



The Effect of Institutional Investors on Dividend Payout

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Abstract:

The dividend payout policy is one of the most important issues for managers and stakeholders. The manager should propose to General Shareholders Assembly the amount of the earnings to be distributed and how much to invest in retained earnings. Although dividend payout directly benefits shareholders, it affects a firm's ability to accumulate earnings to take advantage of growth opportunities. The dividend payout policy is also one of the factors that may affect the firm's ownership structure. The purpose of this study is to investigate the effect of institutional ownership on dividend payout policy. Using the systematic elimination method, a sample of 105 companies listed on the Tehran Stock Exchange from 2009 to 2016 is selected. Moreover, multiple regression analysis with panel data is used to test the research hypotheses. This study's findings show that increasing the ownership of mutual funds and other institutional shareholders increase dividend.

Keywords: Institutional Ownership, Mutual Funds, Dividend Payout Policy.

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1. Introduction

The regulatory effect of institutional ownership on corporate governance has been extensively examined in recent years. Some research streams have focused on the impact of institutional shareholders on firm performance. Smith (1996) shows that high levels of institutional ownership lead to shareholders' reaction to buy and sell shares, which, in turn, can increase the wealth of shareholders. Woidtke (2002) finds a positive relationship between the corporate Tobin's Q ratio and stock ownership. Centralized ownership in the form of independent entities can increase the market value and return on assets. According to Ferreira and Matos (2008), companies with higher stock ownership held by independent and external entities such as insurance companies have higher firm value. Giannetti and Laeven (2009) find that firm value increases with increasing institutional shareholders' ownership. There are different views on how institutional shareholders influence corporate dividend policies. The two dominant views are agency theory and signaling theory. According to agency theory, institutional shareholders pressure companies for dividend payouts (Zeckhauser and Pound, 1990) because the managers may compromise this free cash (Jensen, 1986). In other words, institutional shareholders prefer to distribute free cash flows in the form of cash dividends to reduce related agency costs and force managers to distribute dividends due to their influential position. According to these assumptions, given that the retained earnings are a source of internal financing, a dividend payout can lead to a decrease in liquidity and external financing.

It can increase capital market supervision (for example, stock exchange, capital suppliers) over the firm (Roohi et al., 2011). According to the signaling theory, dividends for the market contain new information, and managers can use dividends to signal and deliver good news to shareholders (Aharony and Swary, 1980). Signaling theory states that as dividends increase, institutional investors conclude that managers have sufficient confidence in the continuation of future profitability. In this situation, shareholders, who were previously assumed not to know as much about the firm's financial situation as managers, react to the increase in dividends and increase the stock market value. However, if managers believe that long-term profitability will decrease, they reduce cash dividends. Therefore, institutional shareholders respond by trading the firm's stock at a lower value (Zeckhauser and Pound, 1990). While much research has been done on ownership structure, little attention has been paid to the institutional shareholders' role, especially the largest shareholder, that may affect the firm's dividend payout policies (Razavi et al., 2015). Large shareholders naturally own the majority of the firm's stock and, as a result, will have a major influence on the firm's decisions, including dividend payout policies (Mancinelli and Ozkan, 2006). Recent studies also show that mutual funds are able to monitor the firm. Yuan et al. (2009) show that senior managers of financial institutions and the board of directors of mutual funds may influence firm managers, while other institutions such as insurance and brokerage firms do not have such features.

Other studies show that institutional shareholders control changes in internal shareholders' ownership and reduce corporate incentives for fraud (Aggarwal et al., 2014). The role of institutional shareholders in dividend policies stems from the institutional shareholder preferences to distribute cash flows in order to reduce agency costs (Sarlak and Kalvani 2015). Given the influential position of the institutional shareholder, this group of owners is expected to influence the firm's financial policies, including dividend policy. Accordingly, institutional shareholders may disagree with the manager's tendency to accumulate more cash flows and, due to their voting power, force managers to distribute dividends (Etemadi et al., 2014). Based on agency theory, a hypothesis in justifying the financial literature's dividend behavior is presented under

the title of the theory of conclusion. The theory of conclusion is based on the free cash flow theory. Based on the free cash flow theory, opportunistic managers use free cash to invest in projects and activities that increase their reputation. The theory of conclusion states that dividend payout is the result of the quality of corporate governance. In fact, firms that do not respect shareholders' rights suffer from opportunistic management as managers have influential power, and shareholders have no oversight.

In this case, the managers try to keep the cash instead of distributing it among the company's shareholders. Therefore, a lower dividend payout is the result of weaker governance. However, if shareholders have enough power, they can influence dividends. The theory of conclusion also states that regulatory shareholders can use their power to remove managers in order to reduce cash and cash dividends. The theory of conclusion states that a firm's owners prefer a higher dividend payout to reduce free cash flows under internal investors' control (Firth et al., 2016). The firm's liabilities for dividend payout impose a disciplinary role on companies, and this disciplinary role helps to separate control from ownership. Dividend payout also reassures shareholders that they are more eager to buy the firm's stock (Cheffins, 2006). According to the theoretical foundations and considering the theory of conclusion, this study investigates the impact of institutional shareholders on dividend payout. However, considering the impact of institutional shareholders on dividend policy in previous studies, this study intended to examine the specific type of institutional shareholders, i.e., investment funds and other institutional shareholders such as insurance companies and brokerages, on dividend policy to determine the impact of the institutional shareholders on the dividend payout. Therefore, the research's main question is whether institutional ownership has a significant effect on dividend policy or not?

2. Research Methods

The current study examines the relationship between different variables using multiple regression models with panel data. Excel and EViews software are also used. The chow test and the Hausman test are used to determine the structure of the data. The F-statistics is used to test the whole regression model's significance, and the t-statistics is used to test the coefficients of the independent variables. The statistical population of this research is all companies listed on the Tehran Stock Exchange. Moreover, the period of this research is from 2009 to 2016. For sampling, the systematic removal method is used, the conditions of which are defined as follows:

- 1- In order to be comparable information, the firm's fiscal year should be ended in March.
2. Firm's share has been exchanged at least once every three months during the period under investigation.
- 3- In order to be homogeneous information, firms should not be included in financial intermediation, insurance, and leasing industries.
- 4- Required data should be available.

The present study's required data are collected from corporate financial statements, audited accompanying notes, weekly reports, monthly journals, and stock exchange yearbooks from 2009 to 2016. For this purpose, the information published by the Tehran Stock Exchange and the software of Rahavard Novin and other related Internet sources is among the data collection tools in this research.

3. Explaining and Measuring the Variable

Dependent Variable:

Dividend payout: In this study, the following criterion has been used to calculate the dividend payout, according to Firth et al. (2016):

Dividend ratio: equal to the ratio of cash dividend per share to book value per share

Independent Variable:

Two criteria of ownership measure the institutional shareholder:

Mutual Fund Ownership: Equals the number of shares held by Mutual Fund companies divided by the total number of shares issued.

Other institutional owners: equal to the number of shares held by other institutional owners (banks, insurance companies, and brokerage) divided by the total number of shares issued.

Control Variables:

Free cash flows: Net operating cash flows (profit before interest, tax, and depreciation less net capital expenditures (capital expenditures are calculated from the difference between tangible fixed assets this year compared to the previous year) divided by total assets

Free Cash Flows: Net Operating Cash Flows - Net Capital Expenditures / (Total Assets)

Growth opportunities: Percentage of annual changes in sales revenue

Growth Opportunities = This Year's Sales Income - Last Year's Sales Income / (Last Year's Sales Income)

Investment opportunities: Asset market value / Asset book value

Asset market value: The market value of ordinary shares plus the book value of total debt

Ownership concentration: Total percentage of shares in the hands of 10 large and non-governmental shareholders of the company

Managerial ownership: The number of shares in the hands of all board members divided by the total number of shares issued.

Company size: Natural logarithm of total assets

Financial leverage: the ratio of total debt to total assets

Return on Assets: The ratio of net profit to total assets

Stock returns fluctuations: equal to the standard deviation of the annual stock daily returns

3.1. Research Hypotheses:

This research includes two hypotheses as follows:

Hypothesis 1: Increasing the ownership of mutual funds increases the dividend

Hypothesis 2: Increasing the ownership of other institutional shareholders increases dividend

The following model is used to test research hypotheses:

$$\begin{aligned}
 DIV_{i,t} = & \alpha_0 + \alpha_1 MF_{i,t-1} + \alpha_2 BIS_{i,t-1} + \alpha_3 FCF_{i,t-1} + \alpha_4 HERF10_{i,t-1} \\
 & + \alpha_5 MAO_{i,t-1} + \alpha_6 MB_{i,t-1} + \alpha_7 SIZE_{i,t-1} + \alpha_8 LEVE_{i,t-1} \\
 & + \alpha_9 ROA_{i,t-1} + \alpha_{10} VOL_{i,t-1} + \alpha_{11} Growth_{i,t-1} + \varepsilon_{i,t}
 \end{aligned}$$

DIV_{i,t}: Dividend ratio

MF_{i,t-1}: Mutual Fund Ownership Ratio

BIS_{i,t-1}: Ownership ratio of other institutional owners (banks, insurance companies, and brokerage)

FCF_{i,t-1}: Free Cash Flows

GROWTH_{i,t-1}: Growth Opportunities

HERF10_{i,t-1}: Concentration of ownership

MAO_{i,t-1}: Ownership ratio of board members
 MB_{i,t-1}: The ratio of the market value of assets to the book value of assets
 SIZE_{i,t-1}: firm size
 LEVE_{i,t-1}: Financial leverage
 ROA_{i,t-1}: Return on Assets
 VOL_{i,t-1}: Stock Returns

Based on the Chow test results, the structure of the data is the panel, and according to the Hausman test results, the fixed effects method is accepted. Applying Wooldridge's autocorrelation test and modified Wald homoscedasticity test, the classical hypotheses of no-autocorrelation and variance homogeneity are performed for the research model. The results show that the model faces the problem of autocorrelation and heteroscedasticity. Therefore, the model estimates the generalized least squares (GLS) regression method. The results of the model estimation are reflected below:

Table 1. Estimation Results of Model

p-value	statistics t	Standard deviation	Coefficient	Variable
0.001	3.167	0.013	0.042	MF
0.002	4.295	0.002	0.011	BIS
0.055	1.915	0.001	0.001	FCF
0.000	4.914	0.001	0.008	HERF10
0.754	0.312	0.002	0.001	MAO
0.854	-0.183	0.004	-0.001	MB
0.002	-3.088	0.001	-0.006	SIZE
0.000	-3.516	0.002	-0.010	LEVE
0.000	4.363	0.003	0.014	ROA
0.529	0.628	0.001	-0.001	VOL
0.061	1.874	0.001	0.002	GROWTH
0.000	6.883	0.034	0.2322	C
20.152	statistics F	0.76	R-squared	
0.000	Prob (F-statistic)	0.72	Adjusted R-squared	

Regarding the p-value obtained for the F-statistic (p-value <0.05), the whole model is significant. This indicates that not all regression coefficients are zero simultaneously. The adjusted R squared equals 72 percent. It means that independent variables explain 72 percent of the dependent variable changes. As an indicator for testing the first hypothesis, MF's coefficient is positive and significant, stating that increasing the mutual funds' ownership increases the dividend. Therefore, the first hypothesis of this study is confirmed at a 5 percent significance level. As an indicator for testing the second hypothesis, BIS's coefficient is also positive and significant, stating that increasing other institutional shareholders' ownership increases dividend. Thus, the second hypothesis of this study is confirmed at a 5 percent significance level.

4. Research Findings

Based on the first test findings, it can be concluded that as ownership of investment funds increases, dividends increase. Corporate governance is a tool for balancing shareholders and management, reducing agency problems, and reducing the likelihood that managers will pursue less-than-desirable dividend policies. According to agency theory, institutional shareholders pressure companies to dividend payouts because insiders may compromise the free cash amount. In other words, institutional shareholders prefer to distribute free cash flows in the form of cash dividends to reduce related agency costs and force managers to distribute dividends due to their influential

position. Dividends reduce agency costs by distributing the free cash flow invested in unprofitable projects by management.

Based on the second test findings, it can be concluded that as ownership of other institutional investors increases, dividend increases. There are many reasons why managers tend to maximize the interests of large corporate shareholders. First, large shareholders, due to their high percentage of ownership, have more voting rights in the company and can control the company's policies and decisions. Second, the presence of large shareholders reduces agency problems in the company and reduces agency costs. The presence of large shareholders reduces the level of information asymmetry in the company. On the other hand, internal shareholders use the dividend policy as a signal to improve the company's governance system. As a result, firms, which are controlled by internal shareholders, are always looking to increase dividends as a sign of improving firm performance.

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