

Investigation of the Relationship between Ownership– Control Discrepancy and Dividend Policy in Tehran Stock Exchange

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Abstract Present research examines the relation between the ownership-control discrepancy the major shareholder and dividend policy in Tehran Stock Exchange. This research focuses on the effect of the conflicts of interests between majority shareholders and minority shareholders on firms' dividend policy, because dividend policy can serve as a replacement for this the conflicts of interests. In this research, Investigation all firms in Tehran Stock Exchange that serves the annual reports for the years 2007 through 2010. In a total the selection 134 firms of different industries. The test of the proposed hypotheses conducted on a panel data. In a total research results show that the influence of the ownership to control ratio of the largest shareholder (OWCONT) on dividend payout rate is significantly positive. Indeed, the more this ratio is high, the more the control is low and payout is high. In contrast, if the largest shareholder has a controlling power that exceeds his/her cash flow right, payout is low. Furthermore, control power is significantly related to the dividend policy.

Key words Dividend policy, Ownership and control, Voting power, Agency conflicts, Banzhaf power index

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1. Introduction

The corporate finance literature has traditionally focused on mitigating agency conflicts between managers and shareholders due to a separation of ownership and control (Jensen & Meckling, 1976). Recent empirical studies have shown that in most countries publicly traded firms often have large shareholders, giving rise to another agency conflict between controlling shareholders and minority shareholders. The potential problems involved in large shareholders representing their own interests become particularly aggressive if their control rights are significantly more important than their equivalent level of cash flow rights (Guizani & Kouki, 2012).

The rule of one share-one vote is not the most practice of the relationship between ownership and control rights (Burkart & Lee, 2008). Compared to North America, such deviations are more frequent in European companies regardless of how this separation is defined; the authors consider this pattern of ownership as a controlling-minority structure (CMS) because it allows a large shareholder to control company's decisions while holding a disproportionately small fraction of cash flow rights. That this control takes into account coalition between shareholders. minority investors of firms in which the controlling shareholder holds control rights in excess of his/her cash flow rights are vulnerable to an expropriation problem (Guizani & Kouki, 2012). Excess control generally implies higher earnings management, a transfer of resources from the firm to the controlling shareholder through self-dealing transactions and value discount and decreasing dividend (Mancinelli & Ozkan, 2006). Always, on problem dividend giving agency off between managers and large shareholders and of another the small outside shareholders that this giving rise to agency

costs (Sadegi sharif & Bahadori, 2009). Dividends play a crucial role in limiting the power of top management and their expropriation activities and consequently remove corporate wealth from insider control to outsider shareholders (Faccio, 2001). Advanced two justifications of the agency problem of dividend policy: (i) The first view considers dividends as an outcome of the agency conflicts between insiders and outsiders as well as between blockholders and minority shareholders. (ii) The second approach argues that dividend policy and governance mechanisms are substitute devices to control insiders' opportunism and entrenchments (Maury & Pajuste, 2002). Abundant empirical literatures that investigation of the relationship between ownership structure and dividend policy focused on direct ownership, that is largest shareholders ownership and managery ownership that is index for controlling shareholders (for exemplar, Sadegi sharif & Bahadori, 2009; Chalmers & Godfrey, 2004; LaFond & Roychowdhury, 2008). Thus they have computed voting power by the size of the stake controlled by different blockholders. In such case, a shareholder with 30% of votes in widely held corporation is more likely to practice an effective control over the firm, while a shareholder with 35% of vote in firm with greater controlling blockholders does not hold sufficient rights to exercise significant influence over management decisions. The main problem with such a measure is that does not compute the set of all possible coalitions between large shareholders. Crespi & Renneboog (2003) propose that is better and more accurate to consider the relative rather than the absolute voting power rights of a given of shareholder, which determines his/her capacity to extract private benefits of control at the expense of minority investors) Guizani & Kouki, 2012).

This paper focuses on the effect of the conflicts of interests between majority shareholders and minority shareholders on firms' dividend policy. It complements the existing empirical literature in two ways. (i) First, we investigate the effect of separation between ownership and control on Iranian firms' dividend policy. (ii) Second, we advocate the use of Banzhaf index, derived from game theory as a relevant measure of voting power in the analysis of the relationship between dividend and control of the largest blockholder for each class of ownership-control structure.

2. Literature Review

According to Jensen & Meckling (1976) agency costs arise with the separation of ownership and control of the firm because managers and shareholders have different objectives. Whenever a firm suffers from agency conflicts, payout policy can serve as a partial remedy to this problem (Rozeff, 1982). Jensen's (1986) free cash-flow hypothesis suggests that if firms have cash in excess of their requirement of investment in positive-NPV projects, it is better to pay these funds as dividends in order to reduce managerial discretionary behaviour and thus avoid agency costs of free cash-flow (Moosavi & Honarbakhsh, 2010).

In recent years, several empirical studies have shown that ownership structures of many firms are significantly concentrated. Research in this area has tended to resolve focal questions like how conflicts of interests between insiders and outsiders affect financial decisions and firm value? What are the best mechanisms which minimize risk of expropriation? As proposed by Shleifer & Vishny (1997), when large shareholders effectively control the firm, they start diverting funds toward private benefits that are not shared by other stockholders. Controlling shareholders may pay themselves excessive compensation, the power to elect board members, the ability to consume perquisites and to transfer resources at the expense of the firm and minority shareholders Therefore, and the relevant agency problem is expropriation of minority shareholders by the large shareholders (Maury & Pajuste, 2010). Dividend policy can had a crucial role in reduce of the conflicts of interests between insider and outsider persons firm (Moosavi & Honarbakhsh, 2010).

Gugler & Yurtoglu (2003) Based on a sample of 736 firms Germany, examined the effect of the conflicts of interests between majority shareholders and minority shareholders on firms' dividend policy and show that lower dividend payout of majority-controlled firms is related to the probability that controlling shareholders extract private benefits at the expense of minority shareholders.

Based on a sample of 8279 firms from 37 countries, Truong & Heaney (2007) examined the possible interaction between dividend policy and the type of the largest shareholders. They showed that firms are likely to pay fewer dividends when the large owner is either an insider or a financial institution.

The study conducted by How et al. (2008) examined the relationship between dividend policy and ownership and control structure in Hong Kong. For a sample of family controlled firms, the authors showed that higher dividend payouts are distributed when the size of family-controlled firms are small or medium.

However when discrepancy between the controlling shareholder's cash flow right and voting rights is significant, large family-controlled firms are more likely to decrease dividend payout ratio.

Sadegi sharif & Bahadori (2009) analyze the effect of the ownership structure on dividend policy in Finish listed corporations for the years 2002 through 2008. They find that firms become less likely to pay dividends when the total stake held by the blockholders represents a significant portion of the equity ownership.

Boulkaran (2009) analyses the association between dividend policy and the opportunity to expropriate wealth from minority shareholders for two classes of ownership structures (single and dual class). The empirical tests are conducted on US firms in order to test three potential explanations of controlling shareholders behaviour: reputation, private benefits and family legacy. The results showed that single class companies pay out more cash dividend compared to dual class. The tests showed as well that dividend payout ratio decreases as the separation between control and cash flow rights is higher.

Guizani & Kouki (2012) examines the relation between the ownership-control discrepancy and dividend policy of Tunisian firms. Using data of 44 Tunisian firms, the current study provides evidence in support of the expropriation hypothesis (1: «excess of control rights over cash flow rights of the controlling shareholder has a negative effect on the dividend payout ratio». 2 “voting power is more likely to affect dividend policy when the largest shareholder is belonging to the controlling minority structure (CMS)). The empirical results show that the largest shareholder maintains a controlling power measured by Banzhaf index in excess of his cash flow rights which, leads to a low level of dividend payout ratios.

3. Data and Methodology

3.1. Sample

The selection of our sample is based on the list of issuers of listed securities admitted to trading on a regulated market or on the unlisted market from the Iranian securities market commission. The data were collected from the annual reports of each company registered in the official bulletins of the Tehran stock exchange (TSE). We have excluded companies whose financial information is incomplete during the period of analysis. We therefore construct a sample of 134 companies with data for the years 2007 through 2010, in a total of 536 observations.

3.2. Variables Construction and Hypotheses Development

Dependent variable:

The dependant variable, Payout is the dividend payout ratio measured as the ratio of dividends to earnings. Dividend is cash dividend and earnings are measured after taxes and interests.

Explanatory variables:

Discrepancy between ownership and control (OWCONT): we use the ratio of ownership rights as measured by the number of shares held by the major shareholder (OW1) deflated to control rights as measured by voting power of the controlled shareholder (BZ1). This ratio is the inverse of the discrepancy between control and ownership. If the expropriation hypothesis is correct, which reflects high discrepancy and equivalent to verify small value of OWCONT, and then we expect ownership to control rights to be positively related to dividend payout. This relationship is equivalent to having negative effect of the inverse of the OWCONT ratio.

How to Measure voting power?

A number of empirical studies have computed voting power by the size of the stake controlled by different blockholders. In such case, a shareholder with 30% of votes in widely held corporation is more likely to practice an effective control over the firm, while a shareholder with 35% of vote in firm with greater controlling blockholders does not hold sufficient rights to exercise significant influence over management decisions. The main problem with such a measure is that does not compute the set of all possible coalitions between large shareholders) Guizani & Kouki, 2012). Crespi & Renneboog (2003) propose that is better and more accurate to consider the relative rather than the absolute voting power rights of a given of shareholder, which determines his/her capacity to extract private benefits of control at the expense of minority investors. Many recent approaches explore the formation of coalitions between the main blockholders in order to have

direct access to the private rents of control. The approach proposed here is to use the game theory to compute the formal power represented by the shareholder votes.

The idea is to consider large shareholders as a players in a voting games, in which each voter compute all the possible coalitions that he/she can build with other players. According to Banzhaf (1965), Guizani & Kouki (2012), we use Banzhaf power index as the measure of the voting power of the controlling shareholders. Specifically, the coalition underlying this model is calculated by the number of swings for player i as a proportion of the number of potential swings where his vote is decisive in such coalition. The Banzhaf swing probability is computed as follows:

$$BZ_i = \frac{n_i}{2^{n-1}} \quad i = 1, 2, 3, \dots, n \quad (1)$$

Where, n is the number of swings for player i .

Free cash flow (FCF): Besides, dividend payout ratio is also determined by other variables. Jensen's (1986) free cash-flow hypothesis suggests that if firms have cash in excess of their requirement of investment in positive-NPV projects, it is better to pay these funds as dividends in order to reduce managerial discretionary behaviour and thus avoid agency costs of free cash-flow. thus we predict a positive relationship between free cash-flow and dividend payout ratio. This variable is measured as operating cash flow minus capital expenditure and change in working capital deflated by total assets.

Past growth (Growth): As the choice of payout policy cannot be separated from investment opportunities available to the firm, our model predicts a negative relationship between past growth and dividend payout ratio since firms prefer to avoid transaction costs due to external financing. According to pecking order theory, we can expect firms to pay fewer dividends if they experienced past growth. We measure past growth by the average of the historical sales growth for the 2007-2010 periods.

Cost of debt (KDebt): Agency conflicts can exist also between shareholders and debt holders. Shareholders can expropriate wealth from debt holders by paying themselves high dividends. Bondholders try to contain this problem through restrictions on dividend payment in the bond commitments) Guizani & Kouki, 2012). Debt holders can impose high level of interests for firms paying high dividends. Therefore, we expect a negative relationship between payout ratio and cost of debt. This variable is defined as the financial expenditure deflated by total bank debt.

Profitability (ROA): Jensen et al. (1992) find evidence of a positive association between return on assets (ROA) and dividend payouts. This variable is defined as the mean ratio between after-tax earnings before extraordinary items and total assets.

Therefore, according to the agency problems related to the behaviour of the controlling shareholders, we propose our main testable hypotheses as follows:

Hypothesis 1: «excess of control rights over cash flow rights of the controlling shareholder has a negative effect on the dividend payout ratio».

Hypothesis 2 "voting power is more likely to affect dividend policy when the largest shareholder is belonging to the controlling minority structure (CMS).

3.3 Regression Specification and Estimation Methodology

Based on predictions of finance theory and our earlier discussion, we consider the empirical model described below (model 1):

$$Payout_{it} = a_0 + a_1 OWCONT_{it} + a_2 FCF_{it} + a_3 Growth_{it} + a_4 Kdebt_{it} + a_5 ROA_{it} + \varepsilon_{it} \quad (2)$$

Where Payout is dividend payout ratio, OWCONT is ownership to control ratio, FCF denotes free cash flow ratio, Growth is past growth of the firm, KDebt is cost of debt, and ROA is return on assets,

The estimation of the proposed model is conducted on a panel data. According to Baltagi (2005), panel data gives multiples solutions to many problems related to cross-sectional specification like unobserved heterogeneity, degrees of freedom, dynamics and collinearity among the explanatory variables. In order to

choose the appropriate specification, panel data methodology offers two tests namely the F-statistics and the Hausman’s specification test. The former measurement tests the null hypothesis that the adequate estimator is OLS regression compared to individual effects model, while the latter statistic tests the null hypothesis that the random effects regression is appropriate compared to the fixed effects models.

For our results (Table 2), the F-statistic is significant at 5% level which indicates an existence of specific effects in our data.

4. Empirical Results

4.1. Descriptive Statistics

We present some preliminary results concerning the dividend-to-earnings ratio for firms with different control structures.

Table 1. Summary statistics for pooled sample (536 firm-years)

St.dev.	Median	Mean	Max.	Min.	Number observ	Variables
0.9659	0.6461	0.7850	13.5472	0	536	Payout
0.2058	0.0617	0.0796	1.3516	-0.9890	53	Fcf
0.4969	0.1598	0.2203	7.3815	-0.8272	536	Growth
0.3890	0.1188	0.1524	8.1020	0	536	Kdebt
0.6021	0.1137	0.2142	8.7714	0.0035	536	RoA
0.1694	0.8298	0.8298	1	0	536	Bz1 (control)
0.2253	0.4949	0.4949	0.9900	0.0201	536	OW1 (ownership)
0.3169	0.6100	0.6100	1.8400	0.0035	536	OWCONT

Table 1 illustrates also the voting power (BZ1), the fraction of shares and the ownership to control ratio of the largest shareholder. Interestingly, we notice that the voting power of the largest shareholder is quite high (82%) making him/her very powerful. He/she holds 49% of the shares which give a mean value of the OWCONT ratio of 61%, which gives an average gap about 1.7 between control and ownership of the largest shareholder (control rights = 1.7 cash flow rights). These results show that ownership in Tunisian firms is concentrated and control is often in the hand of the first largest shareholder.

4.2. Test of the Effect of Ownership to Control Ratio on Dividend Policy

In this section, we present the regression results of dividend-to-earnings ratios on ownership to control ratio and other control variables in a sample of 134 Iranian firms. The model is estimated under random effects.

Table 2. The influence of ownership-control discrepancy on dividend payout

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.7148	0.0092	77.296	0.0000
FCF	0.0894	0.0253	3.5224	0.0005
GROWTH	-0.2135	0.0100	-21.232	0.0000
KDEBT	-0.1069	0.0251	-4.2542	0.0000
ROA	0.2253	0.0669	3.3674	0.0008
OWCONT	0.1282	0.0198	6.4463	0.0000
R-squared	0.7735	Mean dependent var		2.2785
F-statistic	9.8284	Durbin-Watson stat		2.4543
Prob(F-statistic)	0.0000			

As predicted by our main hypothesis (H1), the influence of the ownership to control ratio of the largest shareholder (OWCONT) on dividend payout rate is significantly positive. Indeed, the more this ratio is high, the more the control is low, the company will distribute more significant portion of its profits to shareholders. In contrast, if the largest shareholder has a controlling power that exceeds his/her cash flow right, the retention of profits outweighs the dividend distribution as previously discussed. This result shows that when the largest shareholder holds full control without a majority of shares, he/she extracts private benefits at the expense of minority shareholders. This pattern is consistent with the claim made by Shleifer and Vishny (1997) that the dominant shareholder prefers to extract private benefits rather than receive dividends that equally benefit minority shareholders. In addition, the largest shareholder, since he/she is poorly diversified and risk averse, prefers an internal finance over an external one like bank debt which increases the firm's default risk or equity issue which dilutes his/her control.

The results are also consistent with Faccio et al. (2001) who find that for firms tightly-affiliated to a group at the 20 percent level control, there is a significant positive relationship between OWCONT and dividends. Elsewhere, Guizani & Kouki (2012) find that dividend payout ratio is negatively related to the control stake of the controlling shareholder in Finnish listed firms.

In line with earlier expectations, firms that experienced a higher rate of free cash flow (FCF) pay more dividends. This is consistent with the free cash flow hypothesis of Jensen (1986) which indicates that when a firm has cash in excess of what is required to finance positive-NPV investment project, it is better for managers to return the excess cash to shareholders as dividends in order to maximize shareholders wealth.

The coefficient associated to past growth (Growth) rate is negative and statistically significant (a coefficient of -0.21 with probability of 0.00). Firms that experienced a higher rate of annual growth pay fewer dividends in order to avoid transaction costs of external financing as predicted by pecking order theory.

The cost of debt (KDebt) has a negative and significant effect on dividend payout ratio (-0/10). Debtholders impose higher interest rate for firms paying higher dividends in order to limit wealth transfer via dividend to shareholders. This evidence confirms our prediction that debt has a negative impact on dividends because of debt covenants and related restrictions imposed by debtholders as suggested by Kalay (1982) and Smith and Warner (1979).

The profitability variable (ROA) is seen to positively and significantly influence dividend payouts (0/22). Firms pay higher dividend when they realize a comfortable financial situation. This relationship is consistent with the results of Guizani & Kouki (2012) in the context of Tunisia.

4.3. The Effect of Discrepancy Ownership-Control on Dividend for Each Class of Shareholders

As we have suggested, the power of the largest shareholder in the company does not necessarily reflect its capital ownership but it is more related to the structure of the power among the principal stockholders. Therefore a shareholder may have a higher control in the company without having the majority of legal actions. This difference is remarkable when incentives for expropriation are more pronounced when controlling shareholder's control exceeds its cash flow right.

The data analysis allowed us to distinguish two groups of firms.

Table 3. Groups of firms according to ownership and control of the largest shareholder

Percentage (%)	Number of obs	Frequency	Group
48.51%	260	65	Ow1(-50%) · bz1(+50%) : CMS
51.49%	276	69	Ow1(+50%) · bz1(+50%) : MAJ
100%	536	134	Total

The first group (CMS: "Controlling Minority Shareholders") consists of companies in which the dominant shareholder owns a percentage of shares less than 50% but its power of control (as measured by the Banzhaf index) exceeds 50%. This group represents 48/51% of the total number of firms.

In the third group (MAJ), the largest shareholder holds the majority stake (more than 50% of shares) and thereafter the majority of voting rights. This group represents 51/49% of total number of firms.

Table 4. Descriptive statistics of payout ratio by group

Max.	Min.	Std.dev	Mean	Group
11.2052	0	0.8763	0.7345	CMS
13.5472	0	1.0442	0.8385	MAJ

The descriptive statistics of firms' financial variables show crucial differences between classes of shareholders. In table 4 we report descriptive statistics on the dividend payout ratio for two sub-samples- firms with majority control (ow1>50%, bz1>50%), firms with controlling minority structure (ow1<50%, bz1>50%).

Table 5. Descriptive statistics of each class of shareholder

MAJ		CMS		Variables
Std.dev	Mean	Std.dev	Mean	
1.0442	0.8385	0.8763	0.7345	Payout
0.2059	0.0782	0.1794	0.0733	FCF
0.4376	0.2198	0.5537	0.2209	Growth
0.4979	0.1628	0.2216	0.1413	KDebt
0.3028	0.1886	0.7698	0.2508	ROA
0.1948	0.8439	0.1386	0.8163	Bz1
0.1576	0.6579	0.1419	0.3218	OW1

CMS: control rights = 2.5cash flow rights

MAJ: control rights = 1.3cash flow rights

The results of descriptive statistics reported in Table 5 show that ownership– control discrepancy in firms with controlling minority structure (CMS) compared to firms with majority control (MAJ) are significant and the main shareholder is likely to limit dividend flow. This result suggests that firms are to pay fewer dividends when the ownership– control discrepancy is higher.

Table 6. Effect of voting power of the largest shareholder for each class of ownership-control

MAJ		CMS		Variables
t-Statistic	Coefficient	t-Statistic	Coefficient	
6.8499	1.6358	7.2759	0.8921	c
2.6629	0.1339	9.3755	0.4656	FCF
-14.6139	-0.3860	-2.2452	-0.0689	Growth
-3.6156	-0.1466	-6.4822	-0.1911	KDebt
2.0864	0.4184	5.9651	0.2363	ROA
-3.7763	-0.9218	-2.3173	-0.3328	Bz1
0.5709		0.1550		R-squared
2.4210		1.7703		Durbin-Watson stat
3.6823		9.3220		F-statistic
276		260		Number observ

In Table6, The econometric tests of control rights on dividend policy are performed in one stage: we examine the impact of the level of control of the main shareholder on dividend payout for the two groups of firms separately. Model 2 to be tested is consistent with the above model 1, but we have replaced discrepancy variable with the voting power of the largest shareholder (BZ) for each class of ownership structure (CMS, MAJ).

$$(\text{model2}): Payout_{it} = \alpha_0 + \alpha_1 BZ_{1it} + \alpha_2 FCF_{it} + \alpha_3 Growth_{it} + \alpha_4 Kdebt_{it} + \alpha_5 ROA_{it} + \varepsilon_{it} \quad (3)$$

Where BZ1 is the Banzhaf index which measures voting power of the principal shareholder. We expect a negative relationship between BZ1 and dividend payout. This effect is more to be verified in a controlling minority structure (CMS). Indeed, according to hypothesis 2, the main shareholder has a negative effect on the level of dividend when it has a controlling power that exceeds 50%.

5. Concluding Remarks

This study empirically examined the relationship between ownership and control discrepancy of the largest shareholder and dividend payout using a panel of Iranian corporate firms during 2007-2010. We advocate the use of Banzhaf index as a relevant measure of voting power during analysis of control rights.

Due to divergence between cash flow rights and control rights, the conflict between large and controlling owner and small outside shareholders is one of the main issues in corporate governance literature. We find that the OWCONT ratio is one of the important variables which influence dividend payout policies. As the largest shareholder holds a degree of control (measured by Banzhaf index) that exceeds his ownership (measured by his fraction of shares), firms tend to pay fewer dividends. Furthermore, our results show that free cash flow, cost of debt and profitability influence Iranian firms' dividend policy. As suggested by Jensen (1986), firms pay higher dividend when they have important free cash flow and achieve high profitability. However, they avoid a large distribution when debtholders require a high interest rate. Our analysis would have been more interesting if the effect of other class equity (dual class stock, stocks pyramids) is considered but the lack of information ensures that we leave this challenging question for future work and for other stakeholder-oriented governance regimes.

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