Agency Costs and Free Cash Flow Hypothesis of Dividend Payout Policy in Thailand

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ABSTRACT

Dividend payout policy is the solution to reduce a company's agency costs by using the company's free cash flow in order to solve the problem between the management agent and shareholders. In this research, the mechanism of corporate governance in the independent directors, ownership structure and the dividend payout will be used to reduce agency's costs by using Panel data of listed companies in Technology industry, Resources industry Ago & Food industry and Consumer Products industry during the years of 2009-2013 from the Stock Exchange of Thailand. The data was estimated using Panel Random-Effects Tobit method. The following results have been found. Good governance and the number of independent directors are positively correlated with the dividend in the technology industry. The positions in other companies are positively correlated with the dividend in the resources industry and consumer products industry. The ownership structure and shareholding by foreign shareholders are positively correlated with the dividend in the consumer products industry as well as the shares that are held by institutional investors in the ago & food industry. The study suggests that dividend payout significantly reduced the agency cost based on the free cash flow hypothesis but the result of the study have not been confirmed in all industries.

Keywords: Agency costs, Free cash flow hypothesis, Dividend payout policy

I. INTRODUCTION

The business objective is to maximize their profit and also focus on creating wealth of shareholders. The two approaches that fulfill shareholders needs are Capital gain or dividend. According to the dividend, the company pays the dividend due to the presence of free cash flow (Fama & French, 2001). In addition to this, the dividend policy is the one that has been affected by its ownership structure and administration of the commission. In terms of structure, the major shareholders have the power to

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control the company. Practically, they can specify the policies to achieve personal gain. In the past, there were many researches related to the relationship between the structure of the major shareholders and dividend policy. They found these relationships in many countries, especially East Asian countries company, most of them were controlled by major shareholders (Kouki & Guizani, 2009 ; Ramli, 2010) . Moreover, the administration of the board in company required separation between ownership and management. So, the owners or shareholders could not operate the company themselves, but the self- selected directors. The performance monitoring of the management through the directors creates the conflict of interest between the principal (Principal) and representation (Agency). Typically, administrators will try to maximize the value of organizations. So they grant composition of a director to protect the benefit of the minority shareholders. The principles of good corporate governance of the companies in the Stock Exchange of Thailand 2012 refer to the independent director who is able to equally protect the benefit of shareholder. Independent directors are in the position which makes the proper decisions and reduces conflict between executive board and shareholders (Fama & Jensen, 1983). Moreover, they will face incentives that strongly affect their decision and signaling to the management shareholders. They fully meet the requirement of shareholders (Daily, Johnson and Dalton, 1998; Linck, Netter and Yang, 2009).

The study of the good governance and dividend policy of this research is based on two approaches, shareholding structure and independent directors. Typically, representation issue (agency problem), will be solved by dividend policy (Esterbrook, 1984). The executives often maintain the profit for personal gain rather than compensate to shareholders or business. Therefore, companies with bad corporate governance and independent directors will pay dividends less (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2000) . The dividend policies from around the world found that countries with legal protection of shareholders tend to pay higher dividends. In addition, the dividend policy is able to reduce agency problems, reducing the power of the executive decision affecting the monitoring time and expenditure of the shareholders (Jensen & Meckling, 1976). The ownership structure of the company in Thailand is the most concentrated and family characteristics (Wiwattanakantang, 2001). Moreover, they have the power over the management of the company which includes the payment of dividends.

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II. THEORETICAL FRAMEWORK

LITERATURE REVIEW AND HYPOTHESIS

A. Agency Costs and Free Cash Flow Hypothesis

In describing the motivation and behavior of the management or control of the company, the Principle-Agent Theory, The Agency theory is a concept that explains why behavior or decisions vary when exhibited by members of group. Specifically, it describes the relationship between parties, called the Principle and who are employed or agent (Agent). It explains their differences in behavior or decisions by noting that the two parties often have different goals and, independent of their respective goals, may have different attitudes toward risk. The important factor that drives the relationship is benefit (Interest), if the corresponding benefits (Alignment of Interest), agents will perform its duty to provide the maximum benefit for themselves. In contrast, if there is conflict of interests, the agent will work to satisfy personal interests that may lead to a conflict of interests (Jensen & Meckling, 1976). The concentrated shareholding structure in the Asia region included Thailand, one or several shareholders, with the number of shares and voting rights participate actively in the administration. They may take aggressive actions, either directly or indirectly, over firm decisions such as the election of board members and replacement of CEO or poor management with their voting power. As such, ownership concentration can be an internal governance mechanism that helps reduce the likelihood of managerial opportunism because managers and boards of directors are more likely to take into accounts the preferences and interests of large shareholders, the disadvantage of this ownership structure, they can easily access the information within the enterprise, resulting in conflicts of interest between controlling and minority shareholders (Holderness, 2003). If the administration is inefficient, it becomes a cost that companies have to bear (agency cost). There are two approaches which can reduce agency cost. The first approach is creating obligations to the Executive Council (Bonding) by increasing their ownership. The second part is to investigate the administration of the executive directors (Monitoring) (Morck, Shleifer and Vishny, 1988). According to the board of directors of the company, the independent director, the foreign shareholders and institutional investors, the represent of minority shareholders reviews the administration of the executive to reduce free cash flow. In addition, paying the dividends is the solution to prevent non-interest and non-benefit investing (Esterbrook , 1984; Morck, Shleifer and Vishny, 1988 ; Baba, 2009) which

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reduce the cost of the agency (agency cost) to monitor management.

B. Literature review and Hypothesis

Independent directors

According to the good governance, the independent of the directors is important to assist and balance management power and conflicts of interest between shareholders and management team (Agency Problem). Moreover, the directors have to monitor the management team in order to protect the benefit of the shareholders and the wealth of the company itself. The proportion of independent directors from outside related to the quality of governance. The better governance performance is the better of operating and dividends (Rosenstein & Wyatt, 1990; Weisbach,1988). In addition, the tenure of independent directors may be more likely benefit management decisions that benefit shareholders due to the ability of management and experience with the company, protecting the shareholders to reduce the dividend conflict (Wade, O'Reily and Chanratat, 1990 ; Boeker & Goodstein, 1993; Vance, 1983 ; Vafeas, 2003a). The independent directors are overburdened causing negative impact on the performance monitoring of management, increasing the company's agency cost and resulting in a dividend reduction (Carpenter & Westphal, 2001; Ferris, Jagannathan, and Pritchard, 2003). Researchers hypothesize about the independent directors on the payment of dividends as follows.

H_1**:** The mechanisms of good governance in the independent of directors are significantly related to dividend payout ratio.

It was measured by the proportion of independent directors and is positively correlated with the dividend payout ratio. The duration of the tenure of independent directors is positively related to the dividend payout ratio. Position in the Company's other independent directors are negatively correlated with the dividend payout ratio.

Ownership Structure

The ownership structure will reflect the entity controlling the company and influence the motivation of the administration. The most shareholding structure of Thailand is concentration shareholder. Major shareholders are individuals or families. The second group is foreign investors, major shareholders have the power to make decisions that impact the management (Wiwattanakantang, 2001; Anderson & Reeb, 2003 ; Jeon, Lee and Moffett, 2010). When shareholders come from family, it would reduce the administration efficiently. The dividend will be greater if there are

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monitoring and incentive based on Principle - Agent Theory. The foreign shareholders will review the performance of the executive in the exercise of dividend as well as the institutional investors. They represent institutions with interests in the venture so there is an incentive to monitor the business, closely monitoring the work of the management with regard to enterprise value (Baba, 2009 ; Karpavicius & Yu, 2012). Researchers hypothesize about ownership structure as follows.

H_2 **:** Ownership structure is significantly related to dividend payout ratio.
It was measured by the proportion of major shareholder and is negatively correlated with the dividend payout ratio. The proportion of shares held by foreign shareholders has a positive relationship with dividend payout ratio. The proportion of shares held by institutional investors is positively correlated with the dividend payout ratio.

Firm Age

According to the Life-Cycle Theory, the large and mature companies tend to induce greater free cash flow. They tend to pay a dividend more than small emerging companies because of its size (Fama & French, 2001). The startup company results of operations may not be profitable. Moreover, they tend to expand their investments than the big companies. Researchers hypothesize about the age of the business of the fund as follows.

H_3 **:** Age of the firm is positively related to the dividend payout ratio.

Firm Size

Companies with larger asset size tend to pay the dividend higher than a small company (Ramli, 2010). The smaller companies have to keep their money for investing without incurring related to The Life-Cycle Theory. The researcher hypothesized about the size of the company dividend as follows.

H_4 **:** Company size is positively correlated with the dividend payout ratio.

Leverage

The capital structure of the company plays an important role in the regulation of executive which related to the free cash flow theory (Stulz,1988) In addition, it reduces agency cost which may arise from the conflict of interest between shareholders and executives. The signaling theory research has found a negative relationship between Liability's Ratio and dividend payout ratio (Fama &

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Jensen,1983 ; Gugler & Yurtoglu, 2003 ; Guizani, 2012). The researcher hypothesized about the liability's ratio (leverage) to pay dividend as follows.

H_5 **:** Liability's Ratio is negatively correlated with the dividend payout ratio.

Growth opportunities

According to the free cash flow theory, the growing companies tend to have more money for investment in the future rather than the dividend (Baba, 2009; Sharma, 2011) found a negative relationship market -to-book ratio measured by the researcher. The following assumptions about the growth opportunities of the dividend are as follows.

H_6 **:** Growth opportunities are negatively correlated with the rate of dividend.

Profitability

According to the study in United States of America, as measured by ROA, it is positively related to the dividend (Jensen, Solbery and Zoun, 1992), signaling to shareholders that the dividends may be paid in the future which conform to the signaling theory (Harada & Nguyen, 2005; Ramli, 2010). The researcher hypothesized about their ability to make profits to pay dividends as follows.

H_7 **:** The profitability has a negative relationship with dividend payout ratio.

III. METHODOLOGY

A. Data collection and Sample

The data of Technology industry, Resources industry, Agro & Food industry and Consumer Products industry companies listed on the Stock Exchange of Thailand during 2009-2013 was collected from the website of the Securities and Exchange Commission (SEC). Moreover, annual Report and Form 56-1, financial information in the financial statements, information for shareholders and dividend payout ratio are also collected from SETSMART.

B. Model Specification and variables

Panel Tobit models using Random-Effects are estimated

$$Y_{it} = \begin{cases} Y_{it}^{*} & if \quad Y_{it}^{*} > 0 \\ 0 & if \quad Y_{it}^{*} \leq 0 \end{cases}$$

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$$Y_{it}^{*} = X_{it}\beta + u_{it}$$

Y_{it} = Dividend payout ratio of the company i at time t

X_{it} = The nT x ***11*** matrix of independent and control variables.

C. Variables definitions

Table I Definitions of variable

Variables	Definitions	Prior Studies
Dependent variable		
Dividend payout ratio (DPR)	Regarding to cash, dividend per share divided by earnings per share.	Farinha (2003), Adjaoud and Ben-Amar (2010)
Independent variables		
The number of independent directors (IND)	The proportion of independent directors on the Board of Directors of the Company.	Farinha (2003), Hu and kumar (2004), Sharma (2011), Weisbach (1988), Rosenstein and Wyatt (1990)
Duration of the tenure of independent directors (TENURE)	The proportion of office of the Board of Directors is equal to or more than ***15*** years.	Sharma (2011), Vafeas (2003a), Boeker and Goodstein (1993)
The position of independent directors in other companies (BUSY)	the proportion of positions in other companies or more than ***4*** companies	Shama (2011), Linck et al. (2009), Ferris (2003), Carpenter and Westphal (2001)
The major shareholder (TOP5)	the proportion of ***5*** major shareholder of all shareholder from the date of closing accounts XM.	Thanatawee (2013), Jeon, Lee and Moffett (2010)
Foreign shareholders (FOREIGN)	the proportion of shares held by foreign shareholders. Of all shareholders of the date of closing accounts XM	Harada and Nguyen (2005) Gugler and Yurtoglu (2003), Anderson and Reeb (2003), La Porta et al. (1999)
Institutional investors (INST)	the proportion of shares held by institutional investors. Of all shareholders of the date of closing accounts XM	Jeon et al. (2010), Baba (2009)
Control variables		
The age of the firm (AGE)	the number of years from the date of incorporation until the year of the study.	Fama and French (2001), Amderspm amd Reeb (2003), Harada and Nguyen (2005)
Firm size (SIZE)	logarithm of total assets	Ramli (2010), Gugler and Yurtoglu (2003), Fama and French (2001)
Debt (LEV)	total liabilities divided by total assets at year-end at the end of the year.	GuiZani (2012), Shama (2011), Gugler and Yurtoglu (2003), Stulz (1988)
Growth opportunities (Growth)	Market to book value of equity (The ratio of the market value of equity to book value of equity shares).	Baba (2009), Sharma (2011) Fama and French (2001)
The profitability (PROFIT)	the ratio of net income (loss) before taxes divided total assets.	Ramli (2010), Harada and Nguyen (2005), Fama and French (2001),

IV. RESULTS

The estimated result of Panel Random-Effects Tobit shown in table II

TABLE II

The estimation by Panel Random-Effects Tobit separate industry groups

	TECH	RESOURC	AGRO	CONSUMP
Independent directors				
IND	1.1378 *	0.4533	0.1845	0.5002

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TENURE	0.1058	-1.7101	-0.3602	0.1536
BUSY	-0.0441	2.5960 *	0.0337	0.6438 ***
Ownership Structure				
TOP5	0.4306	-0.0786	0.4669	-0.2195
FOREIGN	-0.1642	-1.4805	-0.0026	0.4821*
INT	-0.1154	-1.7010	0.6514 *	0.3716

	TECH	RESOURC	AGRO	CONSUMP
Control Variable				
AGE	-1.0178	2.5656	2.8578 ***	0.1818
SIZE	4.63E-07 **	4.24E-08	-8.17E-08	-2.84E-06 ***
LEV	-0.4976 *	-3.7731 **	-0.7586 **	0.1316
GROWTH	0.2753	-3.3253	-0.6492	-1.6566 ***
PROFIT	-0.1377	6.1670	0.0853	2.2160
Constant	39.8946	254.1596 *	-11.8846	44.1506
Total observation	141	110	172	147
Number of firm	34	25	40	33
Chi-squares Test	22.7687 **	13.4535*	27.3070 ***	28.0507 ***
Log-likelihood Value	-752.3233	-752.4390	-935.1796	-787.6173
S.D. of Random Effects	2.10E-15	1.64E-15	54.0065 ***	4.02E-15
rho	1.74E-33	5.24E-35	0.5979 ***	6.13E-33

* p < 0.1, ** p < 0.05, *** p < 0.01, rho represents percent contribution of random-effects to total error variance.

First, according to the Panel Random-Effects Tobit model, the mechanism of good governance by the independent directors, ownership structure, and the dividend: the Technology industry has a good governance mechanism from the independent directors. The number of independent directors (IND) is positively and significantly correlated with the dividend payout ratio. However, the independent directors of position tenure (TENURE) and tenure in the company of an independent directors (BUSY) are not correlated. Moreover, the control variables on Firm size (SIZE) showed a positive correlation with the dividend payout ratio. The debt (LEV) has a negative correlation with dividend payout ratios. While the age of the firm (AGE) and growth opportunities (GROWTH) measured by MTB and the profitability (PROFIT) measured by ROA were found no significant correlation.

Secondly, according to the study of the resources industry, there is a good governance cooperation mechanism from the Independent directors on the positions in other companies. (BUSY) is positively correlated with the rate of dividend but its

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direction is contrary to the hypothesis. In fact, the incumbent company's board of directors has a negative correlation with dividend payout ratios. There is no association with any of the number of independent directors (IND), the tenure of independent directors (TENURE) and the dividend payout ratio as well as shareholding structure. With regards to the control variables, leverage (LEV) is negatively correlated with the rate of dividend. The firm size (SIZE), age of the firm (AGE) and growth opportunities (GROWTH) are measured by MTB and the profitability (PROFIT) is measured by ROA where there was no significant correlation.

Moreover, the study of the Agro & Food industries in the mechanisms of corporate governance from independent directors found no relationship at all. According to the ownership structure, the shares of institutional investors (INST) are positively correlated with the dividend payout ratio. The shares held by the major shareholder (TOP5) and held by foreign shareholders (FOREIGN) were not correlated. Regarding to the control variables, age of firm (AGE) and debt (LEV) are positively correlated with the dividend payout. The size of the firm (SIZE), growth opportunities (GROWTH), measured by MTB and the profitability (PROFIT) measured by ROA did not correlate.

Lastly, the study of Consumer Products industry with good corporate governance mechanisms of the independent directors: the positions in other companies (BUSY) are positively correlated with the rate of dividend but dispute with the hypothesis. The incumbent company's board of directors is negatively correlated with dividend payout ratio. The number of independent directors (IND) and the tenure of independent directors (TENURE) found no correlation. Regarding to the ownership structure, foreign shareholders (FOREIGN) found a positive correlation with the dividend payout. The shares held by the major shareholder (TOP5) and held by institutional investors (INST) found no correlation. The controlled variables, such as firm size (SIZE), are negatively correlated with the dividend payout. The growth opportunities (GROWTH), measured by MTB, are negatively correlated with the dividend payout. The firm’s age (AGE), debt ratio (LEV), and the profitability (PROFIT), measured by ROA, did not correlate.

V. CONCLUSION AND DISCUSSION

According to the studies on mechanisms of good governance in the independent directors, the ownership structure and the dividends payout for reducing the agency costs of company’s free cash flow which is associated with free cash flow hypothesis, it is found the dividend payout decreased free cash flow which is under the control of

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the executive management, agency costs, and monitoring the performance of management. Moreover, it protects the interests of minority shareholders. Regarding to the results of studies on the mechanisms of good governance with regards to the proportion of independent board of directors, only the technology industry is positively correlated. It can be explained that the higher number of company board of directors related to the higher dividend. The director is responsible for monitoring the work of the management to protect the benefit of minority shareholders which helps reduce agency costs (Sharma, 2011; Farinha, 2003 ; Hu & Kumar, 2004). Moreover, if the commission has positions in another company of up to four companies, it will result in a huge dividends as well. There are a positive correlation of the resource industry and the consumer products industry. It can be explained that the board of directors of the company that served many diverse experiences affects better operations, higher dividend payouts and reduces agency costs. (Jensen ,1983 ; Harris & Shimizu, 2004). With regards to the time in position of the independent commission measured by the proportion of the independent commission equal or greater than 15 years, the four industry groups showed no significant correlation with the dividend.

Regarding the ownership structure of the consumer products industry, shares owned by foreign shareholders are positively correlated to the dividend payout. It can be explained that with foreign shareholders monitoring, it improves the work of the management in term of paying higher dividends resulting in reducing free cash flow and agency costs (Baba, 2009 ; Thanatawee, 2013) ,which is can also be seen as in the agro & food industry. In case of agro & food industry, the shares held by institutional investors are positively correlated with the dividend payout. It can be explained by the theories (Brickley, Lease and Smith, 1988 ; Karpavicius & Yu, 2012) while shares held by the major shareholders measured by the shareholder ratio, the major shareholders in the top5 industry groups, all four had no significant correlation with the dividend payout.

According to the control variables that may be related to dividend payout, the age of the company is positively correlated with the dividend payout in the agro & food industry. According to the Life -Cycle Theory, the larger and mature companies tend to have higher free cash flow which implies the long term of establishment without investment costs, there will be a higher dividend payout than emerging companies that have just started (Fama & French, 2001). The size of the technology industry has a positive correlation with the dividend payout which corresponds to the same theory. In addition, the consumer products industry is negatively correlated with the dividend payout. As a result, this industry is small when comparing with the total

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assets of the industry. Furthermore, promising growth opportunities in dividends are reduced by growth opportunities measured by market to book value of equity. The growth opportunity is also negatively correlated with the dividend. In addition, the signaling theory can also explains the debt ratio of the technology industry, the resources industry and the ago & food industry. The debt ratio is negatively correlated with the dividend payout due to obligation of a contract (Fama & Jensen ,1983 ; Gugler & Yurtoglu, 2003 ; Guizani, 2012). The growth opportunities are negatively correlated with the dividend of consumer products industry, which is related to the free cash flow theory, that is to say, the growth companies tend to spend on investment in the future rather than the dividend (Sharma, 2011; Thanatawee, 2013). With regards to the profitability measured by ROA, the four industry groups showed no significant correlation with the dividend. The studies on mechanism of corporate governance on the subject of independent directors, ownership structure and dividend payout estimated by Panel Random-Effects Tobit can reduce agency costs of company's free cash flow which is associated to the free cash flow hypothesis. However, the results of the study did not confirm all industries. The benefits of this study will provide assistance for shareholders to assess the trend of dividend payout policies and improve investment decisions. Moreover, the Stock Exchange of Thailand can develop these guidelines to improve independent boards. This will help promote the capital market of the country to be recognized and respected by both domestic and international investors.

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