Hard Times or Great Expectations?: Dividend omissions and dividend cuts by UK firms

Working Paper no. 147

Andrew Benito and Garry Young

The payment of dividends is one of the key unresolved puzzles of company financial behaviour. The importance of understanding dividends also partly stems from their significance as a form of balance sheet adjustment. But relatively little is known about the determinants of a company's propensity to omit or cut its dividend in a particular year. The analysis presented in this paper, which addresses such issues, can also be interpreted in the wider sense of examining how firms respond to financial pressure.

Such analysis is important not least because it sheds light on the transmission mechanism of monetary policy through the corporate sector. If shocks to corporate cash flows affect the real economy through levels of investment then a dividend omission (or cut) may help protect investment plans and thereby attenuate any real effects on investment. Indeed, one view of dividend policies is that they are the central means through which companies attempt to maintain independence of financial and real decisions, adjusting payouts (albeit in a sticky manner) in order to preserve investment plans in the face of shocks to the balance sheet.

In examining the dividend policies of UK companies, the paper draws on the 'new view' model of taxation and corporate finance developed by King (1977). Theoretical suggestions from this approach are confronted with micro-data on large numbers of quoted UK companies over the period 1974 to 1999 in order to understand the propensity for a company to omit and cut its dividend. The analysis produces several novel results. First, an increase in the proportion of quoted UK companies that omit a dividend from 1995 is uncovered. In 1995, the proportion of non-payers stood at 14.3% and reached 25.2% in 1999. Earlier high-points of omission were 16.1% and 17.9%, witnessed in 1982 and 1992 respectively, both periods of recession. This increase in dividend omission since 1995 is largely accounted for by an increase in the proportion of companies that have never paid a dividend. Second, firms with the highest levels of payout in 1999 (that is, at the 90th percentile) distribute more than double the amount to shareholders, relative to sales, than did their counterparts in 1977. Dispersion in the level of dividend payment has increased in recent years.

Third, the paper sheds light on the characteristics associated with a dividend omission and dividend cut. Low levels of cash flow, high levels of income gearing and leverage, small scale and greater opportunities for investment are all associated with an increased propensity to omit a dividend. These factors, in particular those of cash flow and leverage, are more strongly related to the propensity to cut the dividend suggesting that dividend cutting is a stronger indicator of financial fragility than is dividend omission.

Fourth, the paper uses these results to account for the observed increase in dividend omission. The analysis indicates that these characteristics can account for much of the increase in the proportion of zero-payout firms. This implies that there is a more limited role for a change in dividend policies *per se*, controlling for changes in the characteristics of firms, although we do find evidence of a change in the responsiveness of omission propensities to financial characteristics for the post-1995 period. Analysis of aggregate effects on the propensity to omit suggests that there is relatively little evidence to link this to the major tax reform of 1997 that abolished tax refunds on dividend income payable to tax-exempt institutions. We also consider a role for state dependence in the incidence of dividend omission and find that the propensity to omit and cut is highly persistent, controlling for financial characteristics and unobserved heterogeneity. Companies are slow to adjust their balance sheets through their dividends.

These results have a number of implications. The recent increase in dividend omission is associated with a larger number of companies who have never paid dividends. For the most part, these are relatively small companies with strong investment opportunities. It might be felt then that the recent increase in dividend omission is less worrying than in previous periods when the dividend omitters were former payers who were attempting to repair their balance sheets. In this sense, the changes we have identified reflect 'Great Expectations' rather than 'Hard Times'. Nevertheless, the evidence suggests that it is low levels of profitability among dividend-omitting companies that is the single most important factor accounting for the increase. As such, concerns may remain until the investment opportunities are converted into higher profitability.

Another implication is that those investors, such as trustees, that require a record of dividend payments are restricted to a materially smaller share of the quoted company sector than in the past. The increasing incidence of non-dividend-paying companies also implies that the usefulness of company valuation methods based on the existence of such payments, such as the dividend discount model, is called into question.

Finally, for dividend-omitting companies the potential role of dividend policy to respond to balance sheet shocks while maintaining independence of nominal and real outcomes is forsaken. Rather than have the option of adjusting payouts in order to maintain investment plans such companies must instead borrow more or raise more equity finance. The existence of a wedge between the price of internal and external funds makes it more likely that such companies' real investment decisions will be affected by shocks to cash flow.