control and complements the payout policy. Institutional investors will require a higher dividend payout than otherwise.

The methodology

Structural equation modelling (SEM) is a statistical technique which allows the combination of statistical data and qualitative causal assumptions. It was formally defined by Judea Pearl (2000) using a calculus of counterfactuals. In SEM modeling, two main components are distinguished: the structural model, which shows potential causal dependencies between endogenous and exogenous variables, and the measurement model, which shows relations between latent variables and their indicators. Factor analysis models, both

confirmatory and exploratory, contain only the measurement part. Path diagrams usually only contain the structural part.

In the specification of the pathway of a model, two relationships can be specified: (1) free pathways, in which hypothesized causal relationships between variables are tested, and are left free to vary and (2) relationships between variables that already have been estimated, usually in previous studies, and are fixed in the model.

In some studies, structural equation modeling has been employed in corporate finance. For example, Azim (2012) conducts an study with the use structural equation modelling (SEM) to investigate the extent to which different monitoring mechanisms – the board and its committees, shareholders and independent auditors – are complements (i.e. a positive covariance) or substitutes (a negative covariance) for each other. The study finds that in some instants, they are complements and in other ones, substitutes.

The final model is a system of three structural equations. The presence of institutional holders depends on a CEO with family relations. The level of the dividend policy depends on a CEO with family relations. The volatility in the dividend policy depends on the presence of institutional holders. The relations of these variables with debt, beta and earnings were not statistically significant and were omitted in the final model.

The databases are from Economatica and Bloomberg. Average and volatility dividend and beta were estimated from quarterly data for the period of the second semester of 2009 to the first semester of 2013. Dividend payments are the payout ratio of dividends and earnings after taxes. Family ties of the CEO were determined from 2012 Mexican Stock Exchange report fillings. We consider 71 companies, which have corporate fillings at the Mexican Stock Exchange in 2012 and paid dividends in the period.

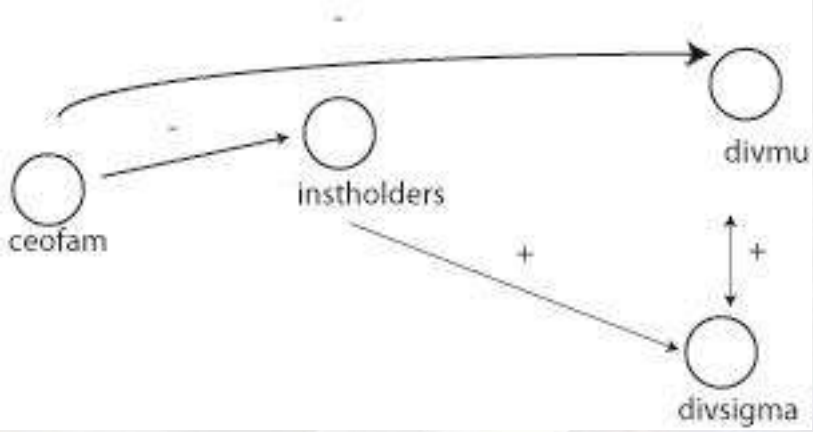
For the final analysis, only 62 companies are considered. Only companies that paid dividends in at least two times, to estimate its volatility, are considered. To exclude companies that can be liquidated, only companies whose dividends were not larger than five times the earnings after taxes of the period were considered.

The model includes the following variables:

CeoFam =1 if the CEO has family relations with board members, 0, otherwise
InstHolders = the percentage of shares held by institutional holders.
DivMu = the average quarterly dividend payment
DivSigma = the standard deviation of the quarterly dividend payments
The system of structural equations are
InstHolders = a0 + a1 * CeoFam + e1
DivMu = b0 + b1 * CeoFam + e2

DivSigma = c0 + c1 * InstHolders + e3
We are allowing that DivMu and DivSigma have correlation among them. Figure 1 illustrates these relationships.

Figure 1 A structural diagram of family links, institutional holders and dividends.



(See Figure: dividend policy diagram 2)

Analysis of results

From Table 1, factor 1 is more related with the dividend policy variables divmu and divsigma, factor 2 is more related with insholders and factor 3 is more related with ceofam and beta.

Table 1 Factor variables

Variable	Factor 1	Factor 2	Factor 3	Uniqueness
Ceofam	0.0684	-0.428	0.3487	0.6905
Instholders	-0.0784	0.6925	0.0298	0.5134
Beta	0.0395	0.4686	0.2759	0.7027
Divmu	0.9272	0.0315	-0.0925	0.1308
Divsigma	0.9275	0.0387	0.0575	0.135

Source: Own elaboration

Table 2 A structural model of family links, institutional investors and dividends

	Coefficient	Standard Error.	Z	
Structural				
Instholders				
Ceofam	-52.2308	16.67763	-3.13	***
_cons	88.5	10.80003	8.19	***
Divmu				
Ceofam	-0.61568	0.188191	-3.27	***
_cons	1.607823	0.14896	10.79	***
Divsigma				
Instholders	0.005969	0.001522	3.92	***
_cons	0.653399	0.176454	3.7	***

Covariance e.divmu e.divsigma

.7969778 .1757434 4.53 ***

*** Statistically significant at the 99 percent.

Source: Own elaboration

From the structural equation relation in Table 2, a CEO with family relations is related negatively with the presence of institutional holders, the variable Ceofam has a negative coefficient -52.23 in the equation of instholders. A CEO with family relations is substitute to institutional holders. The presence of any of them favors strong firm controls.

The presence of a CEO with family relations is related negatively with the payment of dividends. The variable Ceofam has a negative coefficient (-0.61568) in the equation of divmu. The dividend policy and the presence of a CEO with family relations are complements to impose discipline in a firm.
The presence of institutional holders is related with more volatility in the payment of dividends. Firms with institutional holders have higher payment of dividends, but more volatility in these payments. They also are the firms with fewer CEOs with family ties. These is probably because firms with CEO with family ties smooth the pattern of dividend payments, a practice that it is less frequent in firms in which institutional shareholders dominate. Observe that the variable instholders have a statistically significant coefficient of 0.005969 in the equation of divsigma.

The covariance between the average dividend payout ratio and its standard deviation is 0.7969778, which is statistically different from cero.

How the main hypothesis are sustained:

Free cash flow theory in volatility

According with the free cash flow theory, the volatility observed in the dividend payout policy can be related with the systematic risk of the firm. In particular, a higher standard deviation of the payout ratio can be related with the systematic risk measured by the firm beta or the risk premium. There is a statistically significant relationship between the standard deviation of the payout policy and the beta of the firm observed using ordinary least squares. However, in the structural model, the relationship between volatility of the payout policy and the standard deviation of the firm is not statistically significant.

Substitution of governance control with dividend policy:

The evidence supports the theory that firms substitute corporate control from familiar relationships in management with a dividend payout policy to discipline management. The payout ratio is lower and its standard deviation is smaller in firms directed by a CEO who is also a member of the controlling family.

The family company have a control group which manage the firm can reduce the payment of dividends because it has a better internal control (Almazan, Hastzelly & Starks, 2005). An alternate theory is that the family group that controls the firm expropriates other shareholders. For example, Bena and Hanousek (2006) found that differences in profitability affect the dividend policy in Czech firms; however the presence of institutional investors can improve the control of the firm (Almazan, Hartzelly and Starks, 2005, Manos, 2002 and Rozef, 1982).

However, the empirical evidence does not support the expropriation theory because differences in profitability do not affect the dividend policy.

Signal theory by family groups.

Family control firms will send a signal to the market smoothing the dividend payout policy. The volatility in the payout policy will be smaller if the firm is family controlled. On the contrary, a public firm will reflect in its payout policy more of the market reality. Therefore, its payout policy will have more volatility.

Dependency with the sector

In the structural model, we did not find evidence that the payout policy depends on the sector in which the company is. The business risk is related to the sector in which the company operates. The free cash flow theory in volatility states that the volatility of the payout policy will be related with the business risk, therefore, with the sector in which the company operates.

However, using ordinary least squares the payout policy and its volatility can be different in some sectors.

Debt relationship

It is suggested that debt can act as a substitute to the payout policy to discipline management. There is no evidence that debt behaves as a substitute to the payout dividend policy because the payout ratio is not affected by the debt payments. The dividend payout policy is independent of accounting profitable results and leverage. We did not find evidence that profits or leverage is related with the payout policy.

Independent investors

We did not find evidence that family business extract rents from independent investors. Accounting profit does not change with the dividend payout policy. However, the payout ratio is higher if there are institutional investors and lower if the CEO is member of the controlling family group.

Conclusions and recommendations

The family ties of the CEO have important implications in the dividend policy of the firm. There is a substitution effect of more institutional investors that require higher dividends and a CEO with family ties that paid lower dividends, but with lower volatility. The dividend policy, institutional investors and a CEO with family ties are substitutes.

Further analysis on the matter is required to better understand dividend policy in civil law countries.

Bibliografía

Adams, R. B., Almeida, H., & Ferreira, D. (2005). Powerful CEOs and ther Impact on Corporate Performance. *Review of Financial Studies, 18*(5), 1403-1432.

Almazan, A., Hartzelly, J., & Starks, L. (2005). Active institutional shareholders and costs of monitoring. Evidence from executive compensation. . *Financial Management., 34*(4), 5-35.

Azim, M. I. (2012). Corporate governance mechanisms and their impact on company performance: A structural equation model analysis. *Australian Journal of Management (Sage Publications Ltd.), 37*(3), 481-505. doi: 10.1177/0312896212451032

Bena, J., & Hanousek, J. (2006). Rent extraction by large shareholders evidence using dividend policy in the Czech Republic. . *The Center for Economic Research and Graduate Education - Economic Institute Working Paper Series, 291, 1-50. Recuperado de http://www.cerge-ei.cz/pdf/wp/Wp291.pdf*, 1-50.

Chen, C. R., & Steiner, T. L. (1999). Managerial Ownership and Agency Conflicts: A Nonlinear Simultaneous Equation Analysis of Managerial Ownership, Risk Taking, Debt Policy, and Dividend Policy. *Financial Review, 34*(1), 119-136.

Chong, A., Guillen, J. and Lopez-de-Silanes, F. (2009) Corporate governance reform and firm value in Mexico: an empirical assessment, *Journal of Economic Policy Reform* Vol. 12, No. 3, September 2009, 163–188.

Demsetz, H. (1983). The Structure of Ownership and the Theory of the Firm. *Journal of Law and Economics, 26*(2), 375-390.

Demsetz, H., & Lehn, K. (1985). The Structure of Corporate Ownership: Causes and Consequences. *Journal of Political Economy, 93*(6), 1155-1177.

Gompers, P., Ishii, J., and Metrick, A., 2003. Corporate governance and equity prices. *Quarterly Journal of Economics*, 118 (1), 107–155.

Jensen, M. (1986). Agency costs of free cash flow, corporate finance, and takeovers. *The American Economic Review, 76*(2), 323-329.

Kadapakkam, P., Martinez, V. (2008) Ex-dividend returns: The Mexican puzzle Journal of Banking & Finance. Vol. 32 Issue 11, p2453-2461.

Kale, J. R., & Nole, T. H. (1990). Dividends, Uncertainty, and Underwriter Costs Under Asymmetric Information. *Journal of Financial Research, 13*(4), 265-277.

Klapper, L., and Love, I., 2002. *Corporate governance, investor protection, and performance in emerging markets.* Washington, DC: World Bank (mimeograph). .

La Porta, R., López-de-Silanes, F., and Shleifer, A., (2006). What works in securities laws? *Journal of Finance*, 61, 1–33.

La Porta, R., López-de-Silanes, F., Shleifer, A., & Vishny, R. (2000). Agency problem and dividend policies around the world. *The Journal of Finance, 55*(1), 1-33. .

La Porta, R., López-de-Silanes, F., Shleifer, A., & Vishny, R. (2002). Investor Protection and Corporate Valuation. *Journal of Finance, 57*(3), 1147-1170.

Manos, R. (2002). Dividend Policy and Agency Theory: Evidence on Indian Firms.

. *Manchester, UK: Institute for Development Policy and Management, University of Manchester. Recuperado de http://scholar.googleusercontent.com/scholar?q=cache:UWOMZyWL7AIJ:scholar.google.com/++Manos+R+(2002)+dividend&hl=es&as_sdt=0,5*.

Mínguez-Vera, A. (2007). Política de dividendos, riesgo, endeudamiento y estructura de propiedad, un análisis para el mercado español. *El Trimestre Económico, 74*(4), 929-960.

Pearl, J. (2000). *Causality: Models, Reasoning, and Inference.*: Cambridge University Press.

Rozeff, M. (1982). Growth, Beta and Agency Costs as Determinants of Dividend Payout Ratios. *Journal of Financial Research, 5*(3), 249-259.

Treynor, J., & Black, F. (1976). *Corporate Investment Decisions, Modern Developments in Financial Management*. New York: Praeger.