

# Dividend Decapitalization And Financial Performance Signals

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## Abstract

*This study examines the stock price response to dividend announcements which include a return of capital to owners. The continuation of an amount previously distributed exclusively from earnings is effectively a dividend reduction. Dividend cuts have been shown to provide an unfavorable signal to investors. Empirical results indicate that the market does not infer unfavorable subsequent financial performance signals from "decapitalization" dividends.*

## Introduction

The measurement of stock price response is used to determine whether new information is contained in announcements of dividend policy changes. These policies are established by managers, based on their expectations of subsequent earnings. The effectiveness of dividend policy revisions as signals of financial performance is best when the announcement contains information that is not otherwise made available to investors.

Managers have several constraints on their channels of communication with investors, including cost, timeliness, and a desire to avoid unnecessary disclosure of the details of operation. Changes in dividend policies have been shown to efficiently convey information that affects shareholders' expectations of market risk and return opportunities. Announcements of unanticipated dividend revisions contain information that is rapidly disseminated to investors by the financial press and provide insight for investors about expected earnings of the firm and market returns.

Some firms have been observed to maintain their dividend payout level by a payout policy which includes a return of capital. A likely motive is the reluctance of managers to reduce or omit dividends, therein presenting a signal of unfavorable financial conditions to the investment community. Continuation of a payout amount in this manner is most often observed among firms which have a tradition of dividend stability, such as those in the electric utility industry.

There are several reasons that the market response to announcements of dividends which include the return of capital might be different from the market response when dividends are paid exclusively from earnings. One possible aspect of dividend decapitalization is the

implication that current financial performance and earnings are alone insufficient to maintain an established payout level. If this is known, the market response might be similar to that which is observed in conjunction with announcements of dividend reductions. The market could also infer substandard subsequent financial performance from decapitalization announcements. Analysis of the relationship is the purpose of this study.

It has been demonstrated that there must be a general revision of investors' expectations about future earnings opportunities before a market reaction can be observed. Unexpected permanent changes in dividend policy are shown to serve as an unambiguous signal to investors. Short-term and temporary indicators do not provide investors with insight about long-term performance. A similar type of dividend distribution is examined by Brickley (1983). He finds that Specially Designated Dividends (SDD) do not contain sufficient long-term performance information to cause a significant market reaction.

This study examines the effectiveness of dividends which include the return of capital as conveyers of new information regarding financial performance. No evidence is found that dividends which include a "decapitalization" component provide the negative signals which are typically associated with dividend reductions. The findings are similar to those for announcements of unchanged dividends, which are examined by Aharony and Swary (1980) and Woolridge (1982).

The remainder of this paper is organized as follows: Section II describes relationship(s) between dividend changes and shareholder value which Section III provides a description of the sample of dividend decapitalization along with the methodology used to estimate

changes in shareholder wealth. Section IV describes results, and a brief summary and suggestions for future research is provided in Section V.

### Theory and Evidence

Empirical analysis has indicated that, under conditions of information asymmetry, changes in dividend policy affect stock prices and shareholder wealth. Stock price reaction to these signals is generally held to be contingent on a revision of investors' expectations about earnings potential.

The market response is prompted by the size and type of policy change and investors' inferences about earnings. Recent studies of dividend signals are directed toward significant increases, decreases, omissions, and initiations. Initial and increased dividends are shown to convey optimism about future profitability and to provide abnormal positive returns to owner (see Aharony and Swary (1980), Asquith and Mullins (1983), Benesh, Keown and Pinkerton (1984), Eades, Hess and Kim (1985), Born, Moser and Officer (1988), and Richardson, Sefcik and Thompson, (1986). Decreased or deleted dividends convey pessimism about future profitability, and are associated with a decline in returns to shareholders (e.g. Eades, Hess and Kim (1985); and Kalay and Lowenstein (1986). In general, there is evidence of a direct relationship between dividend changes and stock price reaction although that reaction is not monotonic (see Born, Moser and Officer (1988).

When dividend payout policies remain unchanged, there is no consistent market response. This is shown to be true in samples of dividend announcements which succeed forecasts of earnings as examined by Aharony and Swary (1980). They find the abnormal returns for dividend announcement on days -1 and 0 are -0.03% and 0.03% when dividend announcements precede the earnings forecast. When dividend announcements follow earnings forecasts, the excess returns are -0.05% and -0.05%. Woolridge (1983) observes similar insignificant results for the days adjacent to no change in payout policy. However, Eades, Hess and Kim (1985) find significant market adjusted excess returns of 0.013%, 0.047% and 0.058% for days -1, 0 and +1. Following periods of dividend stability, an observed market reaction to dividend policy announcement is held as evidence of both a conveyance of new information and a revision of investors' expectations about subsequent financial performance. It is generally held that unanticipated revisions serve as unambiguous signals of their expectations.

The various dividend policy revision types outlined above have been shown to reflect managers' optimism about future return performance. The evidence suggests that dividend changes of any size are associated with

corresponding significant market responses. Dividend announcements which apparently do not alter investor expectations are (1) the continuation of previous dividend policy and (2) the announcement of specially designated dividends. Analysis of the market response coinciding with these announcements indicates that they contain no new information about subsequent earnings performance.

### Sample and Method

The purpose of this study is to evaluate the share price response of a sample of firms that announcement dividends that contain a return of capital. Dividends which consist wholly or partially of the return of capital should provide a unique signal to investors. If the market recognizes that the dividend contains an equity supplement to the earnings distribution, the share price response should be similar to that which is observed from a dividend reduction. We hypothesize that the dividend which is paid from combined earnings and capital accounts should provide the same signals of subsequent financial performance that is contained in announcements of dividend reductions. If this is indeed the case, the effect will be indicated by significant negative excess returns. In the alternative, a lack of share price response to dividend announcements could be interpreted as a failure of the market to recognize that the dividend is maintained, in part, by the distribution of capital. The share price response could be similar to that observed when there is a dividend continuation announcement.

### Sample Selection

The dividend signaling hypothesis suggests that stock prices adjust when significant changes in dividends convey new information about expected earnings. The following conditions for the period 1963-1988 are imposed for selection of the samples of firms that distribute dividends which include the return of capital to shareholders:

1. The firm must have financial information available from the Center for Research in Security Prices (CRSP) Master file which identifies the type of accounts from which the dividend distributions are made. There must be sufficient daily returns data available from the Center for Research in Security Prices (CRSP) daily returns file surrounding the dividend announcement date.
2. The CRSP Master file dividend disbursement code must include a component labeled "Ordinary dividend, Cash United States Dollar, Quarterly, Return of Capital". In addition, there must be a component which represents the distribution of earnings: "Ordinary dividend, Cash United States Dollars, Quarterly, Normal taxable at same rate as divi-

dends".

3. The return of capital dividend must follow a period of dividends which are paid entirely from earnings.
4. The dividend "decapitalization" must be confirmed by additional sources. Historical financial statement information is used to remove from the sample those firms which paid the dividend from other fund sources.
5. There must be no indication found in the financial press that the forthcoming dividend will include a component which is paid from a capital account.

Many of the firms in the sample are in the electric utility industry. For these companies the typical dividend pattern is relatively constant growth. The firms in this study had a previous history of increasing dividend payments which were paid entirely from earnings.

The well-known market model is used to measure abnormal returns:

$$R_{j,t} = a_j + B_j (R_{mt}) + e_{jt}$$

where

$R_{j,t}$  is the daily return for security  $j$  at time  $t$ ;

$R_{mt}$  is the CRSP value-weighted index;

$a_j$  is the intercept;

$B_j$  is the slope coefficient;

$e_{jt}$  is an error term.

These parameters are estimated during a 50-day observation period prior to the dividend announcement. This period extends from day -60 until day -11 relative to the announcement date. The parameters become estimates of the anticipated return characteristics of the event period. The expected returns are then compared to the observed daily return of the event interval. This estimation interval begins immediately following the previous quarter's dividend announcement.

A significant response implies that the market has responded to the information which is contained in the dividend announcement. The strength of the market reaction is indicated by the  $z$ -statistic that the average daily excess returns are equal to zero. This test is conducted for the 21-day interval extending 10 days before and after the announcement. The specific dividend revision date is the two-day period at the time the announcement is published in the financial press (day 0) and the preceding date (day -1). The two day period will include the effect of any trading activity that is prompted by information about the announcement that occurs immediately prior to publication. (for a detailed description of the event methodology see Brickley (1983).

## Results

The mean dividend of firms which are identified as having maintained a previous dividend payout amount by distributing funds from a capital account is reported in Table 1.

TABLE 1  
DISTRIBUTION OF SAMPLE FIRMS WITH  
EQUITY DECAPITALIZATIONS (1963-1989)<sup>1</sup>  
N=46

|          | Number of Firms | Mean Dividend |
|----------|-----------------|---------------|
| 1963     | 2               | \$ 0.41       |
| 1964     | 0               | -             |
| 1965     | 1               | 0.40          |
| 1966     | 1               | 0.32          |
| 1967     | 3               | 0.38          |
| 1968     | 3               | 0.25          |
| 1969     | 2               | 0.52          |
| 1970     | 1               | 0.28          |
| 1971     | 3               | 0.32          |
| 1972     | 3               | 0.41          |
| 1973     | 2               | 0.44          |
| 1974     | 5               | 0.41          |
| 1975     | 3               | 0.55          |
| 1976     | 1               | 0.30          |
| 1977     | 1               | 0.47          |
| 1978     | 2               | 0.39          |
| 1979     | 7               | 0.45          |
| 1980     | 3               | 0.48          |
| 1981     | 2               | 0.43          |
| 1982     | 0               | -             |
| 1983     | 1               | 0.40          |
| TOTAL 46 |                 | MEAN \$ 0.40  |

1

The years 1984-1989 were examined for distributions of capital, however, no firms met the screening criteria outlined above

A total of 46 firms are identified as distributing capital in the form of dividends. From Table 1 there appears to be no time clustering of dividend decapitalizations. The smallest quarterly dividend decapitalization was \$0.06 with the largest being \$0.64 per share. The mean quarterly decapitalization dividend during the sample period was \$0.40 per share. The results of the share price response are presented in Table 2.

Table 2 presents the daily mean excess returns, the cumulative excess return, and the  $Z$ -statistic.

Observation of significant return responses indicates that there is no consistent modification of investors' perception of firm value. The mean returns for days -1 and 0 are .04% and .17% respectively. Cumulative excess returns, although consistently positive in the pre-announcement periods, are relatively small and insignifi-

**TABLE 2**  
**MARKET RESPONSE MEASURES--PER CENT EXCESS RETURNS**  
**DECAPITALIZATION DIVIDENDS**  
**(N=48)**

| EVENT DATE | EXCESS RETURNS | CUMULATIVE EXCESS RETURNS | Z-VALUE   |
|------------|----------------|---------------------------|-----------|
| -10        | 0.1855         | 0.1855                    | 0.8447    |
| - 9        | -0.0740        | 0.1115                    | -0.3501   |
| - 8        | 0.0698         | 0.1813                    | 0.3190    |
| - 7        | 0.1653         | 0.3466                    | 0.8210    |
| - 6        | 0.0741         | 0.2724                    | 0.3283    |
| - 5        | 0.2263         | 0.4987                    | 1.0067    |
| - 4        | 0.1014         | 0.6001                    | 0.6572    |
| - 3        | 0.5652         | 1.1653                    | 1.9058 ** |
| - 2        | 0.4228         | 1.5881                    | 1.4352    |
| - 1        | 0.0434         | 1.6314                    | 0.2114    |
| 0          | 0.1730         | 1.8044                    | 0.8077    |
| 1          | 0.1627         | 1.9672                    | 0.7345    |
| 2          | 0.2107         | 2.1779                    | 1.0483    |
| 3          | -0.2621        | 1.9158                    | -1.1273   |
| 4          | -0.1579        | 1.7579                    | -0.7730   |
| 5          | 0.3125         | 2.0704                    | 1.7160    |
| 6          | 0.0498         | 2.1203                    | 0.2515    |
| 7          | -0.1421        | 1.9782                    | -0.4489   |
| 8          | -0.1886        | 1.7896                    | -0.7530   |
| 9          | -0.1565        | 1.6331                    | -0.9789   |
| 10         | 0.2278         | 1.8608                    | 0.8938    |

\*\*Significant at the 0.01 level.

cant (1.80% on day 0 and 1.86% on day +10). The lack of a consistent statistically significant mean excess market return coinciding with the decapitalization dividend announcement suggests that investors do not consistently respond to this type of dividend payout announcement in a manner that is similar to that which is observed when dividend policy is changed. The evidence is also consistent with that found by Brickley (1983) regarding specially designated dividends (SDDs). The announcement of a dividend payout continuation which contains a component paid from capital accounts does not convey new information to the market.

### Summary

The information content of dividends which include the return of capital and maintains a payout level is tested. The mean excess market return measures indicate that the response to the announcements of

dividend decapitalization is unlike that which is associated with dividend reduction. We find that dividend payouts that include a return of capital provides no discernable information to the market although the decapitalization represents a distribution of past earnings. The implication is that the combination of earnings and funds from capital accounts which together maintain a previous dividend payout amount does not serve as an unfavorable signal of financial performance to investors.

### Suggestions for Future Research

The motives for dividend decapitalizations vary widely in scope and purpose. We believe an investigation of the cross-sectional attributes of firms announcing a dividend decapitalizations such as firm size, financial performance and industry norms are important in explaining the relative lack of share price response to a

significant dividend decision. In addition, we believe dividend decapitalizations could be explained by market-wide variables such as interest rates and other macro-economic variables. ❧

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