THE RELATIONSHIP BETWEEN BLOCK HOLDERS AND FIRM DIVIDEND POLICY

Gholamreza Zandi

Associate Professor, Graduate School of Business, SEGi University, Malaysia

Alireza Shahabi

Ph.D. Candidate, Accounting Department, Faculty of Management, University of Tehran UT, Alborz

Campus, Alborz, Iran

ABSTRACT

Block holders have significant impacts on the firm's policies, especially strategies regarding the payout policy. The purpose of this study is to investigate the relationship between ownership structure and firm dividend policy considering the role of block investors in the companies listed on the Tehran Stock Exchange (TSE). We selected 37 public listed companies with state block holders and match them with almost similar companies with non-state block holders in 2012. Running a multiple regression, we found that there is a positive relationship between both types of block holders and firm's dividend policy. These results support the tax-based hypothesis.

Keywords: Payout policy, Firm dividend, Block holders, Tax-based hypothesis.

1. INTRODUCTION

Corporate Governance is the mechanism of directing and managing a company and its related affairs in order to increase the level of the company success and enhancing the firm accountability with the objective of considering long-term stockholders and other stakeholders (Cheah and Lee, 2009). This definition of Corporate Governance is broad enough to compromise all aspect of the firms especially when it comes to excavate term "related affairs". It covers cash flow and cash managing policies. However a major corporate policy is dividend payout decisions (Kouki and Guizani, 2009).

Dividends are rewards to investors as a return of their investments and risk tolerances and it depends on different factors (Ali Shah *et al.*, 2011). According to Kouki and Guizani (2009) such items can be firm profitability level, investment opportunities, firm size and pressures from shareholders. Although the latter item plays a key role in firm dividend policy making, it is less researched among all and calls for more attention. Nevertheless it will be strengthen when the

capital structure of the firm consists of large investors which may have a dichotomous effect on dividend policy.

Any decision regarding the company dividend pay outs might influence the firm value in the market. Consequently the interests of the investors will be affected. However different investors have different motivation in their portfolio selection. Generally the motivations are classifiable into two categories, short term against long term motivations. investors whose primary purpose in investing is short term are more interested in higher dividend pay outs by the firm, while inversely those with long term motivations prefer more retained earnings.

A careful overview on the literature reveals two hypothesizes in firm dividend era. First is agency cost-based hypothesis and the next is tax-based hypothesis. Based on the agency cost-base hypothesis presence of the block holders have a better monitor on managers and consequently mitigate the agency problems (Shleifer and Vishny, 1986). Therefore, firms with higher level of concentrated ownership will be less concerned about the agency problems and would pay fewer dividends (Han *et al.*, 1999). This is because of the theory that dividend payout is an alternative for governance problems in the firm (Kouki and Guizani, 2009) and subsequently a way in reducing agency costs is dividend policy. Ali Shah *et al.* (2011)   judge that the underlying impetus for this reasoning is once a company pays out dividends there is a lower level of cash to be abused by the managers in personal projects and in improper investments as well. Inversely based on the tax-based hypothesis firms with higher block holder investors pay more dividend since a part of their income resulted from dividend is tax-exempted. Thus from the tax-based perspective large shareholders are more interested in receiving more dividends (Robin, 1991).

Large shareholders in the Tehran Stock Exchange (TSE) are not beyond two main groups. First major group is state block holders consists of institutional state investors. While the next group is non-state block holders divided to individuals and public listed firms' institutional investors. While Iranian market is experiencing a privatization program it is expected that state block holders have shorter purpose and therefore their preference is more likely to match with higher dividends. In the same time the state investors are not concern about the tax and related exemptions, it is expected to prefer more retained earnings and less dividends. However estimates about non-state large investors i.e., individual large holders and public listed firms are reverse compared to those of governmental investors.

Hence the purpose of this study is to investigate the relationship between ownership structure and firm dividend policy with respect to existence of block investors among the firms listed on the main board of TSE. The reminder of the article is structured as follows. Section II presents a review on the related literature. Section III describes research methodology and data. Section IV discusses the empirical results while section V concludes the paper.

2. LITERATURE REVIEW

Results from presence of large share holders are mixed and dichotomous. While some studies indicate firm dividend policy positively affected by large and institutional investors (Han *et al.*, 1999; Xiya, 2011), others believe there is no significant link between existence of large investors and dividend policy (Weng and Shinong, 2007). Meanwhile Kouki and Guizani (2009) report a negative correlation between institutional ownership and dividend policy.

Xiya (2011) divide institutional investors into two major groups as generalized investors and special investors compromising securities investment funds, securities agency, trust and investment companies and a few more. Focusing on the latter group, Xiay (2011) studied the effects of institutional investors on Chinese firms' dividend policy before and after share reform. Although in both period firm dividend policy was affected by institutional ownership, after share reform the relation got more significant.

Investigating the malicious faction of stockpiled funds, Weng and Shinong (2007) document that although there is no direct association between large shareholders and firm dividend policy, inspection of institutional investors can play a governance role and monitor the dividend distribution process. They claim the higher the ownership of institutional investors, firms are less likely to send malicious. In a similar study, Li and Wang (2007) judge although it is not significant relation, institutional investors' active participation in governance process may moderate the dividend policy of the firm.

Recent idea stems from the agency-cost hypothesis where Han *et al.* (1999) indicate institutional investors may employ market experts to evaluate management efficiency. Hence in presence of large investors, managers are unwilling to use dividend as a means of reducing agency costs. Kouki and Guizani (2009) also argue state large investors play a significant negative role in dividend payout policy. Their results illustrate that ownership structure approach is highly related to the perception of firms' dividend policies. They found other things being the same, large size firms are less willing to pay out dividends.

However, the dividends payout expectations based on the tax-based hypothesis are different (Han *et al.*, 1999). Under this hypothesis institutional investors are more likely to receive higher dividends and less retained earnings due to institutional block holders' income are mainly tax-exempted and consequently they are not concerned about their tax costs.

In Iran, tax regulations exempt 80 percent of dividends income. Therefore, institutional shareholders whom carry block shares may prefer more dividend payouts than retained benefits. Hence, it is assumed the higher the institutional investors, the higher the dividend payouts. Supporting from the government, the institutional investors may invest in firms which are more likely to pay out more dividends. Therefore, firms' willingness to pay out dividends is eclipsed by the presence of institutional investors in their capital structure.

Due to the controversial role of large investors in the dividends payout policy, this study will explore the effect of governmental block holders on the dividend policy in a capital market where companies listed on the TSE are mainly in the hands of institutional large investors.

3. RESEARCH METHODOLOGY

Present study aims to investigate the effects of large investors both governmental and non-governmental on dividend policy of public traded firms listed on the Tehran Stock Exchange (TSE) over 2006 to 2010. In compliance with Kouki and Guizani (2009) a multiple regression analysis is used to examine relationship between presence of institutional investors and corporate dividends. Following parts provide more details on data and research model.

3.1. Research Data and Sample

To be deserved for our sample, firms must be listed on the TSE. This research focuses on the firms' data over 2012. However to have more credible variables the trend of the variables were taken into consideration. The sample consists of two groups of firms having institutional ownership in their capital structure. For the first group we have selected 37 firms compromising state institutional ownership. While a group of 38 firms with no state institutional ownership was also selected. We tried to have similar groups and therefore matched each firm in first group with another company in the same industry and the same size as much it was possible. Ownership data were extracted from corporate annual disclosure. Firms listed on the TSE are required to disclose the capital structure and large investors in their annual reports.

3.2. Methodology and Research Model

After a deep study on influential factors which determine dividends in TSE, we followed a combination of two models. The first one is suggested by Han *et al.* (1999) and the second was proposed by (Kouki and Guizani, 2009). Based on the above discussion therefore, we propose the following as the effective dividend model in TSE.

$$Div_{it} = \alpha_0 + \alpha_1 \, INT_{it} + \alpha_2 \, ISD_{it} + \alpha_3 \, FCF_{it} + \alpha_4 \, NP_{it} + \alpha_5 \, LEV_{it} + \alpha_6 \, SIZE_{it} + \varepsilon_{it}$$

Where:

Div_{it}: which is dependent variable reflects dividend per share which is compulsorily disclosed in annual reports in TSE.

Independent variables however are as follows:

INT_{it}: institutional ownership percentage for firm i in period t; institutional ownership may mitigate firm's agency costs and consequently reduce the dividend pay outs.

ISD_{it}: insider ownership percentage for firm i in period t; insider owners may use their information asymmetry in order to influence the level of dividend.

FCF_{it}: available funds before investment decisions which includes net income plus depreciation and interest expenses and then minus required capital expenditures. This calculation is

based on Crutchly and Hansen (1989)'s definition. The more available FCF, the more dividends pay out.

NP_{it}: net profit of the company *i* in the period *t*.

LEV_{it}: this variable is calculated by dividing long term debt to book value of equity. Under positive accounting theory and based on Jensen and Meckling (1976), when the firm's leverage increase, the firm is more close to the constraints. Additionally leverage can perform as a controlling means to reduce agency costs. Therefore a negative relation between leverage and dividend level is expected.

$SIZE_{it}$: this variable is defined as natural logarithm of assets and plays a controlling role in the equation. Effects of firm size on dividend are mixed. Some scholars unlike the others believe firms with higher assets pay more dividends.

4. EMPRICAL RESULTS

Table 1 shows the descriptive statistics. The table consists of two major sections. Group 1 on the left side and group 2 on right side show data regarded to firms with and without state ownership respectively.

Looking at the means revealed that our two groups are almost equal since there is no significant difference between the means. Therefore we can easier compare the groups. In general firms without state ownership have higher mean of institutional owners compared to firms with state ownership and meanwhile the former group members have higher mean of dividend compared to the attendance of the latter group. However firms with the presence of government in their capital structure have higher mean of net profit. Other statistics also indicate that the firms with state ownership are normally larger size than firms located in the other groups.

Table-1. Descriptive statistics

	Selecting only cases for which STATOWN = State Ownership			Selecting only cases for which STATOWN = Non-State Ownership		
	Mean	Std. Deviation	N	Mean	Std. Deviation	N
DIV	7.3300E2	837.48927	37	7.7832E2	1234.45138	38
INT	66.2205	19.37479	37	69.0800	22.53534	38
ISD	2.0344	4.75747	37	.9672	2.68444	38
FCF	2.4216E5	1.03144E6	37	2.5775E4	32598.09199	38
NP	4.0523E5	7.35749E5	37	1.2105E5	1.11162E5	38
LEV	.2038	.27871	37	.2537	.30830	38
SIZE	13.6564	1.51362	37	12.8952	.83445	38

The Pearson correlation matrix shows that there is no concern about the issue of multicollinearity among the independent variables. If the correlation of the independent variables is more than 80%, it requires more attention to examine the issue of replicating the variables which does not exist in our tests.

Results of running the multiple regression analysis for the companies with the presence of state owners in their capital structure are presented in table 2. Multiple correlation coefficient R

indicates that the correlation between our observed model and our predicted model is almost 59% which shows how fit the model is. In other word around 60 percent of the observed model is matched with what had been predicted before. Nevertheless, Determinant coefficient R^2 illustrates that our model can predict around 35 per cent of the outcomes. In other words, 35% of the variation in dependent variable can be explained by changes in independent variables. To check about the outliers we have run the Durbin-Watson statistic. According to Field (2009) while the recent statistic is between 1 and 3, the occurrence of each error is not affected by other errors which is true here as the Durbin-Watson statistic is equal to 2.090 which in other word indicates that the variation of the residuals are normal.

Table-2. Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson Statistic
1	.588	.346	.215	1.42406	2.090

To check the validity of the predicted model ANOVA table also has been provided. Based on the results, p-value of the model is 0.035 we rejected the null hypothesis and concluded that at least one of the predictors is significant. Therefore almost 35 percent (34.6%) to be exact of the dividends policy in the firms with state institutional investors can be explained by this model. However in order to know the effect of individual independent variables, and also the strength of each exogenous variable in predicting the endogenous variable, the coefficient tables should be taken into consideration.

Table-3. Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	**Std. Error**	**Beta**	**t**	**Sig.**
1	Constant	4.751	0.008		1.353	.001
	INT	1.763	0.026	.299	1.742	.009
	ISD	25.719	30.282	.146	.849	.402
	FCF	.001	.000	-.971	-3.221	.003
	NP	.002	.000	1.349	3.342	.002
	LEV	-284.950	561.384	-.095	-.508	.615
	SIZE	-204.858	132.776	-.370	-1.543	.133

The above table illustrates that in the firms with state institutional investors the only predictors that may contribute the model are institutional owners, free cash flows and net profit. However among all the strongest determinant of dividend policy is net profit, followed by free cash flows.

The positive relationship between presence of institutional investors and the firm's dividend which, is consistent with Han *et al.* (1999) and non-consistent with (Kouki and Guizani, 2009), is an indication of the tax-based hypothesis i.e. there is no concern of agency-based problems in the

presence of institutional owners. However compared to the next group with non-state owners there are still some signs of agency problems among the firms with the state ownership. Therefore this results support the view that institutional investors prefer more dividend income than capital gain. Especially while the Iranian government is under the privatization program, then state owners cannot undertake long term objectives. This approach may also be considered as a toll by the state agents to show the high profitability of the firms in order to draw a good image of the firm in the market where those firms are planned to be sold.

The results also show that there is no significant association between the insider ownership and the firm dividend payout. Therefore based on the results insider ownership in the firm with state institutional ownership has no impact on the firm dividends. When insider ownership has no statistically significant effect on dividends, Han *et al.* (1999) judge that agency-cost hypothesis is not supported.

In the next group which includes firms with non-state institutional owners, however independent variables can explain around 45 percent of the variation in firm's dividend. As illustrated in table 4, the multiple correlation coefficient MCC for this group is more than 67% which indicated that the observed and predicted model are correlated in the scale of 67.4 percent. Furthermore, the Durbin-Watson statistic shows the independence of error occurrence among the residuals.

Table-4. Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson Statistic
1	.674	.455	.350	1.81700	2.193

In comparison, the predictive items in the second group have more ability to determine the changes in the dependent variables than the independent variables in the first group. Although both models are statistically important, the explanatory power of the model for the companies without state institutional owners is nearly 10% more than the explanatory power of the model for the firms with the state institutional investor.

The table of analysis of variance also revealed that at least one of the exogenous variables influence the endogenous variables, since the p-value in ANOVA table is 0.003 which is lower than 5%. However to extract the model it is required to recognize the effect of each independent variables. Table 5 presents the information regarding the coefficients.

In addition with the presence of institutional investors, free cash flow and net profit, the leverage also has statistically significant effect on the dividends. However the relationship between the leverage and dividends is negative that is the higher leverage, the lower dividend. The high leverage represents the higher amount of obligation that a firm has and hence the firm's priority is with settling down the liabilities first. Therefore, in companies with high leverage, managers try to reduce the dividends to have enough funds for payments of their debts.

In the firms with non-state shareholders, the existence of institutional owners affects the firm's dividends like as the firms with state owners. However, the state institutional owners have greater power to change firm's dividend compared to non-state institutional owners. The reason behind the phenomenon is that the state owners have a far higher legal power in the society and they can abuse their legal power either directly or indirectly to force the managers and consequently change the firm's dividends policy.

Interestingly in both groups of the firms there is a negative relation between the free cash flow of the firm and the level of firm's dividends which is not matched with Kouki and Guizani (2009). In other words the more available funds that the firm has, the lower amount of dividend will be distributed. Jensen (1986) claim that if the firm has cash more than what is required to finance the projects, will pay more dividend or retire debts in order to mitigate the agency cost of cash flow. However our results with negative relationship are reverse which might be due to the fact that whatever more cash is available can pursue managers to invest in a new additional project to increase the shareholders' wealth and this motivation will never be stopped. Thus, this motivation may hinder managers in distributing high dividends and save the funds for their target investment project.

Companies' financial leverage of the second groups of firms has statistically significant relationship with the dividends payout. This result is consistent with (Kouki and Guizani, 2009). As it can be predicted the association of leverage and dividend is negative indicating the more debt that a company has the lower dividend will pay and this is due to debt covenants. In other word firms with high leverage have high liabilities and probably higher bond; hence they prefer to fulfill their obligation regarding the bonds and attached interest instead of paying out dividends (Kalay, 1982). Table 5 below illustrates the coefficients of the independent variables and the model intercept as well.

Table-5. Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	Constant	2.422	2.665		1.718	.009
	INT	16.364	.101	.295	2.020	.042
	ISD	33.381	71.211	.073	.469	.643
	FCF	-.013	.007	-.345	-1.811	.009
	NP	.010	.002	.910	4.406	.000
	LEV	-1.193	.167	-.414	-2.825	.008
	SIZE	-507.350	274.544	-.343	-1.848	.074

The insider ownership and size of the company in both groups of companies have no effect on the dividends level. Therefore the insider parties who own the slots of companies shares have no effect on the firm's dividend level. Generally, based on the standardized coefficient of beta the most significant determinant of the firm's dividends level is firm's net profit.

5. CONCLUSION

The main objective of this article is to examine the effect of institutional investors on firm's dividend policy among the Iranian listed companies. Institutional investors are either state investors or non-state investors in Tehran Stock Exchange. We have selected two groups of firms. The first group are 37 firms with the presence of state owners in their capital structure while the second group formed by 38 almost similar firms with non-state block holders.

We were considered two related hypothesizes i.e. agency-cost hypothesis and tax-based hypothesis. According to the former there is a negative association among block holders and firm's dividends. However based on the latter hypothesis the mentioned relationship is positive. We found that the block holders positively affect the firm's dividend level regardless of whether they are state block holder or non-state one. However the state owners have a greater impact on firm's dividend. In other word we have found evidences for the tax-based hypothesis. Therefore in the Iranian firms, block holders are more interested in receiving dividend rather than capital gains. Preferring dividend which is a short term against capital gain that is a long term view may be due to the uncertainty of the investors about the future of their investment in an economically unstable environment.

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