DIVIDEND POLICY

A Business Perspective

QUOC TRUNG TRAN

Dividend Policy

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Dividend Policy: A Business Perspective

BY

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Foreign Trade University, Vietnam

United Kingdom – North America – Japan – India – Malaysia – China

Emerald Publishing Limited
Emerald Publishing, Floor 5, Northspring, 21-23 Wellington Street, Leeds LS1 4DL

First edition 2024

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British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

ISBN: 978-1-83797-988-2 (Print)
ISBN: 978-1-83797-987-5 (Online)
ISBN: 978-1-83797-989-9 (Epub)

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About the Author

Quoc Trung Tran is an Associate Professor at Foreign Trade University (Vietnam). He is also the Vice Director of Ho Chi Minh City Campus of Foreign Trade University. He holds a PhD in Management Science from University of Lille (France). He started his academic career in 2008. His research focus is on corporate finance, corporate governance, and international business. He has published many papers in *Economic Modelling, Research in International Business and Finance, The North American Journal of Economics and Finance, Economic Analysis and Policy, The Quarterly Review of Economics and Finance, Journal of Multinational Financial Management, International Journal of Emerging Markets, Australian Journal of Management, Multinational Business Review, Finance Research Letters*, etc. Most of his works are about the effect of business environment on corporate finance and corporate finance in emerging markets. He has many research projects granted by the Vietnam National Foundation for Science and Technology Development (NAFOSTED), the Ministry of Science and Technology of Vietnam (MOST), and Foreign Trade University. He has served as reviewer of many high-quality journals in finance, economics, and business. His most recent book is "Political Corruption and Corporate Finance."

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Preface

"Our goal is to increase enterprise value. Which would you rather have us be? A company with our stock price, and $40 billion in the bank? Or a company with our stock price and no cash in the bank?" – Steve Jobs replied when he was asked about Apple's dividend policy. Under this philosophy, the world's largest technology company did not pay dividends from 1996 to 2011. After Tim Cook succeeded Jobs to be the CEO, Apple started to pay dividends in 2012. Although Cook stated: "We can still maintain a war chest for strategic opportunities and have plenty of cash to run our business" (dividends are also considered as residuals), to some extent this dividend payment was interpreted that Cook "actually meets with and listens to investors and shareholders" (Paczkowski, 2012). In fact, dividend decisions are much more complicated in corporations. For example, Boeing Corporation's dividend per share tends to increase steadily while earning per share and stock price experience many fluctuations over the period from 2000 to 2013. Remarkably, dividend per share exceeds earnings per share in the year of 2002. Therefore, dividends are not only residuals and not only completely determined by investment opportunities to some extent. In fact, dividend policy has many determinants from different levels of business environment.

A proper understanding of dividend paying policy is essential for other fields of financial economics including capital structure, mergers and acquisitions, and capital asset pricing (Allen & Michaely, 1995). Firstly, firms paying more dividends tend to use external funds including new share issues and debt to finance their investment projects. On the other hand, paying dividends is considered as a means to disgorge abundant cash which is available for managers to invest in negative net present value projects. Therefore, dividend policy is relevant to capital structure theories including transaction cost theory, pecking order theory, residual theory, and agency cost theory. Secondly, dividend policy is also related to the probability of takeover. The free cash flow theory suggested by Jensen (1986) posits that managers do not use retained earnings to maximize shareholder wealth optimally. High dividends are considered as a signal to the markets that firm managers act prudently and the likelihood of takeover is reduced. For example, to defend Scottish and Southern Energy against a possible takeover, its leaders announced a new dividend policy with an increase in the payout ratio by 18% in the year 2007 and an annual growth rate of at least 4% over three following years (Shelley, 2007). Thirdly, dividends have employed commonly to estimate the intrinsic value of shares over more than 40 years since Gordon (1962)

initially suggested the dividend growth model. Fama and French (2015) also use the dividend growth mode to explain the impact of profitability and investment on average returns and add these two factors to their three-factor model to establish a five-factor model. Therefore, understanding dividend policy is useful to asset pricing.

In a classic work, Black (1976) fails to find a reasonable argument to explain why firms distribute cash dividends to their stockholders and consider dividends as a "puzzle." Since then, dividend policy is studied intensely by financial economists and has become one of the most debatable topics in corporate finance. Most prior books consider dividend policy as financial decisions and investigate both theories and practices in dividend policy from a financial perspective, for example, "Dividends and dividend policy" by Baker (2009), "Dividend policy: Theory and practice" by Frankfurter et al. (2003) and "Dividend Policy and Corporate Governance" by Correia da Silva et al. (2004). However, this book analyzes cash dividend decisions and related issues from a business perspective. Cash dividends are a distribution of cash to shareholders; therefore, dividend decisions affect business activities through reducing corporate cash reserves or investors' behavior. On the other hand, dividend decisions are also affected by firms' business environment – the main source of information for managers' decision-making process. Consequently, this book focuses on how different levels of business environment determine cash dividend policy. Particularly, dividend decisions are made under the impacts of internal environment, industry environment, and macro-environment. Besides, we also present how corporate dividend policy affects shareholders' wealth through stock price.

This book is structured as follows. The first three chapters present fundamentals of dividend policy. Chapter 1 introduces corporate dividend policy from a business perspective. Chapter 2 describes dividend policy around the world. Chapter 3 presents dividend theories – the mechanism through which market frictions determine dividend decisions – and their empirical evidence. The next four chapters analyze how firms make dividend decisions under the three levels of business environment. Chapter 4 analyzes the effect of internal environment (i.e., internal management and internal stakeholders) on dividend policy. Chapter 5 presents the relationship between industry environment and dividend decisions. Industry environment includes participants in both the product market and the financial market. Chapter 6 focuses on how macro-environment including political, economic, social, environmental, and legal factors influence corporate dividend policy. Especially, Chapter 7 examines the effect of business environment on dividend smoothing – a special dividend decision. Finally, Chapter 8 presents the reaction of stock price to dividend payments. It provides readers with comprehensive understandings in dividend policy and related issues under the impact of business environment. In this book, dividend policy is examined as both business-related and financial decisions. Therefore, it is attractive to both academics (e.g., researchers, lecturers, and students) in Finance and Business Administration and practitioners (e.g., investors, managers and policymakers).

Acknowledgments

First and foremost I would like to sincerely thank Professor Pascal Alphonse, one of the greatest teachers in my academic life. He inspired and taught me with patience and kindness.

I also thank Foreign Trade University for supporting me to publish this monograph. I would like to express our sincere gratitude to my colleagues for their valuable comments on my work.

This book is for my little son and daughter, Yoyo and Pony. You made me take this leap. You study hard every day and so do I. I hope you grow up safe, strong, free, and fearless. Thank you for being my children. I love you.

Although I have spared no efforts to write this book and made it as perfect as possible, mistakes and errors may be unavoidable. Therefore, I hope that colleagues and readers sympathize with me for these problems. I look forward to your valuable comments and criticisms so that I can improve it in the future.

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Chapter 1

Introduction of Dividend Policy

Abstract

This chapter introduces dividend policy as both financial and business decisions. First, it presents the history of dividend payment, definition of dividend, and typical types of dividend. Dividends originate from liquidating payments of sailing vessels in the early 16th century and become popular with the development of corporations. In this book, a dividend is defined as a cash payment to shareholders. By payment time, there are three typical types of dividend including final dividend, interim dividend, and special dividend. Second, it presents definition, important dates, measures, and patterns of dividend policy. Dividend policy includes two decisions: the first is to pay or not to pay dividends, and the second is the dividend magnitude. Investors have to follow important dates of dividend payments in order to make their investment decisions. Important dates include declaration date, record date, ex-dividend date, and payment date. Dividend payout ratio and dividend yield are two common measures of dividend policy. Common patterns of dividend policy are no dividend policy, residual dividend policy, stable dividend policy, and irregular dividend policy. Finally, dividend policy is both financial and business-related decisions. Therefore, dividend decisions are affected by various levels of business environment such as internal, micro (industry), and macro-environment. Dividend theories are the behind mechanisms to explain the effect of each factor in the business environment on corporate dividend policy. Dividend policy, in turn, determines shareholders' wealth through its impact on stock price.

Keywords: Dividend; dividend policy; types of dividends; important dates; cash holdings; analytical framework; business perspective

1.1 What Is Dividend?

1.1.1 History

The term "dividend" originates from a Latin word "dividendus," which means "something divided." The history of dividends goes with the development of joint

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doi:10.1108/978-1-83797-987-520241001

stock corporations. According to Williston (1888), the embryonic form of corporation was developed in Greek/Roman times. However, until 14th century, precursors of modern corporations were initially established as federations of traders in Italy and Denmark (Kindleberger, 2000; Scott, 1912). These federations have limited goals, simple principles, and loose organization (Frankfurter & Wood, 1997). In the early 16th century, captains of sailing vessels started calling for investors to finance their voyages. They sell ventures on parts to investors in order to raise funds. Later, these parts were standardized and traded publicly in the open market. A vessel property was divided into fixed denomination shares such as 8, 16, 32, 48, and 56 and sold to investors. Investors could buy shares from different vessels to avoid risk of loss (Masselman, 1963). At the end of each voyage, all of the vessel's assets were liquidated and the profit was distributed to investors in proportion to their shares. If investors were willing to continue their investment, they negotiated with the captain for a new voyage (Lease et al., 1999). This basic mechanism is called liquidating dividend policy. Although investors could avoid the captain's fraudulent behavior by receiving all proceeds, this distribution practice was not economically efficient. Investors had to receive nonfinancial assets that they failed to utilize and manage efficiently. In addition, human capital gained from previous ventures was not exploited (Kindleberger, 2000).

Based on the original cooperation between investors and sea captains, joint stock companies were established since merchants needed more capital for their foreign trade (Kindleberger, 2000). Investors gave their money to corporations where captains use capital with their expertise to create profits. Then, the corporations pay dividend to their investors. According to Frankfurter and Wood (1997), Eastland Trading Company was the first joint stock corporation in Great Britain which received exclusive rights to trade with the Baltic countries. Then, the Muscovy and Levant corporations were granted charters to trade with Russia and Turkey, respectively (Scott, 1912). However, these charters were valid within certain periods. When they were renewed, the government could amend their terms and collect more charges and taxes. According to Van Loon (1913), the first corporation that granted a perpetual charter was the Dutch East India Company whose name is the Verenigde Oostindische Compagnie (VOC) in Dutch. It was founded by Amsterdam merchants in the Netherlands on March 20th, 1602. These wealthy merchants raised about 64 tons of gold to make many vessels for their international trading activities. The Dutch government provided the VOC with the exclusive right to trade with Asia. The VOC's shares were traded publicly in the open market until 1613 when the first stock exchange (in the world) was built in Amsterdam. At the initial public offering (IPO) launched in 1604, its share price was 500 pounds. After about 10 years of development, the company started paying a dividend of 287.50 pounds per share in 1612. This amount was equivalent to 57.5% of the initial share price (Freedman, 2006). Over the first 15 years, the VOC's average dividend yield is 25% (Scott, 1912). In 1799, the VOC was dissolved after 198 years of business.

Along with the development of corporations, law makers recognized and developed legal regulations on dividend payment. In the late 17th century,

regulations on profit and impairment were approved by the British Parliament. They are legally fundamental rules to govern corporate dividend policy (Lease et al., 1999). Corporations are free to conduct their dividend policies based on legal regulations, their charter provisions and practices (Scott, 1912). Consequently, modern corporations have not followed liquidating dividend policy. Their dividends are now a symbolic vehicle of liquidation. They pay dividends to maximize shareholders' wealth.

1.1.2 Definition

From a broad view, a dividend is any kind of property distributed to shareholders. Accordingly, a dividend may be in different forms, such as cash, stock, and other assets. While corporations are obliged to pay interest to their debtholders periodically, they are flexible to decide whether to distribute or not to distribute dividends, and which forms of dividends are distributed. If a corporation fails to pay dividends, there shall not be a breach of contract.

Based on the broad definition, stock dividend is a common form of dividend when firms do want to disgorge cash. According to Ross et al. (2010), stock dividend is not a real dividend since the corporation loses no cash. A stock dividend reduces stock price since it raises the number of shares outstanding. A stock dividend is paid as a percentage. For example, a 5% stock dividend means a shareholder obtains five additional stocks for every 100 stocks held. A stock split also leads to a larger number of shares outstanding and a lower level of stock price. However, the effects of a stock split are commonly stronger. When a corporation launches a stock split with the ratio 2:1, a shareholder holding 100 stocks receive 50 additional stocks and the stock price declines from $75 to about $25 per stock.

From a narrow view, a dividend is defined as a cash payment made by a corporation to its shareholders. Corporations may pay dividends from two sources of funds. The first is their current net income or accumulated retained earnings. The second is other funds. Some academics claim that a payment from other funds should be called as a distribution instead of a dividend. However, it is commonly acceptable to define a cash distribution as a dividend regardless of its source of fund (Ross et al., 2010). When a corporation pays a dividend except a liquidating dividend, its retained earnings and cash reserves decrease. A dividend is the return of shareholders' investment. This book follows the narrow definition.

1.1.3 Types of Dividends

Based on the narrow definition, dividends are classified into three groups by payment time. Table 1.1 shows that they are final dividend, interim dividend, and special dividend.

First, a corporation pays its final dividend after its financial reports are audited. Commonly, the final dividend is suggested by the board of directors and approved by the shareholders' annual meeting. The board of directors often

Table 1.1. Different Types of Dividend.

Criteria	Final Dividend	Interim Dividend	Special Dividend
Time of payment	After the release of final financial reports	Before the release of final financial reports	Regardless of the release of final financial reports
Frequency	Annually	Monthly, quarterly, or semiannually	Nonrecurring
Common source of fund	Current earnings	Accumulated retained earnings	Excess cash reserve

suggest a final dividend as a ratio of the current income and pay it on a per share basis.

Second, an interim dividend is distributed to shareholders before the final financial reports are released. The board of directors often announce interim dividends when releasing interim financial reports. However, the final decision to pay interim dividends is made by shareholders. Interim dividends are commonly paid monthly, quarterly, or semiannually from accumulated retained earnings since the current income has not been available.

Third, a special dividend is an exceptional payment to shareholders. It is not a regular dividend like final and interim dividends. A corporation may pay a special dividend in order to reduce the extra-large cash reserve, change its financial structure, or create a signal to investors.

1.2 What Is Dividend Policy?

1.2.1 Definition

When a corporation creates a dollar of profit, it faces many choices to use the dollar. It may hold the whole net income for future investment or distribute the whole net income to its shareholders or use a certain proportion to pay dividend and keep the rest for future investment. It needs to find an optimal approach in order to maximize its shareholders' wealth. Dividend policy is defined as a set of principles to distribute a corporation's profit. With these principles, corporate managers have to make two decisions: (1) whether their corporation should pay or not pay a dividend and (2) if yes, how much their corporation should use their earnings to pay the dividend. In other words, a dividend policy is reflected by the decision to pay and the dividend magnitude.

In practice, corporations may have other ways to distribute cash to shareholders without paying dividends as shown in Table 1.2. For example, a corporation may use its cash to repurchase shares. Share repurchasing is an alternative of dividend payment. When a corporation buys back its shares, the number of

Table 1.2. Comparison of Cash Dividend, Stock Dividend, Stock Split, and Share Repurchase.

Criteria	Cash Dividend	Stock Dividend	Stock Split	Share Repurchase
Par value	Constant	Constant	Lower	Constant
Number of shares outstanding	Constant	Higher	Higher	Lower
Ex-day stock price	Lower	Constant	Lower	Higher
Common stock	Lower	Higher	Constant	Lower
Common source of fund	Earnings	No need	No need	Earnings

shares outstanding is reduced. Therefore, a share purchase increases shareholders' capital gains and stock price. The corporation decides to repurchase its shares when its managers recognize or want to show that its stocks are undervalued. In this book, we only focus on cash payments as the only way to conduct corporate dividend policy.

1.2.2 Important Dates

Dividend payment procedures start when a corporation releases a declaration of dividend distribution. Main contents of this declaration include the amount of payment, the date of record, and the date of payment. There are four important dates that investors have to remember so that they can make right investment decisions:

- *Declaration date:* The date at which the dividend distribution is officially announced.
- *Record date:* The date at which investors are recognized as the corporation's shareholders to receive the declared dividend. Shareholders who are in the corporation's books after the record date shall not be allowed to obtain the dividend.
- *Ex-dividend date:* The date is commonly from 1 to 3 days before the record date. The gap between the record day and the ex-dividend date relies on the settlement cycle (T + n). When a person buys a stock today, he/she will receive the stock and be officially recognized as a stockholder in the corporation's books after n working days. The ex-dividend date is the most important date to investors who intend to sell or buy stocks. If an investor buys stocks on that day or later, he/she will not receive dividends for them. In principles, the corporation's stock price is reduced by a dividend per share as a compensation for investors who fail to obtain the dividend on the ex-dividend day. The

differences between the ex-dividend date and the record date are presented in Table 1.3.
- *Payment date:* The date at which shareholders receive dividends for their stocks in their bank accounts.

For example, XYZ Corporation announces a dividend of $3 per share on February 5th, 2023. Its announcement shows that the record date is March 31st, 2023 and the payment date is June 30th, 2023. After receiving this declaration of dividend, the stock exchange calculates and announces the ex-dividend date is March 29th, 2023 if the settlement cycle is T + 2. Investors who officially hold XYZ stocks on March 29th, 2023 or later shall not receive the dividend of $3 per share. If you want to obtain this dividend, you should buy the stock before March 29th, 2023 or sell it after March 29th, 2023. In principles, the stock price on March 29th, 2023 decreases by $3.

1.2.3 Measures of Dividend Payment

As discussed above, a dividend policy includes the decision to pay or not to pay and the decision to determine the dividend magnitude. The dividend magnitude is commonly represented by dividend payout ratio and dividend yield. First, dividend payout ratio is defined as the proportion of net income paid to shareholders. Accordingly, the payout ratio is computed by the amount of dividend divided by net income. However, corporations may not pay dividends only from their current earnings but also from their accumulated retained earnings. If the current net income is negative, it is difficult to interpret the negative value of payout ratio. Therefore, academics usually replace net income as a deflator by total assets or

Table 1.3. Ex-Dividend Date Versus Record Date.

Criteria	Ex-Dividend Date	Record Date
Importance	Important to investors to buy or sell their stocks	Important to corporations to identify shareholders who are eligible for dividends
Source	Announced by stock exchanges	Announced by corporations
Calculation	Calculated from the record day and the settlement cycle (T + n)	Set by corporations
Eligibility for dividend	Stocks bought on the ex-day or later shall not be eligible for dividends	Stocks bought on the record day or earlier shall be eligible for dividends
Stock price adjustment	Decreased by a dividend per share	No adjustment

sales revenue in order to avoid this problem. In several academic papers, dividend to assets and dividend to sales are used commonly as proxies of dividend payout ratio.

Second, dividend yield is computed by dividend per share divided by stock price. As a result, dividend yield is determined by stock price which is beyond the corporation's control to some extent. According to Fama and French (1988), dividend yield is more effective than dividend payout ratio in forecasting stock returns. This implies that dividend yield is more informative. However, McManus et al. (2004) show that dividend payout ratio is more effective in signaling outside investors, since it reflects internal information only. Chapter 2 presents dividend policy around the world.

1.2.4 Patterns of Dividend Policy

Although dividend policy is determined by many factors including firm characteristics and business environment, there are common patterns of dividend policy as follows:

- *No dividend policy:* This pattern is followed by firms with many attractive investment opportunities. When they need to save much cash for future investment, they are less likely to pay dividends. According to DeAngelo and DeAngelo (2006) and Grullon et al. (2002), young firms have more investment opportunities than older ones, and thus they have high incentives to conduct no dividend policy. However, no dividend policy cannot be implemented without shareholders' support. Shareholders may insist on dividend distribution rather than retained earnings when they are concerned about the future prospect (Gordon, 1959). Therefore, the management has to persuade shareholders so that they are optimistic about their firms' future development. Long-term investors tend to prefer capital gains to dividends. Therefore, they support no dividend policy more than speculators.
- *Residual dividend policy:* This pattern considers a dividend as a residual leftover. If firms still have cash after financing all profitable investment opportunities and business activities, they resort to pay dividends in order to improve their asset management efficiency (Weston & Brigham, 1979). Excess cash creates no added value; therefore, dividend payment is necessary to clear it. In other words, firms following residual dividend policy only distribute dividends when they do not have to raise external funds.
- *Stable dividend policy:* This pattern focuses on maintain a stable payout ratio or dividend per share. Firms may set a specific percentage of their earnings annually to pay dividends or keep their dividend per share constant for many years despite fluctuations of their earnings. Stable dividend policy is a financial burden to firms when their earnings are low. However, it is a good opportunity for many shareholders such as retired people, low-income households, and blue-collar workers. These people need stable investment returns in order to pay for their living expenses.

- *Irregular dividend policy:* This pattern fails to consider dividend payment as an obligation. Firms following this pattern never pay dividends periodically and thus investors cannot predict when they make payment and how much they pay. Unlike stable dividend policy, irregular dividend policy fails to create pressure to firms when their financial performance is limited. Their investors are not shocked when receiving no dividends.

1.3 Why Do Firms Hold Cash?

When firms pay cash dividends, their cash reserves decline. Therefore, motives of cash holdings provide a better understanding of dividend policy. Common cash holding motives include transaction motive, precautionary motive, agency motive, predation motive, and tax motive. First, transaction motive drives firms to save cash when transaction costs are significant. A lack of internal funds may force firms to sell noncash assets, raise external funds, and reduce dividends. Selling noncash assets leads to advertising costs and brokerage fees. Raising external funds results in floatation costs including but not limited to brokerage, underwriting, legal, registration, and audit fees. Therefore, firms are more likely to reduce dividends if they want to avoid these transaction costs. Second, precautionary motive drives firms to hold cash in order to handle unpredictable events and have enough resources for emerging investment opportunities. Firms with insufficient cash reserves face high probability of bankruptcy and miss profitable investment projects, which leads to low profitability (Campello et al., 2010). Consequently, cash holdings play the role of a safety buffer. Firms tend to save more cash from their cash flows when they are financially constrained and their cash flows are more volatile (Almeida et al., 2004; Bates et al., 2009). Third, agency motive makes corporate managers prefer cash. As an agent, corporate managers have high incentives to expropriate shareholders since they control resources that they do not own. Accordingly, managers prefer to hold more cash for overinvestment in order to build their empire and strengthen their positions (Jensen, 1986). Fourth, predation motive drives firms to accumulate cash when they face aggressive competition. Cash reserves can play the role of a deterrent to predation, prevent potential entrants, and create cash flow pressure on weak rivals (Haushalter et al., 2007; Hoberg et al., 2014; Root & Yung, 2022). Finally, tax motive drives multinational corporations to save cash in order to avoid the tax burden. When home countries impose high tax rates on foreign income, multinational corporations are less likely to transfer foreign income to their home countries. Their foreign subsidies hold high levels of cash in host countries which have low income tax rates to avoid repatriation costs. Many US firms have high levels of cash holdings due to tax motive (Fritz Foley et al., 2007).