Insider Ownership and Dividend Payout Policy: Evidence from India

Dr. Poulomi Lahiri
Doctoral Fellow, Institute of Development Studies Kolkata,
Kolkata-700064, West Bengal, India.

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ABSTRACT *Using a balanced panel data for 751 NSE listed firms for the period 2006 to 2015 and applying the random-effect panel probit regression technique, this paper tries to explore whether insider ownership has any impact on dividend payout policy or not. Our results indicate that an increase in insider ownership would increase the chance of paying dividends in the following years. Our results support the alignment of interest between insiders and outside dispersed or minority shareholders and the dividend is used as a means to limit agency problems between insiders and outside shareholders of Indian corporate firms. Again, the transparent corporate governance regulations along with strong investor protection rights of shareholders compel the insiders to distribute more dividends. Our control variable supports the free cash flow theory, the pecking order theory and the maturity theory of dividend.*

Keywords: *Dividend payout ratio, Panel Probit regression, Corporate Governance.*
JEL Code: G30, G35, C24.

1. Introduction

This paper tries to explore whether insider ownership has any effect on dividend payout policy of Indian corporate firms. The ownership structure differs from developed to developing countries. In developed countries, the ownership structure is dispersed in nature, implying the separation of ownership and control. Under such structure, insiders are professional managers who possess better information about the financial position of the firm than outside shareholders and hence, the conflict of interest between professional-managers (insiders) and shareholders (outsiders) create the vertical or the type I agency problem (Berle and Means, 1932). However, in emerging countries, the ownership and control is concentrated in the hand of controlling shareholders who are owner-managers as a consequence, the horizontal or type II agency problem crops up between owner-managers and minority shareholders (Roe, 2004). To address agency problems, the corporate governance mechanism introduced dividend as a reward to both insiders and outsiders.

There are several theories that deal with the issue of insider ownership and dividend payout. It is well documented in the existing literature that higher dividend payouts may check the discretionary power of managers to misuse retained earnings and force the managers to go to external capital market to finance a new project, where they will be under the monitoring of regulatory bodies and thus agency problem could be addressed(Easterbrook,1984). In short, dividend payouts are used as a means to discipline the self-interested managers to disgorge cash to the shareholders rather than making a wasteful investment (Jensen, 1986).

In a concentrated ownership structure, insiders are aligned with the interest of dispersed minority shareholders, thus distribute higher dividends. This is commonly known as the alignment of interest theory (Frankfurter and Wood, 2002). By granting higher dividends, insiders signal the outside shareholders that the financial prospect of the firm is robust. On the other hand, insiders may expropriate minority shareholders in a concentrated ownership structure. Hence, the distribution of dividends would be less under such circumstances. This is widely known as the entrenchment theory (Shleifer and Vishny, 1997). Keeping all these explanations in mind, it could be suggested that dividend could be used as a means to eliminate agency problems.

In common law countries, shareholders having strong legal protection rights may compel insiders to distribute more dividends (La Porta et al., 2000). Thus, the dividend is an outcome of legal protection.

The empirical corporate governance literature deals with insider ownership and dividend payout shows mixed results. There are several empirical studies that show a positive impact of insider ownership on dividend payout policy. Insiders being professional managers or controlling shareholders are more aligned with the interest of shareholders (alignment of interest effect) and hence, agency problem could be mitigated through monitoring the managers directly by controlling shareholders or indirectly by regulatory bodies (Mitton, 2005; Nor and Sulong, 2007). However, there are other studies which document a negative relationship between insider ownership and dividend payout policy, implying agency problems (Khan,

2006; Harada and Nguyen, 2006). There are a few empirical studies that show no relationship between insider ownership and dividend payout policy (Roy, 2015).

Indian private sector companies are classified into business groups and standalone firms. The group affiliated firm exhibits the concentrated ownership structure and thus generates the horizontal or type II agency problem between controlling shareholders (insiders) and minority shareholders (outsiders). On the other hand, the ownership structure of standalone firms is widely dispersed in nature and hence creates the vertical or type I agency problem. In short, Indian corporate firms show both dispersed as well as concentrated ownership structures and having both type I or vertical and type-II or horizontal agency problems. Keeping in mind the above-mentioned explanations offered by the corporate governance literature, we could suggest that dividend could play a crucial role to mitigate agency problems. It is observed from the existing Indian literature that dividend payout ratio is more or less stable in the recent period (Kamat and Kamat, 2010).

Again, India being an emerging economy has better corporate governance regulations and strong investor protection laws in books. Hence, the relation between insider ownership and dividend payout policy may provide new insight in the context of Indian corporate firms.

Using a balanced panel data for 751 NSE (National Stock Exchange) listed firms for the period 2006 to 2015 on firm-related variables, this paper endeavors to explore whether insider ownership has any impact on dividend payout policy.

Applying the random-effect panel Probit regression technique, our results show that insider ownership has a positive and significant impact on dividend payout ratio. It indicates that insider ownership may increase the chance of paying dividend payout ratios in the succeeding years. It suggests that insiders align with the interest of outside shareholders may use dividend as a signal to outside shareholders that the financial position of the firm is robust. Thus, it supports the alignment of interest theory and the signalling aspect of the dividend. Among control variables, the positive and significant impact of firm size indicates that as the age of the firm increases, it becomes matured and would likely to distribute higher dividends in the following years. Thus, it supports the maturity theory of dividends (Fama and French, 2002). Again, leverage has a negative and significant impact on dividend, implying that highly leveraged firms would reduce the probability of paying dividends in the succeeding years. Hence, it supports the pecking order theory (Myers and Majluf, 1984). Growth opportunity has a negative and significant impact on dividend payout policy. It suggests that firms with low growth potential would increase the chance of paying dividends in the following years and thus supports the maturity theory of dividend.

The rest of the study is arranged as follows. Section 2 discusses methodology. In Section 3 we discuss the database and variables to be used. The empirical results and discussions are discussed in Section 4 and Section 5 includes concluding remarks.

2. Methodology

To explore whether insider has any impact on dividend payout ratio, the random effect panel Probit regression is used because our dependent variable is a categorical one that takes the value 1 if the firm pays dividend or 0 otherwise.

The random effect panel Probit regression with probability $Y_{it}=1$ can be expressed as follows:

$$P(Y_{it}=1 \mid X_{it}, \beta, u_i) = \varphi(u_i + X'_{it}\beta) \quad i=1,2,\ldots,N ; \; t=1,2,\ldots,T$$

$$[u_i \sim \text{iid } N(0, \sigma^2_u)]$$

Here X_{it} is the vector of explanatory variables, β is the parameter vector, u_i is the individual effect terms which are normally distributed i.e. $[u_i \sim \text{iid } N(0, \sigma^2_u)]$. $\Phi(.)$ is the standard normal cumulative distribution function.

The standard normal probit regression model is expressed as follows:

$$Y_{it}=1 = u_i + X'_{it}\beta + \varepsilon_{it} > 0 \quad [u_i \sim \text{iid } N(0, \sigma^2_u)] \text{ and } [\varepsilon_{it} \sim \text{iid } N(0, \sigma^2_\varepsilon)]$$

Y_{it} is the dividend payout ratio which is a categorical variable with values 1 or 0. X_{it} is the independent variable – percentage share of insider holding, the control variables are firm-size, leverage, the age of the firm, the growth of total assets, cash flow and tax. u_i is the individual effect term and ε_{it} is the random effect term.

3. Data and variables of the study

To explore whether insider ownership has any impact on dividend payout policy, the firm-specific data is collected from the prowessiq database for 751 NSE listed firms for the period 2006 to 2015.

The dependent variable is the dividend payout ratio (DPYR), which is a categorical variable with values 1 and 0.

The primary independent variable is the insider holding which is measured as the percentage shareholding by promoters of Indian corporate firms (INSIDERSHARE).

The control variables are described as follows:

Firm size (FIRMSIZE) measured as the natural logarithm of total assets. Age of the Company (FIRMAGE) is calculated as the number of years since inception. Leverage (LEV) is calculated as debt to lagged total assets. Free cash flow (FCFLOW is calculated as cash flow from operating activities which is normalized by the lagged total assets. Growth opportunity of the firm (GROWTHTA) is calculated as the growth of total assets.

4. Empirical Results and Discussion

Insider ownership has a positive and significant impact on dividend payout ratio. This result indicates that an increase in insider ownership would increase the probability of paying dividends in the following years. This result could be explained by the existing theory that insiders are more aligned with the interest of outside investors and hence would like to distribute dividends in the succeeding years. Thus, our result supports the alignment of interest theory and the signaling aspect of the dividend. Our result is consistent with the existing literature ((Mitton, 2005; Nor and Sulong, 2007).

Among control variables, firm size and age of the firm have a positive and significant impact on dividend payout ratio. Our results imply that larger and matured firms may increase the chance of paying dividends in the following years, supporting the maturity theory of dividend. Leverage has its usual negative and significant impact on dividend payouts. It could be explained as follows: highly leveraged firms would reduce the chance of paying dividends in the subsequent years, implying support to the pecking order theory and the free cash flow theory. Growth opportunity of the firm, measured by growth of total assets has a negative and significant impact on dividend payout policy. It suggests that firms with low growth potential would increase the chance of paying dividends in the following years and thus supports the maturity theory of dividend.

5. Conclusion

This paper tries to explore does insider ownership affect the dividend payout policy of Indian corporate firms. Using a balanced panel data for 751 NSE listed firms for the period 2006 to 2015 and applying the random-effect panel probit regression technique, our results indicate that an increase in insider ownership would increase the chance of paying dividends in the following years. Our results support the alignment of interest theory. It negates agency problems. Dividend is used as a means to solve such problems. Again, the stringent and transparent corporate governance regulations along with strong investor protection rights of shareholders of India compel the insiders to distribute more dividends. Our control variable supports the free cash flow theory, the pecking order theory and the maturity theory of dividend. In a nutshell, we can infer that insider ownership increases the chance of paying dividends in the subsequent years.

Table 1: Results for Random-effect Panel Probit Regression for the Full Sample

Variables	DPYR
INSIDERSHARE	.009(.003)***
LEV	-3.560(.259)***
FIRMSIZE	.245(.034)***
CFLOW	.100(.520)
GROWTHTA	-.001(.009)***
FIRMAGE	.004(.002)**
Constant	-.622(.352)*
Observations	7510
Wald-Statistics	483.03***

Source: Author's Calculations

1) Standard errors are reported in parenthesis. 2) ***, ** and * denote level of significance at 1%, 5% and 10% respectively. 3) _STDEV stands for the standard deviation.

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