Communicating Private Information to the Equity Market before a Dividend Cut

Posted by R. Christopher Small, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Saturday July 13, 2013

Editor’s Note: The following post comes to us from Thomas Chemmanur, Professor of Finance at Boston College, and Xuan Tian of the Department of Finance at Indiana University.

How should firms communicate with the capital market in advance of corporate events? If firm insiders receive some private information that their firm may perform poorly in the near future, should they inform investors about this adverse information as soon as possible, or should they wait to release this information? Further, is the manner of communication by firms related to their performance in the short or the long run?

A concrete example of the above situation is that of a firm contemplating a dividend cut in the future. Firm insiders may have received some private information about a potential decline in future earnings, or that the current level of dividends is unsustainable for some other reasons (e.g., a change in the competitive environment requiring it to retain more cash within the firm). Under these circumstances, should insiders release a statement to the market that they are reviewing the firm’s dividend policy, and indicating that there is a possibility of a dividend cut (in other words, “prepare” the market)? Or should they wait till they in fact decide to cut their firm’s dividends before making any announcement?

While there have been several theoretical as well as empirical analyses of dividend signaling (see, e.g., Bhattacharya (1979), John and Williams (1985), and Miller and Rock (1985) for theoretical models), unfortunately, there has been no systematic empirical analysis so far in the literature that provides guidance to decision makers regarding the right way to communicate adverse private information to the equity market. The objective of this paper is to fill this gap in the literature by providing the first empirical analysis of a firm’s choice between preparing and not preparing the market before a dividend cut and the consequences of market preparation.

In our paper, Communicating Private Information to the Equity Market before a Dividend Cut: An Empirical Analysis, forthcoming in the Journal of Financial and Quantitative Analysis, we address
the above issue by examining several questions in this paper. First, we analyze the characteristics of firms that prepare the market before a dividend cut versus those that do not do such market preparation. Second, we examine the implications of a firm preparing or not preparing the market for the announcement effect on the market preparation days as well as on the day of the dividend cut announcement. Third, we analyze how a firm preparing or not preparing the market relates to its stock return volatility after the dividend cut. Finally, we examine how operating performance, dividend payment, institutional equity holdings, and stock returns after the dividend cut differ across prepared and non-prepared dividend cutters. The results of the above analyses help us to better understand how firms optimally choose to communicate negative private information to the equity market before a potential dividend cut.

In a recent paper, Chemmanur and Tian (2012) develop a signaling model that analyzes a firm’s decision regarding whether or not to prepare the market before a dividend cut. They consider a setting in which there are three types of firms with only insiders observing firm types to begin with, i.e., firm insiders have private information about long-run intrinsic value. High intrinsic value firms have no significant chance of being in short-run financial difficulties and have high long-run growth prospects; medium intrinsic value firms have a significant chance of being in short-run financial difficulties (and therefore having to cut their dividends) but have high long-run growth prospects; and low intrinsic value firms have a significant chance of being in short-run financial difficulties (and having to cut their dividends) and have low long-run growth prospects. In the above setting, Chemmanur and Tian (2012) show that, in equilibrium, high intrinsic value firms do not prepare the market for a dividend cut at all; medium intrinsic value firms prepare the market with a high probability; and low intrinsic value firms prepare the market with a significantly lower probability than medium intrinsic value firms. Note that preparing the market is the mechanism through which medium intrinsic value firms separate themselves from low intrinsic value firms in the event of a dividend cut: the signal is made credible due to the fact that market preparation separates them from high intrinsic value firms, causing them to suffer a negative stock market reaction on the market preparation day. We rely on the implications of Chemmanur and Tian (2012) primarily to generate hypotheses for our empirical tests. We will refer to the above theory as the “signaling through market preparation” theory.

While we are not aware of any formal model other than that of Chemmanur and Tian (2012) which analyzes market preparation by firms before dividend cuts, we propose an alternative to the above theory, which we will refer to as the “stock return volatility reduction” theory. The basic assumption underlying this theory is that there is no difference in long-run intrinsic value between prepared and non-prepared dividend cutters, and market preparation is simply a means adopted by some firms to split up the release of information over multiple days, in an attempt to reduce their stock return volatility in the months immediately after a dividend cut. While some of the
predictions of this alternative theory are similar to those of the signaling through market preparation theory, its other predictions are different from those of the signaling theory, allowing us to empirically distinguish between the above two theories.

Using a hand-collected data set of dividend cutting firms which allows us to distinguish between firms that prepared the market before a dividend cut and those that did not do so (we are also able to identify cases of firms that prepared the market multiple times), we test the hypotheses generated by the above two theories and develop a number of new findings. First, we find that firms with poorer current profitability but higher long-term growth opportunities are more likely to prepare the market before potential dividend cuts. We also find that firms are less likely to prepare the market during years of economic recessions when long-term growth prospects are poorer. These findings are consistent with the predictions of the signaling theory.

Second, we find a significantly negative cumulative abnormal stock return (CAR) for firms preparing the market on the first market preparation day. A firm preparing the market, on average, experiences a -3.2% CAR in the [-1, +1] event window around the first market preparation day. However, we do not find significant CARs in the subsequent market preparation days. Meanwhile, the announcement effect of firms cutting dividends after market preparation is indeed less negative than that of firms cutting dividends without such market preparation. The announcement effect of a prepared dividend cutter is less negative by about 5.1% than that of a non-prepared cutter in the [-1, +1] event window around the dividend cut announcement day. Even combining the stock market reactions of prepared dividend cutters (the sum of market reactions on all the market preparation days and the dividend cut announcement day) and comparing those with the announcement effects of non-prepared dividend cutters, prepared dividend cutters still experience a 3.4% less negative CAR than non-prepared dividend cutters in the [-1, +1] event window, suggesting that prepared dividend cutters are not simply “splitting up” the negative news over separate event days. The first two findings above are consistent with the predictions of both the signaling theory and the volatility reduction theory. However, the last finding is consistent only with the signaling theory and not consistent with the volatility reduction theory.

Third, we find that the stock return volatility of prepared dividend cutters is lower than that of non-prepared dividend cutters in the quarters subsequent to a dividend cut. This finding is consistent with the predictions of both the signaling theory and the volatility reduction theory. Finally, we show that the long-term operating performance of prepared dividend cutters is significantly better than that of non-prepared dividend cutters. We also find that prepared dividend cutters increase dividends more than non-prepared cutters in the years following a dividend cut. Further, in the years after a dividend cut, the percentage ownership by institutional investors in prepared
dividend cutters is significantly larger than that in non-prepared dividend cutters, and the number of institutional investors investing in prepared dividend cutters is also greater than that in non-prepared cutters. Finally, we show that the long-term stock return performance of prepared dividend cutters is better than that of non-prepared dividend cutters. The above findings provide support for the signaling theory but not for the volatility reduction theory.

Overall, what do we learn from our empirical analysis about the right way for firms to communicate adverse private information to the equity market before a dividend cut? Our analysis suggests that it may be optimal for firms in temporary financial difficulties but with better long-term growth prospects to signal this to the equity market by preparing the market for a possible dividend cut. Further, our comparison of long-term operating, dividend payment, institutional equity holdings, and stock return performance of prepared versus non-prepared dividend cutters after dividend cuts suggests that market preparation before a dividend cut is not really a way for firms to reduce stock return volatility by splitting up adverse information over time.

This is the first paper in the literature that empirically examines a firm’s strategy of market preparation before adverse corporate events in general, and a dividend cut in particular. However, there is a small empirical literature on the timing of dividend announcements, which is related to our paper: see, e.g., Kalay and Loewenstein (1986), who show that late announcements of dividends are disproportionately associated with bad news (dividend reductions). Our paper is also distantly related to the large literature analyzing the relation between dividend changes and omissions and subsequent operating performance, as well as the literature on the information content of dividend changes (see, e.g., Watts (1973), Aharony and Swary (1980), Kalay (1980), Asquith and Mullins (1983), and Kalay and Hanjincolaou (1984)).

The full paper is available for download here.