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DIVIDEND INITIATIONS AND IPO LONG-RUN PERFORMANCE

Abstract:

Dividend initiations are an economically significant event that has important implications for a firm's future financial capacity. Given that the market's expectation of a consistent payout, managers of IPO firms must approach the initial dividend decision cautiously. We compare the long run performance of IPO firms that initiated dividends with those of similarly matched non-payers. We found that firms which initiated dividends perform significantly better up to three years after the initiation date. Moreover, we measure investor reactions by 2-day around dividend announcement date cumulative abnormal return. We evidence no statistically significant differences between cumulative abnormal returns (CAR) of IPO firms and cumulative abnormal returns of Non-IPO firms, indicating that investors do not response to dividend announcement of IPO firms more than they do to the dividend announcement of Non-IPO firms.

Keywords:

dividend initiations, IPO, long-run performance, dividend

CHAPTER 1 INTRODUCTION

Financial economists have documented 3 anomalies in the pricing of initial public offerings (IPOs) of common stock: the short-run underpricing phenomenon, positive excess returns in the short run; the “hot issue” market phenomenon, strong concentration of IPO activity in certain periods; the poor long-run performance phenomenon.

Many of theoretical researches on IPOs have focused on explaining the short-run underpricing phenomenon and the “hot issue” market phenomenon. However, there are several reasons why the long-run performance of initial public offerings (IPO) is of interest. First, from an investor’s viewpoint, the existence of price patterns may present opportunities for active trading strategies to produce superior returns. Second, finding of nonzero aftermarket performance calls into question the informational efficiency of the IPO market. It provides evidence concerning Shiller’s (1990) hypothesis that equity markets in general and the IPO market in particular are subject to fads that affect market prices. Third, the cost of external equity capital for companies going public depends not only upon the transaction costs incurred in going public but also upon the returns that investors receive in the aftermarket. To the degree that low returns are earned in the aftermarket, the cost of external equity capital is lower for these firms.

Empirical studies on long-run performance of IPO: Ritter (1991) reports the low long-run returns –in the first three years of trading– on the stocks of those firms that carry out IPOs, compared with those obtained by firms that have not performed IPOs. Álvarez and González (2001) report a positive relation between the level of underpricing of the IPOs and the long-run performance of the firm since underpricing understood as a signal of the firm’s value argues that firms choose to undervalue with the aim of later selling more stocks in the market, contrasts with Ritter (1991) Brav et al. (2000) that have revealed that there do not exist low long-run returns of the IPOs. Thus, these firms obtain long-run returns that are similar to those obtained by firms that have not gone public if the comparison is made in terms of size and book-to-market ratio of firms evidently stronger than that of the IPOs with small market capitalization. Loughran and Ritter (2000) posit that underperformance is more severe in high-volume trading periods than in low-volume periods. This evidence remains consistent with Krigman et al. (1999) find an interesting link between initial trading volume and the long-term performance.

Under signaling hypothesis, since managers possess more information than outsiders, they have incentives to unambiguously signal the information to investors when it contains good news. For instance, when a firm has high quality investment opportunities, investor will positive react to an increase in dividend payouts although it implied to get outside financing. The second reason to support an increase in dividends lies in the fact that a firm with valuable investment opportunities may possess liquidity enough to finance its investments and also distribute a dividend, in which case the combined signal sent to the market is especially positive. This should translate into greater investor demand and a positive drift in returns following the dividend announcement.

The empirical evidence suggests that the average stock price response, at the announcement of a dividend increase (decrease), is positive (negative). It is also observed that the magnitude of abnormal return is positively related to the degree of

unexpected changes in dividends (see, Aharony and Swary, 1980; Eades, Hess, and Kim, 1985). The results are having the same nature but stronger in magnitude for the extreme events like dividend omissions and dividend initiations (Asquith and Mullins, 1983).

The announcement effects associated with dividend changes appear to be consistent with signaling models based on asymmetric information. For instance, Bhattacharya (1979) and Miller and Rock (1985), among others, develop models in which dividends convey information about the firm's earnings. Their model indicates that the possibility of dividend initiation is higher in the presence of asymmetric information relative to that under full information so the positive post-announcement drift is expected to be more pronounced for newly listed firms than for Non-IPO firms due to the pervasive nature of information asymmetry in the IPO market (Bessler, Drobetz and Seim, 2009).

Dividend signaling models also suggest that managers initiate/increase dividends only when they are confident that higher dividends can be maintained with higher subsequent earnings. Healy and Palepu (1988) shows that firms that initiate (omit) dividends have significant increases (decreases) in their annual earnings for at least one year before and the year of dividend policy change. Similarly these firms have significant increases and decreases respectively, in earnings for at least one year afterward the announcement. In case of initiating firms, earnings increases for two years following these increases.

In light of the importance of the dividend initiation decision and its proximity to the IPO listing in Thailand, we test whether the act of dividend initiation is a distinguishing feature that can explain why some newly listed firms perform better or worse than other (similar) firms in the long-run and how investors response to the first dividend, or dividend initiation.

CHAPTER 2 REVIEW OF LITERATURE

The poor long-run performance of IPO firms is a well-documented phenomenon in the literature. In the US, Ritter (1991) reports the low long-run returns –in the first three years of trading– on the stocks of those firms that carry out IPOs, compared with those obtained by firms that have not performed IPOs. Similar findings of poor long-run performance of IPO firms are observed elsewhere including Australia (Lee, Taylor and Walter, 1996), the UK (Levis, 1995), and Spain (Álvarez and González, 2001)

Ritter (1991) also reports a strong positive relation between age and aftermarket performance. For the initial return, there is a strong monotone pattern in the other direction, consistent with the notions that risky issues require higher average initial returns and that age is a proxy for this risk. Ljungqvist (1997) finds a negative link between long-run performance and ownership retention for a sample of Germany IPOs similar to Jane and Kini (1994). In contrast, Goergen (1998) reports that the underperformance of IPOs cannot be explained by the observed dilution of ownership after the IPO and possible agency conflicts caused by this dilution. Brav et al. (2000) have revealed that there do not exist low long-run returns of the IPOs. Thus, these firms obtain long-run returns that are similar to those obtained by firms that have not gone public if the comparison is made in terms of size and book-to-market ratio of firms. This result reveals that the return patterns of firms that have carried out IPOs

are not different to those of firms that have not done so and that the results found in previous works are motivated by the long-run returns measures used.

Álvarez and González (2001) report a positive relation between the level of underpricing of the IPOs and the long-run performance of the firm since underpricing understood as a signal of the firm's value argues that firms choose to undervalue with the aim of later selling more stocks in the market. Wang Meijin and Zhang Song (2000) find that the long-run performance of IPOs was connected with their market capitalization sizes and the long-run performance of the IPOs with large market capitalization are evidently stronger than that of the IPOs with small market capitalization. Loughran and Ritter (2000) posit that underperformance is more severe in high-volume trading periods than in low-volume periods. This evidence remains consistent with Krigman et al. (1999) find an interesting link between initial trading volume and the long-term performance.

Recently, D. E. Allen, N. J. Morkel-Kingsbury and W. Piboonthanakiat(2010) find an negative relationship between initial return and aftermarket performance in Thailand, IPOs that have a higher initial return tend to have the worse aftermarket performance, which is consistent with the overreaction hypothesis reported by Aggarwal and Rivoli (1990); Ritter (1991) and Levis (1993).

The interactions between dividend policy and asymmetric information have been widely examined in the context of signaling models. One very intuitive paper in this class is that by Miller and Rock (1985), who developed a model in which the information asymmetry pertains to current earnings and the level of investment. In their model, dividends convey information about current earnings through the sources and uses identity. Because earnings are assumed to be correlated through time, investors can infer future earnings once current earnings are revealed. Since the level of investment is unobservable, firms have an incentive to pay higher dividends to signal higher earnings by reducing investment. In equilibrium, a firm with higher current earnings pays a level of dividends that is high enough to separate itself from a firm with lower earnings. The equilibrium in the model also indicates that the level of dividend payout is higher in the presence of asymmetric information relative to that under full information. The above arguments imply that a firm with a higher level of asymmetric information, other things equal, will have to pay a higher level of dividends to signal the same level of earnings as a firm with a lower level of asymmetric information. Other things equal, the signaling argument predicts that the higher the level of asymmetric information, the higher the probability of a dividend initiation. Alternatively, the higher the level of asymmetric information, other things equal, the lower the time until dividend initiation.

Under the signaling model, initial dividend announcements act as a positive signal to the market, reducing the information asymmetry problem which in turn decreases total and systematic risk (Dyland Weigand, 1998). This should translate into greater investor demand and a positive drift in returns following the dividend announcement. Asquith and Mullins (1983) examined the impact of initiating dividend payments on shareholders' wealth by using a sample of 168 firms. They reported a two day (for day -1 and 0) excess return of 3.7%. Healy and Palepu (1988) also tested the 'information content hypothesis' using dividend initiations and omissions. Consistent with the signaling hypothesis they reported a mean abnormal return (for day -1 and 0) of 3.9% for the initiation firms and -9.5% for the dividend omission firms. It is also observed that the magnitude of abnormal return is positively related to the degree of unexpected changes in dividends (see, Aharony and Swary, 1980; Eades, Hess, and Kim, 1985).

The results are having the same nature but more strong in magnitude for the extreme events like dividend omissions and dividend initiations (Asquith and Mullins, 1983).

The positive post-announcement drift is expected to be more pronounced for newly listed firms than for Non-IPO firms due to the pervasive nature of information asymmetry in the IPO market (Bessler, Drobetz and Seim, 2009). Signals have empirically been known to induce a greater market response in firms with greater ambiguity (Dewenter and Warther, 1998). The signaling theory also suggests that dividend initiations are an indication of the firm's confidence in current and future profitability (Brav, Graham, Harvey, and Michaely, 2005) since the commencement of a dividend distribution implies a long run commitment to consistent payouts. Increases in operating performance following a dividend initiation would therefore have positive implications for the present and long run value of the firm, which would be reflected in the stock price. Lipson, Maquieira and Megginson (1998) find direct evidence of this and document that earnings increases are more common in firms that have initiated dividends.

Consequently, we expect IPO firms that initiate a dividend payment will experience better returns in equity value, reflecting greater expected profitability, than firms that did not initiate a dividend. Due to the "seasoning" of IPO firms over time, we expect the dividend signal is the most important in the period immediately after the IPO when the information asymmetry problem is at its peak.

CHAPTER 3 DATA AND VARIABLE MEASUREMENT

3.1 Data

Our primary data source is the IPO prospectuses, which we obtain from DataStream of Thompson Financial Service and SETSMART, the Thailand Stock Exchange (SET). The final sample consists of Thai IPO firms listed between 2001 and 2009 after excluding firms that were previously listed on the SET and firms in financial sector and matched-dividend paying Non-IPO firms.

To determine if the IPO sample has initiated a dividend payment, we track down the dividend history of each firm using DataStream for a period of up to one year after listing. If no dividend history was found for a firm, we denote the firm as not having paid a dividend and classify it as a non-payer. For firms with at least one record dividend payment, the first dividend payment is noted as the initial dividend and the announcement date of the initial dividend as the initiation date.

3.2 Hypothesis

H1: Firms that initiated a dividend payment have better long run stock returns than firms that did not initiate a dividend payment.

H2: Investors response to the dividend initiation of the IPO stocks more than they do to the dividend announcement of Non-IPO firms.

3.3 Methodology

3.3.1 Multivariate

To test whether firms that initiated a dividend have better long run stock performance than non-payers, we compute the long-run returns using monthly stock returns over a time horizon of three years after the initiation date for each firm

$$Return_{i,T} = \sum_{t=1}^{36} Return_{i,t}$$

$$Return_{i,t} = R_{it} - R_{i,t-1}$$

Where $R_{i,t}$ represents yearly return of firm i at period t

$R_{i,t-1}$ represents yearly return of firm i at period $t - 1$

And run the following pooled OLS regression:

$$Return_{i,t} = \beta_0 + \beta_1 Market + \beta_2 Dividend_i + \beta_3 Ln(Size)_i + \beta_4 Underpricing_i + \beta_5 Ln(Age)_i + \beta_6 Retention_i + \beta_7 Hot\ market_i + \varepsilon_i$$

3.4 Event Study Methodology

To assess the investor's reaction on dividend initiations of IPO stock, we use a standard event study methodology. And we choose the 'market model' to project expected returns (Brown and Warner, 1985)

3.4.1 Estimation Window

We took the period (-42, -3), 40 days prior to day -2, being day 0 the event date or day of the dividend initiation

3.4.2 Event Window

We took the period (-2, +2), being day 0 the event date or day of the dividend initiation. The post-event period selected is (+1, +2) and the pre-event period is (-2, -1) and attempts to detect any market reaction occur prior to the announcement. (Jijo Lukose P. J. and S Narayan Rao, 2004)

3.4.3 Calculation Procedure

To measure return of the market and return for each firm in each day in estimation period, we employed the difference of closing prices for two consecutive days divided by the closing price of the first day as followed:

$$R_{j,z} = \frac{P_{j,z} - P_{j,z-1}}{P_{j,z-1}}$$

$$R_{m,z} = \frac{P_{m,z} - P_{m,z-1}}{P_{m,z-1}}$$

Where $R_{i,t}$ represents firm i return at period z

$R_{m,z}$ represents market return at period z

$P_{j,z}$ represents for closing price of firm i at period z

$P_{j,z-1}$ represents for closing price of firm i at period $z - 1$

1. 2. To estimate parameters α_j and β_j , we run the OLS regression to account the relation between firm j return and return of the market
2. With these parameters, we predicted expected return for firm j in each day in the event period.

$$E(R_{j,z}) = \hat{\alpha}_j + \hat{\beta}_j R_{m,z}$$

Where $E(R_{i,t})$ represents firm's j return at period z

$R_{m,z}$ represents market return at period z

3. We computed abnormal return for each day in event period or period (-2, +2) where $AR_{(T)}$ is defined as:

$$AR_{jz} = R_{jz} - E(R_{jz})$$

4. To account for the effect of the dividend initiation or dividend announcement, we calculated cumulative abnormal return where $CAR_{(T)}$ is defined as:

$$CAR_{jz} = AR_{jz} + CAR_{jz-1}$$

5. To test whether investors response to the dividend initiation of the IPO stocks more than they do to the dividend announcement of Non-IPO firms, we run the following OLS regression:

$$CAR_{jz} = \beta_0 + \beta_1 IPO + \beta_2 Dividend Yield + \beta_3 Ln(Size)_j + \varepsilon_j$$

CHAPTER 4 RESULTS AND DISCUSSION

4.1 Dividend Initiation and Long-run Performance of IPO Firms

H1: Firms that initiated a dividend payment have better long-run stock returns than firms that did not initiate a dividend payment.

We begin our analysis with Multivariate tests of difference in the long run stock performance of dividend payers and non-payers. Table 1 reports the regression results. Consistent with our hypothesis, the dividend initiation variable is statistically significant and positive. In economic terms, the estimated coefficient on Dividend shows IPO firms that initiated a dividend payment on average outperform non-payers by 29.59%. Therefore the initial dividend decision is a corporate initiative that has a positive impact on IPO long run stock returns for a period of up to 3 years after the listed date. Our results are thus in line with Michaely, Thaler and Womack (1995), Boehme and Sorescu (2002) and Janice, How and Peter (2011) who reported evidence of a positive market reaction to initial dividends of IPO firms. Looking at the control variables, In line with Janice, How and Peter (2011) we report that firm with a higher retained ownership perform worse in the long run. Consistent with the evidence in Ritter (1991), underpricing and the hot-market variables are significantly negative. Firms with higher initial dividend, consistent with the notions that risky issue require higher average initial returns and firms those issue in the hot-market period perform worse in long-run, consistent with the following scenario: firms choose to go public when investors are willing to pay higher multiples (price-earnings or market-to-book). As expected, age variable is significantly positive. Firms with more aged perform better in the long-run, indicating that age is a proxy of risk.

Table 4.1 Regression results for long run stock returns and dividend initiation

Regression				
Dependent Variable: 3-year return				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	76.288	104.85	0.728	0.468
Market	0.46	0.226	2.037	0.044
DIV	29.592	16.667	1.775	0.078
Size	-2.631	4.785	-0.55	0.583
Underpricing	-58.675	17.569	-3.34	0.001
Age	1.612	0.712	2.265	0.025
Retention	-36.914	21.723	-1.699	0.092
Hot market	-44.614	14.777	-3.019	0.003
R-squared	0.299	F-Statistic		7.183
Adjusted R-squared	0.0257	Prob.(F-Statistic)		0.000

4.2.2 Multivariate Methodology

Table 6 reports the regression results that the cumulative abnormal return (CAR) around dividend announcement is significantly positively related to firm size, contrasts with Laarni Bulan, Narayanan Subramanian and Lloyd Tanlu (2005). Dividend yield variable is significantly positive, indicating that investor response more to higher dividend yield announcement than to lower dividend yield announcement.

Contrary to Bessler, Drobetz and Seim (2009) and our expectation, we find that IPO dummy variable is not significant, indicating that there are no statistically significant differences between the Cumulative abnormal Returns of IPO firms and Cumulative abnormal Returns Non-IPO firms.

Table 4.2 Average abnormal return of IPO firms

T-test (IPO firms)				
DAY	AAR	Std. Deviation	t-test	Prob.
Day -2	0.318	1.890	1.398	0.167
Day -1	0.124	3.441	0.299	0.766
Day 0	0.578	2.508	*1.913	0.060
Day 1	0.731	2.807	**2.164	0.034
Day 2	0.628	2.041	**2.555	0.013

Table 4.3 Average abnormal return of Matched firms

T-test (Matched firms)				
DAY	AAR	Std. Deviation	t-test	Prob.
Day -2	0.077	1.901	0.336	0.738
Day -1	0.197	2.465	0.662	0.510
Day 0	-0.595	2.494	*-1.981	0.052
Day 1	0.111	2.877	0.321	0.749
Day 2	0.012	2.310	0.042	0.966

Table 4 and Table 5 report the cumulative average abnormal returns (CAARs) over the event period (-2 to +2) of IPO firms and Non-IPO firms respectively. As expected, we report statistically significant positive cumulative average abnormal return (CAARs) for the IPO firms but we evidence no significant cumulative average abnormal return around dividend for the Non-IPO firms.

CHAPTER 5 CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusion

We have two purposes in this paper. First purpose is to examine whether firms that initiated a dividend have better long run stock performance than non-payers by employing multivariate methodology. Our findings support the hypothesis that dividend initiating firms perform significantly better than non-initiating firms 3 years after listed date. We measure firm performance by stock returns the presence of control variables in the regression was provided in the prospectus. Our findings therefore suggesting that the initial dividend decision is a corporate initiative that has a positive impact on IPO long run which is consistent with the findings of Janice, How and Peter (2011).

Our second purpose is to examine investor reactions to the dividend initiation of IPO firms and dividend announcement of Non-IPO firms by employing event-study and multivariate methodology. We measure investor reactions by 2-day around dividend announcement date cumulative abnormal return. We evidence significantly positive average abnormal return(AAR) on the dividend initiation date and significantly positive cumulative average abnormal returns(CAAR) on the event date and two consequent date after the event date of the IPO firms, consistent with the Asquith and Mullins (1983) and Healy and Palepu (1988). However, we evidence significantly negative abnormal returns on the dividend announcement date of the Non-IPO firms and significantly positive cumulative abnormal returns for the Non-IPO firms. Results do not support our hypothesis; there are no statistically significant differences between cumulative abnormal returns (CAR) of IPO firms and cumulative abnormal returns of Non-IPO firms, indicating that investors do not response to dividend announcement of IPO firms more than they do to the dividend announcement of Non-IPO firms.

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