Cost Of Debt And Dividend Policy: Evidence From The MENA Region

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ABSTRACT

How does dividend policy effect cost of debt in emerging markets? Does it increase the perceived conflict of interests between creditors and shareholders or vice versa? This paper seeks to answer these questions by documenting the relationship between dividend payout ratios and cost of debt in emerging markets. Using a dataset from the MENA region, we document a significantly negative relationship between dividend payout ratios and cost of debt during the period between 2005 and 2011. We argue that high dividend payouts reduce information asymmetries. Consequently, creditors demand lower return for providing their capital to firms. We also show that the negative relationship between dividend payout ratios and cost of debt are more pronounced in firms with higher information asymmetries. It indicates that value relevance of high dividend payout ratios is more in firms that have higher information asymmetries. These firms have scarcity of information. Therefore, whenever information environment improves, it is highly valued by creditors.

Keywords*:* MENA Countries; Cost of Debt; Dividend Policy; Emerging Markets

INTRODUCTION

An important concern faced by every investor in emerging markets is to accurately gauge the financial conditions of firms they are planning to invest in. Financial conditions of firms determine the associated risks and, therefore the required rate of returns. Investors demand lower returns for investing in firms with lower risk. However, it is not always easy to obtain true information about firms in emerging markets. Prior literature associates emerging markets with inadequate disclosure and governance mechanisms – both at the firm-level and the country-level. Claessens and Fan (2003), for instance, document that firm-level governance mechanisms are weak in emerging markets. While, Khwaja and Mian (2006) show that country-level governance structures are relatively ineffective in Pakistan – an emerging market. These and numerous other studies argue that weak enforcement of investor protection laws, presence of family control, and lax implementation of anti-director rights contribute to ineffectiveness of disclosure and governance mechanisms in emerging markets. An important implication of ineffective disclosure and governance mechanisms is that the culture of information disclosure could not evolve in these markets. Leuz et al. (2003) document that managers and insiders do not disclose true information about their firms in emerging markets. This leaves investors with an impossible task of assessing true value of firms. As a consequence, it becomes hard for them to make any informed investment decision.

This paper documents how creditors – one of the main providers of capital – can resolve information asymmetries in emerging markets. We argue that dividend policies adopted by firms have incremental information, in excess of what is present in the financial statements, for investors regarding the financial conditions of firms. Prior literature argues that high dividend payouts alleviate agency conflicts through the reduction of free cash flow available with managers (Grossman and Hart, 1980). In a related study, Jensen (1986) concludes that high dividend payouts lessen agency problems by reducing free cash flows that can be expensed on unprofitable projects. This strand of literature argues that paying high dividends reflects managements' good faith and signals low agency problems. La Porta et al. (2000) formalize the above findings in a theory known as the substitute model. The substitute model argues that dividends can substitute for the monitoring roles of the stakeholders. It posits that firms operating in relatively poor governance environments make dividend payments to establish a reputation for acting in

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the best interest of minority shareholders. High dividend payments signal to the market that there is less cash at the expense of management to expropriate. Consequently, high dividend payments are associated with lower information asymmetries. This paper argues that lower information asymmetries associated with firms paying high dividends should translate into lower cost of debt. Our arguments are consistent with Bhojraj and Senpgupta (2003) who document a positive correlation between disclosure and bond ratings and a negative relation between disclosure and bond yields. They argue that superior disclosure and governance mechanisms reduce default risk by mitigating agency costs. In another related study, Mathur et al. (2013) show that debt holders view dividends as a positive signal about firm's prospect. They argue that positive signal emanating through dividend payout results in lower bond yields.[1]

In this paper, we extend the above findings by documenting the impact of dividend payout ratios on cost of debt in the MENA region (Bahrain, Egypt, Jordan, Kuwait, Morocco, Oman, Qatar, Saudi Arabia, Tunisia, and United Arab Emirates) during the region between 2005 and 2011. Our results show that cost of debt is negatively related to dividend payout ratios. Our results are consistent with previous literature that associates high payout ratios with lower information asymmetries (La Porta et al., 2000). Lower information asymmetries reduce the risk faced by creditors. We argue that lower risk faced by creditors translates into lower required return (Blom and Schauten, 2008; Farooq and Derrabi, 2012). Interestingly, we also show that our results are more pronounced in firms with higher information asymmetries. We argue that value relevance of dividend payout ratios is greater for firms that have higher information asymmetries. These firms have scarcity of information. Therefore, whenever information disclosure improves, it is highly valued by investors.[2] Our arguments are consistent with Lang et al. (2004) who document a positive valuation effect of mechanisms that improve information asymmetries in countries with poor information environment. They argue that countries with high information asymmetries have dearth of information. Therefore, whenever information disclosure improves, it is highly valued by investors.

The remainder of the paper is structured as follows: Section 2 summarizes the data and Section 3 presents assessment of our hypothesis. Section 4 documents robustness of our results and the paper ends with Section 5 where we present our conclusions.

DATA

This paper documents the relationship between cost of debt and dividend policy in the MENA region. Our sample consists of nonfinancial firms listed at the stock exchanges of Bahrain, Egypt, Jordan, Kuwait, Morocco, Oman, Qatar, Saudi Arabia, Tunisia, and United Arab Emirates. Our sample covers the period between 2005 and 2011. We will, briefly, describe the data in following sections.

Cost of Debt

Cost of debt is calculated as the interest expense for the financial year divided by total debt during the same year.[3] The data for interest expense and total debt are obtained from the Worldscope. Table 1 documents the descriptive statistics for the cost of debt during our sample period. The result in Panel A shows that cost of debt is the highest in Egypt and Tunisia, while it is the lowest in Saudi Arabia and Qatar. Our results in Panel B show that firms belonging to Oil and Gas sector are able to raise debt at the most competitive rates. Panel C indicate relative

[1] Given that information asymmetries are associated with corporate governance mechanisms, prior literature has extensively related various proxies of corporate governance with the cost of debt. For instance, Boubakri and Ghouma (2010) relate ownership structure with cost of debt, Ortiz-Molina (2006) relate managerial incentives with cost of debt, and Liu and Jiraporn (2010) CEO power with cost of debt.

[2] We would like to mention here that we are aware of the arguments that relate higher dividend payouts with higher cost of debt. These arguments revolve around the conflicts of interests between creditors and shareholders. These arguments state that high dividends can increase the agency conflicts between creditors and shareholders. Dividends reduce the cash available to meet firm's predetermined obligations including principle and interest payments on debt. Given that there is adverse market reaction associated with dividend reductions, many firms would rather borrow to avoid cutting dividends. The additional leverage increases firm's risk with a consequent increase in the cost of debt. To the extent that creditors view dividends negatively, they demand a higher rate of return from firms with large dividend payouts. This yields a positive relation between dividend payouts and cost of debt.

[3] The preliminary statistics indicate that the outcome provides abnormal values, and thus may introduce noise in the measurement of the effective cost of debt for a firm. Therefore, following Pittman and Fortin (2004), we trim the data to address extreme observations, and winsorised the allowed spread at the 5th and 95th percentiles of the initial pooled distribution.

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homogeneity in the cost of debt across the years. We report, approximately, same cost of debt across our sample period.

Table 1. Descriptive statistics for cost of debt

Panel A: Cost of debt within each country

Country	Mean	Median
Bahrain	0.0617	0.0561
Egypt	0.0827	0.0797
Jordan	0.0787	0.0736
Kuwait	0.0649	0.0579
Morocco	0.0618	0.0534
Oman	0.0581	0.0526
Qatar	0.0429	0.0359
Saudi Arabia	0.0402	0.0329
Tunisia	0.0823	0.0684
United Arab Emirates	0.0531	0.0474

Panel B: Cost of debt within each industry

Industry	Mean	Median
Oil and Gas	0.0491	0.0457
Basic Materials	0.0616	0.0575
Industrials	0.0636	0.0554
Consumer Goods	0.0716	0.0627
Consumer Services	0.0647	0.0571
Telecommunications	0.0709	0.0641
Technology	0.0607	0.0565
Utilities	0.0681	0.0551
Healthcare	0.0703	0.0557

Panel C: Cost of debt during each year

Year	Mean	Median
2005	0.0667	0.0554
2006	0.0688	0.0604
2007	0.0693	0.0615
2008	0.0673	0.0587
2009	0.0684	0.0577
2010	0.0611	0.0534
2011	0.0568	0.0517

Dividend Policy

In this study, we consider dividend payout ratio as a proxy for dividend policy. The descriptive statistics for dividend policy are presented in Table 2. Panel A reports relatively low level of payout ratios in the sample countries. None of the countries, except Morocco, have payout ratio exceeding 50%. This observation is consistent with the findings of previous studies that document relatively lower level of payout ratios in emerging markets. Panel B and Panel C support our earlier observation of low payout ratios. We report low payout ratios across all industries and across all years in our sample, suggesting homogeneity in dividend policies across industries and years. Our result in Panel C also show that increase in payout ratios in the later part of our sample. Given that payout ratios are proxy of governance mechanisms, our results may indicate the improvement in governance mechanisms in the region.

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Table 2. Descriptive statistics for dividend policy

Panel A: Dividend policy within each country

Country	Mean	Median
Bahrain	48.3147	47.4800
Egypt	44.2284	48.7800
Jordan	45.4483	54.0250
Kuwait	29.5610	21.3400
Morocco	51.8411	56.4700
Oman	41.2477	44.2000
Qatar	39.7201	41.4100
Saudi Arabia	33.7605	33.0600
Tunisia	36.8356	41.0000
United Arab Emirates	30.5116	25.8400

Panel B: Dividend policy within each industry

Industry	Mean	Median
Oil and Gas	38.3303	40.6700
Basic Materials	38.4881	41.9250
Industrials	39.9966	43.2650
Consumer Goods	36.6310	39.1200
Consumer Services	38.5508	38.0500
Telecommunications	42.5294	46.9250
Technology	47.8950	50.7800
Utilities	53.5380	55.0500
Healthcare	39.9127	48.8000

Panel C: Dividend policy during each year

Year	Mean	Median
2005	34.5838	32.8650
2006	38.8504	42.5400
2007	38.8078	39.065
2008	37.5717	38.8900
2009	37.7137	40.5400
2010	41.1799	44.8300
2011	45.0737	51.4300

Control Variables

This paper uses log of total assets (SIZE), total debt to total asset ratio (LEVERAGE), earnings per share (EPS), growth in assets (GROWTH), and interest coverage ratio (COVRATIO) as control variables. Descriptive statistics for control variables are provided in Table 3. An interesting observation from Table 3, Panel A, is low median EPS. It indicates that almost half of the firms in the MENA region were not very profitable in our sample period. Table 3, Panel B, shows low levels of correlations between variables. It indicates that we can include all of the variables together in our regression equation.

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Table 3. Descriptive statistics for control variables

Panel A: Variables

	Mean	Median
SIZE	11.9651	11.8895
LEVERAGE	19.1314	13.8200
EPS	4.4892	0.1300
GROWTH	11.8737	6.75500
COVRATIO	18.6321	4.7300

Panel B: Variables

	SIZE	LEVERAGE	EPS	GROWTH	COVRATIO
SIZE	1.0000				
LEVERAGE	0.1180	1.0000			
EPS	0.2382	-0.0060	1.0000		
GROWTH	0.1499	0.0614	0.0032	1.0000	
COVRATIO	0.0739	-0.2608	0.1028	0.0257	1.0000

Methodology

The paper documents the effect of payout ratio on cost of debt in the MENA region. More In order to test this hypothesis, we estimate a panel regression with cost of debt (CoD) as a dependent variable and dividend payout ratio (PoR) as an independent variable. Furthermore, mindful of the effects that firm-specific characteristics may have on cost of debt, we also add number of firm-specific variables in our regression equation as control variables. These variables are SIZE, LEVERAGE, EPS, GROWTH, and COVRATIO. To control for unobserved heterogeneity, we also include dummy variables representing firm-specific fixed effects (FDUM). It is important to mention here that we use panel data regression with fixed effects for our analysis. Hausman test was used to decide between fixed effect and random effects. Our basic regression takes the following form.

$$\begin{aligned} \text{CoD} &= \alpha + \beta_1(\text{PoR}) \\ &+ \beta_2(\text{SIZE}) + \beta_3(\text{LEVERAGE}) + \beta_4(\text{EPS}) \\ &+ \beta_5(\text{GROWTH}) + \beta_6(\text{COVRATIO}) + \sum_{\text{Fxd}} \beta^{\text{Fxd}}(\text{FDUM}) + \varepsilon \end{aligned} \tag{1}$$

The results of our analysis are reported in Table 4. Our result shows that increase in dividend payout ratio causes cost of debt to go down by 0.0080 units. We report significant and negative coefficient of PoR. We argue that increase in dividend payout ratios are used by firms as a signal to tell investors that firms are governed properly. Good governance should result in lowering information asymmetries, thereby reducing the cost of debt. Furthermore, high payout ratios may also indicate lower level of agency problems within the firm by signaling to the market that no excess cash is available to expropriate (Easterbrook, 1984). This will also result in lowering the cost of debt.

Table 4. Relationship between dividend policy and cost of debt

Variables	Equation (1)
PoR	-0.0080**
GROWTH	-0.0204***
SIZE	0.4399
LEVERAGE	-0.1334****
EPS	-0.0170*
COVRATIO	-0.0305***
Fixed Effects	Yes
No. of observations	1437
No. of groups	407
F-value	12.12
R^2 within	0.2166

Note: The results significant at 10% significance level are followed by *, at 5% significance level by **, and at 1% a significance level by***.

ROBUSTNESS OF RESULTS

Effect of Legal Traditions on the Relationship Between Dividend Policy and Cost of Debt

In this section, we divide our sample into two groups – one group with firms headquartered in the civil law countries and the other group with firms headquartered in the common law countries. We re-estimate Equation (1) for both groups. Our results are reported in Table 5. Our results show that our earlier findings hold only in the civil law countries. We report significantly negative coefficient of PoR in the civil law countries and insignificant coefficient of PoR in the common law countries. These findings are interesting as well as intuitive. Given that firms in the civil law countries experience higher information asymmetries, conventional wisdom would suggest that value relevance of dividend policy should be higher in the civil law countries. Our arguments are consistent with Lang et al. (2004) who document a positive valuation effect of mechanisms that improve information asymmetries in countries with poor information environment. They argue that countries with high information asymmetries have scarcity of information. Therefore, whenever information disclosure improves, it is highly valued by investors.

Table 5. Effect of legal traditions on the relationship between dividend policy and cost of debt

Variables	Common Law	Civil Law
PoR	-0.0034	-0.0092**
GROWTH	-0.0293***	-0.0197***
SIZE	0.8484	0.4252
LEVERAGE	-0.1170***	-0.1379***
EPS	-0.0644	-0.0163*
COVRATIO	-0.0183***	-0.0356***
Fixed Effects	Yes	Yes
No. of observations	346	1091
No. of groups	99	308
F-value	5.71	9.29
R^2 within	0.2482	0.2206

Note: The results significant at 10% significance level are followed by *, at 5% significance level by **, and at 1% a significance level by***.

Effect of Growth Opportunities on the Relationship Between Dividend Policy and Cost of Debt

In this section, we divide our sample into two groups – one group with above median growth of entire sample and the other group with below median growth of entire sample. Main motivation behind dividing our sample into low growth and high growth firms is our assumption that high growth firms have higher information symmetries. Existing studies argue that the asymmetric information problem is more severe for firms with significant growth opportunities (Smith and Watts, 1992). We re-estimate Equation (1) for both groups. We present our results in Table 6. Our results show that our earlier findings hold only in high growth firms. We report significantly negative coefficient of PoR for high growth firms and insignificant coefficient of PoR for low growth firms. As was mentioned earlier, we argue that high information asymmetries embedded in high growth firms make payout ratios more value relevant in these firms relative to low growth firms.

Table 6. Effect of growth on the relationship between dividend policy and cost of debt

Variables	High Growth	Low Growth
PoR	-0.0091*	-0.0084
GROWTH	-0.0191***	-0.0216
SIZE	0.1444	1.0505
LEVERAGE	-0.1283***	-0.1290***
EPS	-0.0094	-0.0278
COVRATIO	-0.0273***	-0.0325***
Fixed Effects	Yes	Yes
No. of observations	805	632
No. of groups	337	315
F-value	6.07	5.41
R^2 within	0.1982	0.2645

Note: The results significant at 10% significance level are followed by *, at 5% significance level by **, and at 1% a significance level by***.

CONCLUSION

This paper explores the relationship between dividend payout ratios and cost of debt in the MENA region during the period between 2005 and 2011. Our results show a significantly negative relationship between cost of debt and dividend payout ratios. We argue that high payout ratios alleviate agency conflicts and lower information asymmetries. Lower information asymmetries reduce the risk faced by creditors. As a result, they require lower return for providing capital to firms with high dividend payout ratios. We also show that our results are more pronounced in firms with higher information asymmetries. This indicates that value relevance of dividend payout ratios is higher in firms that have higher information asymmetries. These firms have scarcity of information. Therefore, whenever information environment improves, it is highly valued by creditors.

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