The Role of Leverage and Quality in Dividend Changes

Dividend increases are typically met with a positive reaction from investors, while dividend cuts are typically met with a negative reaction. Whether these changes signal positive or negative information, however, depends on the quality of the company and its leverage.

Companies with low-to-moderate levels of leverage—defined as liabilities to total assets—can signal positive information by raising their dividend. There is particularly a greater incentive to favor dividends over new projects when the marginal return on investment is declining.

When leverage becomes too high, a higher-quality firm can convey positive information by doing the opposite: cutting its dividend. Though this may seem counterintuitive, the firm benefits shareholders by reducing the risk of default and being able to allocate more cash to potentially profitable projects.

Overall, higher-quality non-utility, non-financial firms have a greater incentive to pay dividends when their ratio of liabilities to total assets is below approximately 0.83. (By means of comparison, the study's author calculates the median leverage ratio for such companies as being 0.49.) When the liabilities-to-total-assets ratio exceeds 0.87, "higher dividends become unambiguously bad news." About 0.3% of fiscal-year observations had leverage levels in this top range. In comparison, about 1% of U.S. publicly traded firms file for bankruptcy.

For U.S. banking firms, the leverage ratios are higher. Dividend increases convey positive information when liabilities to total assets are 1.008 or lower. They convey bad news when the leverage ratio is 1.018 or higher. The median leverage ratio is 0.87.

For lower-quality firms, the equation changes. New projects have a lower expected return. As such, there is less incentive to have a low level of dividend payouts. This is particularly the case at a higher leverage, where cash not distributed to shareholders can be seized by creditors if the company defaults. Thus, raising the dividend gives shareholders a priority claim on assets up until the time default occurs or the company is forced to reduce or end its dividend.

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