Are they Listening?:

An M&A Approach to Dividend Catering

M&A Research Centre – MARC

May 2018

MARC – Mergers & Acquisitions Research Centre

MARC is the Mergers and Acquisitions Research Centre at Cass Business School, City, University of London – the first research centre at a major business school to pursue focussed leading-edge research into the global mergers and acquisitions industry.

MARC blends the expertise of M&A accountants, bankers, lawyers, consultants and other key market participants with the academic excellence of Cass to provide fresh insights into the world of deal-making.

Corporations, regulators, professional services firms, exchanges and universities use MARC for swift access to research and practical ideas. From deal origination to closing, from financing to integration, from the hottest emerging markets to the board rooms of the biggest corporations, MARC researches the wide spectrum of mergers, acquisitions and corporate restructurings.

Overview

There has recently been a flurry of academic literature concerned with activist investors and their influence (benign or otherwise) on decisions made by targeted companies. But what about the 'silent majority', those fund managers who invest without taking an activist stance? Do they get what they want from the company? Specifically, do they get the dividend policy they want?

This is very difficult to study directly. Institutional holdings normally change gradually and so will each institution's influence. This makes it hard to match institutional desires with any changes in dividend policy. And in the static case, observing a company and seeing if its payout policy matches the needs of its current shareholders requires one to judge if a payout policy is particularly generous or not, in the context of the industry, and then placing a judgement on each institution's wants or needs, an almost impossible exercise.

The dividend / M&A link

What we need is an event, a before and after point, when we can look for changes in dividend policy before and after the event, and similarly with the shareholder base, also before and after the event. Then we effectively have a controlled experiment where we can see if there are changes in dividend policy to reflect the desires of the new shareholding base. Fortunately, we have such an event, an event where dividend policy often changes and where there is an engineered change in the shareholder base: an equity-financed acquisition.

In this report we show that firms actively manage their dividend policy towards the preferences of their investors. We use a novel setting, namely, merger-induced changes in the shareholder base, in order to establish this effect. Acquiring firms adjust their dividend policy towards that of the target when they inherit target firm shareholders through a stock-swap transaction. These catering activities are more pronounced when the target represents a larger part of the combined firm and when dividends are tax-advantaged.

Interestingly but not surprisingly, adjustment towards the pre-merger dividend policy of the target is lower when the acquirer comes from a better governance regime. Our analysis also shows that acquirers are less likely to pay for the target company in the form of stock when the target pays higher dividends than the acquirer. Finally, we show that mergers overall have a negative impact on the combined firm payout: merging firms reduce dividends and are less likely to be dividend payers after the deal relative to firms that do not merge.

Implications

These findings imply something else to think about if you are a shareholder of a serial acquirer. That firm you bought into years ago is not only not going to be static in terms of business mix but the regular payouts you receive may well change as well. And if you are a shareholder on the target company side, you don't necessarily have to sell the received stock payment after the deal, as you can stick around (together with other shareholders) and make the new entity fit your needs more closely. And finally, if you are a shareholder of one of these acquirers who is wary of stock issuance, you should probably steer the company towards targets with attractive yields.

What we knew about dividend payouts

Why do firms pay dividends? This question has attracted significant academic attention following the publication in 1961 of the seminal Miller and Modigliani "dividend irrelevance" proposition. According to their theory, in the absence of capital market imperfections, investors should be indifferent between a dollar in dividends and a dollar in capital gains. An important capital market imperfection that gives rise to the potential relevance of dividend policy for firm value is taxation. If dividends are taxed at lower rates compared to capital gains, or not at all as is the case for certain investor groups in many jurisdictions, then dividend policy becomes an important consideration for the firm. Similar effects may arise if investors are subject to behavioural biases, for example, viewing dividend and capital gains differently in their mental accounts. A firm would pay dividends when its investors prefer dividend income and would refrain from paying dividends when its investors prefer capital gains (that also may be tax driven). This argument is known as the "dividend clientele" effect.

Is there a dividend clientele effect?

There is, however, limited evidence on the importance of such dividend clienteles. Empirical studies provide mixed evidence on the existence of a dividend clientele effect. And if they do exist, it is not clear whether investors preferring dividends simply choose to invest in dividend-paying stocks or whether firms actually cater to their investors. Some studies show that the level of dividend payout does not exert a significant influence on portfolio selection decisions. However, others document that retail investors' stock holdings are characterised by a preference for dividends that decreases with income and increases with age.[1]

One study examines the effects of the concentration of institutional investors on companies' dividend behaviour.[2] They show that institutional investors have a preference for dividend paying stocks, however among these stocks they prefer those that pay lower dividends. They also find that a high concentration of institutional shareholders does not result in companies paying higher dividends. In their survey analysis of companies' dividend policies, others provide evidence that institutional investors are not characterised by a distinct preference for dividends over share repurchases.[3] Thus the research doesn't provide a clear picture…yet.

Mixed messages about institutional behaviour

One study from 1995 investigated the change in institutional ownership following dividend omissions and found no evidence of significant shifts in ownership structure.[4] In contrast, other studies suggest that companies' institutional investor clientele adjusts according to its tax preferences following dividend initiations, with a significant shift in ownership towards tax-deferred/tax-exempt and corporate institutions.[5]

Several more recent studies identify the presence of dividend clienteles that are not based on tax preferences, for example, demonstrating that retail (as opposed to institutional) investors can display a preference for investing in local companies while older investors are more likely to invest in companies which pay high dividends.[6] The authors suggest that the combined effect of these two distinct preferences results in geographically varying demand for dividends.

[1] As an example, see Graham, J. and Kumar, A., Journal of Finance, 2006

[2] Grinstein, Y. and Michaely, R., Journal of Finance, 2005

[3] As an example, see Brav, A et al, Financial Management, 2008

[4] Michaely, R., Thaler, R. and Womack, K., Journal of Finance, 1995

[5] As an example, see Dhaliwal, Erickson and Trezevant, National Tax Journal, 1999

[6] As an example, see Becker, Ivkovic and Weisbenner, Journal of Finance, 2011

We focus here in this study on shareholders "inherited" through merger transactions based on differences in the demand for dividends.

Our research builds on earlier studies by investigating whether a substantial shift in the dividend clientele of a firm resulting from changes in the shareholder base due to a stock swap merger leads to changes in the dividend policy. This setting allows us to capture differences in the preference for dividends across different investors in a more direct way, without the need to make underlying assumptions about the likely preferences of these different investor groups (e.g., as in the earlier studies above, assumptions about the preferences of retail, institutional or older investors). Finally, this setting allows us to demonstrate that firms actively cater to their investors and alter their dividend policy to accommodate shareholder preferences, rather than different dividend clienteles simply selecting into firms with compatible dividend policies.

Our questions and our approach

We set out to tackle the following four questions:

1. Do firms actively set dividend policies to please investors?
2. When do policies change the most?
3. Before making an acquisition, will bidders be put off by differences in dividend policy?
4. More generally, what is the effect of M&A on the propensity to pay dividends?

The 'investor preference' question

In a stock-swap merger, the acquirer inherits the shareholders of the target firm. If the pre-merger dividend policies of the two firms are different, the newly-acquired dividend-seeking shareholders (called here, 'dividend clientele') may compel the acquirer to adjust its dividend level payout towards that of the target's. To the extent that acquisitions have an impact on the firms' dividend policy, cash-financed acquisitions provide a natural control group, since they do not entail a change in the shareholder base.

Our main outcome variable of interest is the change in the acquirer's dividend policy from before to after the deal. We measure the change in acquirer's dividends per share (DPS) over periods starting one year before and ending one, two and three years following the completion of the M&A deal.

To capture the difference in dividend preferences of the shareholders of the acquirer and the target prior to the acquisition we define a Dividend Gap variable (DPS and Dividend Gap are described more fully in the Appendix), which is equal to the ratio of target to acquirer dividend yields.

To further isolate the clientele effect from alternative explanations, we control for other potential determinants of the change in the dividend policy of the merged firm. (We show below two particularly significant ones and six others are detailed in the Appendix).

- To control for the implications of the signalling theory of dividends which states that companies signal their future improved prospects by raising dividend payout rates, we adopt a measure of the change in expected future earnings of the acquiring firm as a consequence of the acquisition. We use the change in expected/forecasted EPS measured over a period starting one year before and ending one year after the deal completion to capture the change in expected acquirer earnings, or synergies.

- The life cycle view of dividends suggests that a company begins to distribute funds to shareholders when its profitability and growth are diminishing. This is diametrically opposed to the predictions of the signalling theory. To control for the implications of the life cycle view of dividends, we measure the change in acquirer growth opportunities in the period surrounding the completion of the M&A deal. Specifically, growth opportunities are measured using the market to book ratio of the acquirer.

The 'drivers' question

In order to tackle the second question, we consider governance, tax and relative size as potential drivers of dividend policy change.

We therefore test whether acquirers are less likely to cater to the newly-acquired dividend clientele when the acquirer comes from a superior governance regime, where the need for dividends as a pre-commitment device is lower. To implement this test we take advantage of cross-border deals in our sample and measure the difference in the quality of corporate governance in acquirer and target countries using an anti-self-dealing index.[7] Higher values of the index indicate better governance quality, and therefore higher values of the difference between the acquirer and the target country's index are associated with greater improvements in the degree of protection afforded to target shareholders who receive acquiring firm shares as payment.

Our second test exploits cross-country differences in dividend tax regimes. If dividend clienteles are tax-related, one would expect that the incentives to cater to newly-acquired dividend clienteles increases with the tax advantage. To capture cross-sectional differences in the degree of dividend tax advantage, we classify countries into three different tax systems depending on the corporation tax rate and dividend tax credit:[8]

- *Full Imputation* - where investors pay personal taxes on distributed earnings but receive full tax credit for the corporate taxes paid on these earnings
- *Partial Imputation* - where investors pay personal taxes on distributed earnings but receive partial tax credit for the corporate taxes paid on these earnings
- *Classical* - where investors pay personal taxes on distributed earnings in addition to the corporate taxes paid on these earnings

Finally, the incentives to cater to newly-acquired dividend clienteles should be greater when this new clientele represents a larger fraction of the merged firm. We therefore test whether the policy change effect is further increased in deals where the target is large relative to the acquirer.

The 'could a dividend policy put you off' question

Another way in which dividend policies may impact M&A deals is the payment method choice. Specifically, the acquirer may choose to avoid inheriting the target's shareholders when the dividend policy of the target is sufficiently different (more generous) to that of the acquirer such that satisfying the new clientele is prohibitively costly. This can be achieved by making a pure cash offer as opposed to an offer containing equity as part of the consideration. We therefore test for the existence of this effect by investigating whether differences in the dividend policy of the merging firms (as captured by the Dividend Gap variable) influence the payment method choice.

The 'big picture' question

We further use our sample to examine another unexplored question regarding dividend policy and M&A. We are interested in whether mergers have an abnormally positive or negative effect on total dividend payout for a shareholder holding both acquirer and target stock.

To that end, we consider yearly observations on dividends paid by both the acquirer and target in the year prior to the deal and by the combined firm in each of the three years following the deal.

7 Dyankov, S et al, Journal of Financial Economics, 2008

8 Alzahrani, M. and Lasfer, M., Journal of Corporate Finance, 2012

Our findings

In the regression analysis we found that:

Firms adjust dividend policy towards that of the target only if there is an exchange of equity, which implies that firms do set dividend policies to please investors

The results show that acquirer DPS increase by 20.6% one year following the merger when the target used to pay higher dividends, while this increase is only 19.4% when the target paid either equal or a lower amount of dividends than the acquirer. The difference between the two figures is 1.2% but is not statistically significant. The same pattern is observed for years two and three following the deal. We would expect that any policy change effect comes primarily from deals containing some stock as the method of payment whereby the acquirer inherits some of the target's shareholders and experiences a shift in its dividend clientele.

As predicted, we observe that the magnitude of the adjustment of the acquirer's dividend payout towards that of the target is considerably higher (and significant) when the method of payment includes some stock. Specifically, for deals containing some stock as consideration, the difference in acquirer dividends per share between cases where the target pays higher dividends than the acquirer versus cases of equal or lower target payout is 5.5%, 9.3%, and 11.7% for years one, two, and three following the deal, respectively. In contrast, the corresponding differences in the case of cash deals are actually negative. Note that if we include acquirers that pay no dividend we get the same directional results, only with slightly less significance.

Eliminating other explanations

Next, we conducted tests which allowed us to fully utilize the variation in the dividend gap and percentage stock paid as well as to control for other potential explanations of the change in acquirer dividend payout following the deal. We did find support (although weak) for our expectation that acquirers adjust their dividend policy towards that of the target. This effect, however, is entirely due to cases where the payment method includes stock. The greater the change in the dividend clientele of the acquirer, the greater the change in its post-acquisition dividend policy. In other words, the acquirer is more likely to increase dividend payments following a deal when the target's dividend clientele was accustomed to receiving higher dividend payments than the acquirer before the completion of the deal.

There are certain factors that can imply larger changes in dividend policy

Our results support the idea that dividend payments are a governance tool and that there is less need to pay dividends in countries with strong investor protection, reducing the incentives to cater to newly-acquired dividend clienteles when governance quality afforded to those new clienteles is improved. We find that when the acquirer company is domiciled in a country with relatively stronger investor protection to that of the target's country of domicile, the clientele effect is reduced.

Consistent with our predictions, we also find that acquirers are more likely to cater to their newly acquired dividend clientele following acquisitions in countries with full or partial imputation systems, i.e. when the tax cost associated with dividends is relatively lower.

Finally, the results confirm our intuition that the acquirer is more likely to accommodate preferences of target shareholders inherited through a stock swap when the target company is large relative to the bidder.

Differences in dividend policy discourage the use of stock in a deal

Results confirm our conjecture from question three. When acquirers are unwilling or expect to be unable to adjust their dividend policy towards that of the target, they are less likely to structure the deal as a pure stock swap.

M&A reduces the propensity to pay dividends

Our analysis shows that mergers are associated with a 16.1% reduction in the combined firm dividend payout relative to other merging firms that have not yet merged. It appears that mergers, on average, lead to a decline in dividend payments. Mergers are associated with a 4.0% reduction in the propensity of the combined firm to be a dividend payer. These results are interesting for at least two reasons. First, they complement the literature on the effects of mergers on shareholders through abnormal stock performance [9] and operating performance changes.[10] Secondly, if M&A is associated with reduced dividends, does that mean that consolidating industries will gradually see reduced payouts?

9 Bhagat, S. et al, Journal of Financial Economics, 2005

10 Heron, R. and Lie, E., Journal of Financial & Quantitative Analysis, 2002

Conclusions

We find that acquirers adjust their dividend policy towards that of the target in the three years post-merger, but only when they inherit target firm shareholders through stock swaps. This is after we controlled for various ways in which the merger or the payment method choice can affect the payout through channels other than the clientele effect (e.g., past growth in dividends of the two firms, increased cashflows due to synergies, liquidity, etc.).

Specific drivers of increased effects

We then turned to specific drivers and show that the adjustment of the dividend policy of the merged firm towards that of the target in stock swaps is stronger when dividends are more tax-advantaged and when the target firm shareholders represent a larger part of the combined firm. We also found that dividend policy adjustment to that of the target is weaker when the bidder comes from a superior governance regime. All of these effects are consistent with post acquisition catering to dividend-seeking shareholders.

Impact on payment method

We also examined whether differences in dividend policy of the merging firms have an influence on the payment method choice. To the extent that bidders cannot commit to adjust the payout towards the target firm levels, larger differences in dividend policy of the merging firms have an influence on the payment method choice. Similarly, bidders may prefer cash payment in order to avoid having to make large changes to their dividend policy to cater to target firm investors. This is exactly what we find. The likelihood of an all-stock payment, as well as the fraction of the consideration in the form of stock, is strongly negatively associated with the ratio of target firm dividend yield to that of the acquirer.

Does M&A increase shareholder payout?

Finally, our data allowed us to address another interesting question regarding mergers and acquisitions and dividend policy. Specifically, and abstracting from the dividend clientele effect, we studied whether M&A deals in general result in increased or decreased payout to shareholders. We found that mergers are associated with reduced combined firm payout: our estimates indicate there is a 16% reduction in dividend payout in the post-merger years, as compared to control sample firms that have not yet merged. Moreover, the combined firm is 4% less likely to be a dividend-payer than the two stand-alone firms. Reduced propensity to pay following takeovers could suggest that the more mature (concentrated) the industry the lower the payout.

Appendix

We collected a sample of global M&A deals announced between 1 January 1990 and 31 December 2013 from the Thomson Reuters SDC Mergers and Acquisitions Database. We do not impose any geographical restrictions on acquirers or targets in order to increase the size of our sample. (See Figure 1 below for the geographical breakdown).

The final sample of deals consists of transactions that constitute a transfer of control, such that the acquirer owns less than 50% of the target before the bid and owns more than 50% of the target upon completion. We exclude both acquirer and target companies which operate in regulated industries, namely financial services (SIC codes 6000-6999) and utilities (SIC 4900-4949). The final sample consists of 3,458 M&A transactions.

Variable definitions:

The change in dividends per share (Δ DPS) is calculated as follows:

1) *Δ DPS* is equal to zero when the acquirer distributed equal levels of dividends before and after the acquisition (including not paying any dividends before and after)
2) *Δ DPS* is equal to one when the acquirer did not distribute dividends before the acquisition but initiated dividend payments after the bid.
3) In all other cases, *Δ DPS* is equal to the percentage difference between DPS before and after the completion of the acquisition.

Dividend Gap is calculated as follows:

1) *Dividend Gap* is equal to 1 when the target and acquirer have the same dividend yield or when the acquirer and target both pay zero dividends prior to the acquisition.
2) *Dividend Gap* is equal to the value of the 99th percentile of the ratio of target to acquirer dividend yields when the target pays dividends before the acquisition and the acquirer does not pay dividends before the acquisition.
3) In all other cases *Dividend Gap* is calculated as:

$$Dividend\ Gap = \frac{Target\ dividend\ yield_{Y-1}}{Acquirer\ dividend\ yield_{Y-1}}$$

Factors controlled for in the analysis

1. Signalling theory of dividends
2. Life cycle view of dividends

We also include standard control variables. Specifically, we control for the acquiring and target companies' growth rates in dividends during the three-year period prior to the deal. We also control for the acquirer and target companies' growth opportunities, measured as the market-to-book ratio of the acquirer and target one year prior to the deal; acquirer and target liquidity, measured as the ratio of operating cash flow to sales one year prior to the deal; and acquirer and target maturity, measured as the age of the bidder and target one year prior to the deal. We further control for acquirer and target profitability, measured as the return on assets one year prior to the deal; acquirer and target size, measured as total assets one year prior to the deal; as well as acquirer and target leverage, measured as the ratio of long-term debt to total assets one year prior to the deal. The regressions further control for acquirer and target business risk profiles, captured by the standard deviation of operating cash flows calculated over a three-year period prior to the deal, acquirer country's economic growth, measured as the annual growth in GDP. Finally, we control for country, industry and time effects.

Geographic split of transactions

Figure 1: Acquirer and target countries

Year	Number of Targets	Number of Acquirers
US	1,672	1,653
Japan	554	608
UK	358	383
Australia	158	135
France	115	166
Canada	93	6
Germany	89	99
Netherlands	49	70
Sweden	39	53
Norway	33	28
Other	298	257
Total	3,458	3,458

Source: Cass Business School

Notes on Authors

Valeriya Vitkova, MARC Research Fellow. Her research and teaching at Cass focus on M&A, corporate restructuring, hedge fund activism and related topics.

Scott Moeller, Director of MARC and Professor in the Practice of Finance. His research and teaching focuses on the full range of mergers and acquisitions activities.

Contact: **cassmarc@city.ac.uk**

.

Notes

Notes

M&A Research Centre

Cass Business School
106 Bunhill Row
London EC1Y 8TZ
T: +44 (0)20 7040 5146
E: CassMARC@city.ac.uk
www.cass.city.ac.uk/marc

Cass Business School
In 2002, City University's Business School was renamed Sir John Cass Business School following a generous donation towards the development of its new building in Bunhill Row. The School's name is usually abbreviated to Cass Business School.

Sir John Cass's Foundation
Sir John Cass's Foundation has supported education in London since the 18th century and takes its name from its founder, Sir John Cass, who established a school in Aldgate in 1710. Born in the City of London in 1661, Sir John served as an MP for the City and was knighted in 1713.