

# DOES A HIGH DIVIDEND PAYOUT RATIO SIGNAL PROPER CORPORATE GOVERNANCE OR HIGH AGENCY COST OF DEBT?

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## Abstract

This paper examines the relationship between dividend policy and the cost of debt in Morocco. The results show that high dividend payments reflect a low level of agency costs of equity and low information asymmetries. Consequently, creditors demand lower return for providing their capital to high dividend-paying firms. The findings reveal that creditors are less concerned with agency costs of debt. The study shows that the negative relationship between dividend payout ratios and cost of debt is more pronounced in firms with higher information asymmetries.

**Keywords:** Cost of Debt, Dividend Policy, Agency Problems, Information Asymmetries, Emerging Markets

**JEL Classification:** G34, G35

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## 1. INTRODUCTION

For investors in emerging markets, corporate governance mechanisms must be closely watched. The United States, Germany, Japan, and the United Kingdom have some of the best corporate governance systems in the world (Shleifer & Vishny, 1997). On the contrary, emerging markets are characterized by weak governance mechanisms at both the country and firm level which may trigger severe agency problems (Claessens, 2003; Denis & McConnell, 2003; Khwaja & Mian, 2006). Furthermore, several studies report that, in emerging economies, the absence of corporate governance mechanisms facilitates diversion of assets and managerial expropriation of many privatized firms (Boycko, Shleifer, & Vishny, 1994). Therefore, in these markets, firms are prone to corruption and abuse of minority shareholders rights through assets tunneling, asset stripping, insider trading and self-dealing (Claessen & Fan, 2002; Sawicki, 2008). As a result, capital markets have witnessed an increase in the fear of investors and dearth of external capital, which limit firms' ability to access external sources of financing, and jeopardize the development of capital markets (Grossman & Hart, 1986; Williamson, 1985).

Prior research has addressed the relationship between dividend policy and agency costs of equity. This research shows the role of dividends as a reputation building tool that not only facilitates access to capital markets, but also enables managers to minimize their cost of equity (Easterbrook, 1984; Jensen, 1986; La Porta et al., 2000b; Rozeff, 1982). The relationship between dividend policy and agency cost of debt has also been thoroughly investigated. The empirical findings show how the firm's dividend policy affects creditors' decisions and their required rate of return (Agrawal & Jayaraman, 1994; Brockman & Unlu, 2009; Crutchley & Hansen, 1989; Faccio, Lang, & Young, 2001; Gugler & Yurtoglu, 2003; John & Nachman, 1985; Nini et al., 2007).

Notwithstanding prior research, the relationship between dividend policy, as an indicator of the quality of corporate governance within the firm and cost of debt can benefit from further investigation. Farooq and Jabbouri (2015) document how dividend payments help firms reduce their cost of debt by improving their reputation and lowering the level of information asymmetry. Conversely, Byun (2007) argues that corporate governance generally benefits shareholders, but at the same time, it could involve different consequences for creditors. The alignment of interests between debtholders and shareholders does not eliminate the potential conflicts of interests between them. Therefore, Byun suggests that the net impact of quality shareholder governance on debtholders is theoretically unclear; hence, this issue remains an empirical question which deserves further exploration (Anderson, Mansi, & Reeb, 2003; Klock, Mansi, & Maxwell, 2005). This paper attempts to bridge this important gap in the literature by investigating the relationship between dividend policy and cost of debt in the Moroccan market in the period between 2004 and 2015. It attempts to answer the following question: Does a high dividend payout ratio signal proper corporate governance or high agency cost of debt?

Morocco appears to be the most stable country in the Middle East and North Africa MENA region thanks to the ongoing and extensive political and economic reforms undertaken by the king and the government in recent years. Reverence and worship for monarchy in Morocco has contributed to a reduced risk of revolts and a more assured political stability in the country. However, due to the domination of the political elites on the decision making power, large segments of the population are being alienated and the trajectory of policy development for many investors is hazed. Yet, the main challenges for this social and political stability come from high unemployment rates, high poverty rates and high discrepancy between the social

classes as well as the widespread of corruption and favoritism. Morocco's economy is expected to remain a relative outperformer compared to other MENA countries over the short and medium term. The positioning of Morocco as an export-oriented manufacturing hub for the European market and progressively to the Sub-Saharan Africa makes it a favorable destination for international investors. Further, the growing tourism industry strengthens the attractiveness of the country and increases its potential growth over the next coming years. The strong ties with the Gulf countries and the new links with Russia and China are expected to materialize in terms of increased investment from these countries over the long term. The massive investments of the kingdom in renewable energy over the last few years and that are expected to continue over the coming period, as part of the National Energy Plan 2020, should lessen its heavy energy bill, advance Morocco's economic growth, and improve its desirability for international investors.

The Casablanca Stock Exchange (CSE), created in 1929, is the official stock market of Morocco and the third largest stock exchange in Africa. Morocco has similar characteristics to mature African markets; hence, the results of this study can be generalized to this region. Poor governance mechanisms at firm and country level, lax information disclosure requirements, and institutional underdevelopment limit the ability of this financial market to stimulate economic growth. Despite all the efforts made by the CSE, it recently started suffering from a reputational problem because of its downgrade from an emerging market to a frontier market. In the past two years S&P and Moody's have downgraded the equities market in Morocco. The downgrade was justified by the liquidity problems CSE was facing. Investors and creditors were shaken by the news of the downgrade, and it is taking time to recover the confidence they had in the Moroccan stock market despite the attempts made by the CSE to energize the underperforming Moroccan market.

CSE addresses corporate governance issues to improve the integrity of local markets with the hope to reassure local investors and attract international investors. Furthermore, most of the actions undertaken by the regulatory authorities over the last two decades in emerging markets in general and more particularly in Morocco, have focused on protecting shareholders' rights. Neglecting creditors' rights may weaken their role as the primary source of financing in this economy and give rise to severe agency problems between shareholders and creditors. Hence, Morocco provides a distinctive environment to explore the impact of good shareholders' governance on debtholders. Moreover, most of the research in finance focuses on the G-7 countries (Bekaert & Harvey, 2003). The authors argue that the conditions in these markets are in harmony with the theoretical model assumptions. In many cases, models based on these assumptions fail to be supported when implemented in emerging markets. This research attempts to contribute to either developing new models or adapting existing ones to the individual characteristics of emerging markets.

The paper proceeds as follows. Section 2 reviews the literature, section 3 describes

methodology and discusses the results, while section 4 concludes.

## 2. LITERATURE REVIEW

The relationship between dividend policy and corporate governance has been studied extensively. As the free cash flow of the firm increases agency problems between insiders and minority shareholders intensify (Jensen, 1986). In their attempt to serve their goals, the agents spend the excess cash on projects with a negative present value, which decreases shareholders' wealth (Hu & Kumar, 2004; Jensen, Solberg, & Zorn, 1992; Smith & Watts, 1992).

Many researchers contend that high dividend payments can be used to alleviate agency conflicts through the reduction of free cash flow available to managers (Holder, Langrehr & Lawrence, 1998; La Porta et al., 2000b). Several studies support this finding showing that firms in emerging countries tend to pay high dividends in order to build a reputation of decent treatment of minority shareholders (DeAngelo, DeAngelo, Stulz, 2004; Rozeff, 1982; Sawicki, 2008). On the same line, Mitton (2004) uses a sample of 365 firms from 19 emerging countries to examine the relationship between corporate governance and dividend policy. The author concludes that firms with stronger corporate governance have higher dividend payouts<sup>18</sup>. High dividend payments also indicate a reliance on capital markets for financing. Paying high dividends reflects management's willingness to undergo analysts' examination, which reduces information asymmetry and mirrors good governance at the firm level (Bhattacharya, 1979; Crutchley & Hansen, 1989; Dempsey & Laber, 1992).

Monitoring and the risk-aversion problems<sup>19</sup> are lessened if the firm is repeatedly in the market for new capital and being scrutinized by financial analysts. If managers decide to raise equity or debt from financial markets, investors (equity and/or debt-holders) will have an opportunity to carefully examine and review the business. In this situation managers are more likely to serve investor interests than agents who are immune from this kind of monitoring (Easterbrook, 1984). Given that firms paying high dividends are perceived to be less risky and experiencing low agency problems, firms can improve their reputation by disgorging high amount of cash and raise capital at competitive rates (Gomes, 2000; Hope, 2003).

It follows from the above discussion that dividend policy is an important determinant of the quality of corporate governance in emerging markets (La Porta et al., 2000). High dividend payouts not

<sup>18</sup> Mitton (2004) provides evidence that firms with strong corporate governance have a tendency to exhibit a higher profitability. He also shows that the higher profitability provides only a partial explanation of the higher dividend and that the latter is a result of strong corporate governance mechanisms. The author also suggests that firm-level corporate governance and country-level investor protection are complements rather than substitutes since the positive relationship between corporate governance and dividend payouts is limited primarily to countries with strong investor protection.

<sup>19</sup> The problem of avoiding risky projects that could maximize shareholders' value.

only improve the firm's reputation vis-a-vis outside investors, but lower agency problems and information asymmetries as well (Grossman & Hart, 1980). In this research, we argue that a high dividend payout ratio, being an indicator of better governance, lowers agency problems and reduces information asymmetry; hence, it should be associated with a lower cost of debt. Therefore, we hypothesized that there is a negative relationship between cost of debt and dividend payout ratio.

An opposing view contends that in emerging markets characterized by weak protection of creditors and low level of creditor rights, debt-holders would be more concerned with agency cost of debt. Black and Scholes (1973) state that dividend payments always favor stockholders at the expense of creditors. The authors use the following example to illustrate how high dividend payments can be used to transfer wealth from creditors to shareholders:

*"To take an extreme example, suppose again that the corporation's only assets are the shares of another company, and suppose that it sells all these shares and uses the proceeds to pay a dividend to its common stockholders. Then the value of the firm will go to zero, and the value of the bonds will go to zero. The common stockholders will have "stolen" the company out from under the bond holders".*

This extreme example summarizes the influential role agency cost of debt plays in setting dividend policies all over the world. Shareholders are motivated to substitute assets and invest in high risk projects with high-expected return since shareholders enjoy the gains while losses are shared with creditors. This risk of adverse selection deepens the agency cost of debt and contributes to the transfer of wealth from creditors to shareholders. When taken into consideration by lenders, these potential problems increase the perceived risks and result in more stringent credit terms. Further, when information asymmetry is high, the overall risk perceived by creditors is higher because the firm's environment encourages value destroying actions as well as earning manipulation by management (Roberts & Yuan, 2006).

In an attempt to reassure creditors, management planning to tap the credit market repeatedly, either voluntarily or under creditors' pressure, would accept restrictions on dividend payouts to signal a low level of agency cost of debt within the firm (Agrawal & Jayaraman, 1994; Brockman & Unlu, 2009). One of the most important arguments cited to explain the relationship between a restricted dividend payout policy and a lower cost of debt is that creditors seek additional protection when their rights are weak, legal protection is inappropriate and the confidence to recover their claims is low (Jensen et al., 1992; Nini, Smith & Sufi, 2007). However, creditors are able to restore confidence and lower their risks by ensuring that bond indentures contain covenants that restrict the firm's dividend payout policy (Day & Taylor, 1996; Kalay, 1982; Mather & Peirson, 2006). Yet, there is evidence that covenants can be used to either lower the risk of investments and protect creditors or signal the potential hazard of the borrower (Chava, Livdan & Purnanadam, 2009; Cremers, Nair & Wei, 2006). These mixed results suggest that the role of covenants in protecting creditors is still ambiguous.

Therefore, the insufficient monitoring provided by covenants reflects the important and influential role of firm and country level corporate governance in shaping creditors' decisions and determining their required rate of return (Zhu, 2009).

Several studies suggest that firms planning to access capital markets frequently in the future are keen to establish a good reputation of decent treatment of creditors by restricting dividends (Brockman & Unlu, 2009). These studies show that a restrictive dividend policy minimizes the conflicts between equity-holders and debt-holders and substitutes for the low level of creditors' rights as managers try to establish a decent reputation and minimize future financing costs. A conservative dividend policy would reflect a low level of agency cost of debt, grant creditors more control over the company, and provide a balance against the weak level of creditors' rights (Agrawal & Jayaraman, 1994; Gugler & Yurtoglu, 2003). Therefore, an opposing hypothesis suggests that a restrictive dividend policy may signal low agency cost of debt, which would minimize the firm's risk and result in a lower required rate of return by creditors.

This paper attempts to confront the two contradicting explanations reported by previous research. Some studies consider high dividends a major indicator of proper shareholders' governance, others document that high dividends are associated with an expropriation of creditors by shareholders. This study adds new empirical evidence on the relationship between dividend policy, agency costs of equity, and agency costs of debt and the outcome of this research reveals new evidence on the net impact of shareholders decent governance on debtholders.

### 3. METHODOLOGY AND EMPIRICAL RESULTS

#### 3.1. Data and Variables

This research includes all firms listed on CSE between 2004 and 2015. The choice of the period is driven by the fact that it has attracted significant interest from investors and regulators resulting in an increased market activity. The study excludes financial firms due to their special financial structures, accounting methods, and corporate governance (Berger et al., 1997). Final sample size includes 715 firm year observations. Datastream and Worldscope are used to assemble data. All data is yearly and expressed in Moroccan Dirham.

##### 3.1.1. The dependent variable: cost of debt

We define the cost of debt (CoD) as the interest rate on the firm's debt, which is equal to interest expense net of capitalized interest for the year divided by average short- and long- term debt for the year (Francis, Khurana & Pereira, 2005; Zhu, 2009). One of the reasons for this choice is the unavailability of data on the yield on outstanding bonds while banks and equity are the main components of the Moroccan capital markets. Panel A of Table 1 shows that the mean cost of debt in the study period is 0.079 and the median is 0.048.

### 3.1.2. The independent variable: dividend policy

The dividend payout ratio (PoR) is used as a proxy for dividend policy, defined as the ratio of total dividends to operating profits, that is profits before interests and taxes (Chen & Dhiensiri, 2009). This measure helps avoid issues based on traditional measure of dividend payout ratio, computed as total dividends divided by net income, in case the firm incurs losses and decides to pay dividends. Panel A of Table 1 shows that the sample firms have a mean payout ratio around 29.12% and a median of 25.11%.

### 3.1.3. Control variables

A number of firm specific characteristics that may play a role in driving the results of the study are used as control variables. We use size, leverage, profitability, growth, liquidity, default risk, and expected inflation as control variables.

We use the natural logarithm of total market value of equity as a proxy for the firm's size (SIZE). In this respect, several studies report that larger firms are less risky and enjoy greater access to debt markets compared to smaller firms, which are less diversified on production and distribution side, and hence, would encounter more financing restrictions (Behr & Güttler, 2007; Plattner, 2002). Smaller firms are often charged a higher interest rate due to their lack of diversification as well as their inability to provide appropriate collateral because of their low asset base (D'Auria, Foglia, & Reedtz, 1999; Lehmann & Neuberger, 2000).

Total debt to common equity ratio (LEVERAGE) is added as a proxy for financial leverage (Jensen et al., 1992). Prior literature associates higher leverage with higher risk. Leverage increases firms' obligations including principle and interest

payments on debt, and consequently, results in a higher required rate of return by creditors (Zhu, 2009). Profitable firms are irrevocably in a better position to honor their obligations and enjoy a lower cost of debt. To control for the profitability of the firm we use return on equity (ROE). Fourth, high growth entails more external financing. A possible explanation is the investment in working capital needed to support the growth is higher than the incremental cash flow provided by growth in sales (Higgins, 1981). However, high growth firms benefits from a lower cost thanks to their high profitability (Zhu, 2009). Growth in assets (GROWTH) is used as a proxy for the firm's growth opportunities.

Liquidity is highly important for firms planning to raise debt. More liquid firms enjoy an easier access to debt markets and at lower rates (Morellec, 2001; Shleifer and Vishny, 1992). Quick or acid test ratio is the proxy used for liquidity (Papadopoulos & Charalambidis, 2007). Interest coverage ratio defined as the ratio between earnings before interest and taxes (EBIT) and total interest expenses, is used as a proxy for the default risk of the firm (DEFAULT). Prior literature documents that rating agencies take into consideration business risk, financial risk, and industry risk, amongst others, to arrive at an appropriate credit rating (Altman, Caouette, & Narayanan, 1998). This strand of literature notes that rating agencies pay a special attention to interest coverage ratio while determining the credit ratings (Baker & Powell, 1999). Finally, expected inflation (INFLATION) is a main determinant of risk free rates, and therefore the cost of debt. We use Treasury bill rates for the year to capture the effect of inflation on the cost of debt (Clifton, Douglas & Jerry, 1995). Appendix A contains variables' definition and their various uses in the literature

**Table 1.** Descriptive statistics for the variables used in the study

#### Panel A. Mean and median values the variables used in the study

	Mean	Median		Mean	Median
CostOfDebt	0.079	0.048	GROWTH	17.43	10.39
PoR	29.12	25.11	LIQUIDITY	1.13	.54
SIZE	12.41	12.12	COVRATIO	17.63	6.07
LEVERAGE	21.40	18.16	INFLATION	2.02	1.90
ROE	14.58	7.21			

#### Panel B. Correlation matrix

	PoR	SIZE	LEVERAGE	ROE	GROWTH	LIQUIDITY	DEFAULT	INFLATION
PoR	1.0000							
SIZE	0.0188	1.0000						
LEVERAGE	-0.0987	0.1542	1.0000					
ROE	0.2315	-0.0398	0.0255	1.0000				
GROWTH	-0.0203	0.0308	-0.0411	0.0346	1.0000			
LIQUIDITY	0.1985	-0.2319	-0.1145	0.2761	0.0511	1.0000		
COVRATIO	0.0105	0.2231	-0.1218	0.0309	0.0398	0.0421	1.000	
INFLATION	0.0327	0.1301	-0.0781	0.0923	0.0429	-0.0221	-0.0856	1.0000

Descriptive statistics for control variables are provided in Table 1. Panel B of Table 1 shows low levels of correlations between control variables. It indicates that all of the variables can be included together in the regression equation<sup>20</sup>.

<sup>20</sup> The Variance Inflation Factor (VIF) for each of the explanatory variables is used to scrutinize multicollinearity issues from which the sample may suffer. Fortunately, all the VIF values are low and none of them exceeds 1.24.

### 3.2. Model and Empirical Results

In order to study the effect of payout ratio on cost of debt in CSE, we employ a panel regression with cost of debt (CoD) as a dependent variable and dividend payout ratio (PoR) as an independent variable. To control for unobserved heterogeneity, dummy variables representing firm-specific fixed effects (FDUM) are also included. The basic regression takes the following form.

$$\text{CoD}_{it} = \alpha + \beta_1(\text{PoR}_{it}) + \beta_2(\text{SIZE}_{it}) + \beta_3(\text{LEVERAGE}_{it}) + \beta_4(\text{ROE}_{it}) + \beta_5(\text{GROWTH}_{it}) + \beta_6(\text{LIQUIDITY}_{it}) + \beta_7(\text{DEFAULT}_{it}) + \beta_8(\text{INFLATION}_{it}) + \sum \beta_{\text{Fixed}}(\text{FDUM}) + \varepsilon \quad (1)$$

where, the subscript *i* represents the cross-sectional dimension and *t* denotes the time-series dimension.

For equation (1), the fixed effects model and the random effects model are produced. Hausman test is used to decide between the two models and resulted in the choice of the fixed effects model. The results of the analysis are reported in Table 2. The adjusted R-squared for equation (1) is relatively high at 0.4211. The coefficient of PoR is negative and significant. For an increase in dividend payout ratio by one unit, the cost of debt decreases by 0.0072 units. High dividend payments convey a low level of information asymmetry and agency problems. Better corporate governance lowers the risks perceived by creditors who require a lower rate of return for properly governed firms. A low level of agency costs of equity signal to debt-holders that the firm's resources are used efficiently, which enhances its performance and increases its ability to service its debt obligations.

These results are consistent with the prior findings reported by Farooq and Jabbouri (2015) for a larger sample of MENA countries. The results support the conclusion that corporate lenders are less concerned with agency cost of debt that may arise from dividends. Plausible explanations for this result include a low level of agency cost of debt, or creditor actions that reduce these potential problems. This finding is consistent with prior studies that document that the use of debt covenants and the active monitoring of lenders, especially banks, the main providers of debt in Morocco, help reduce agency cost of debt and improve firms' organizational efficiency (Agrawal & Knoeber, 1996). The large amounts banks have at stake increase their incentives to monitor the projects of borrowers and establish a long-term relationship (Besanko & Thakor, 1993; Von Thadden, 1995). As a result, corporate lenders seem more focused on the quality of corporate governance, the level of information asymmetry and agency costs of equity that may harm the firm and affect its ability to honor its debt obligations. This result is also in line with the findings of Baker and Jabbouri (2016) who surveyed the managers of CSE listed firms to learn their views about the factors influencing dividend policy. Moroccan managers rank the "Desire to send a favorable signal to current or potential lenders" as one of the main factors taken

into account in setting their dividend policy. The same study reports that Moroccan managers acknowledge the existence of severe agency problems, which justifies the concern of creditors about the quality of corporate governance.

**Table 2.** Relationship between dividend policy and cost of debt

	Equation (1)
PoR	-0.0072***
SIZE	-0.0164**
LEVERAGE	0.0729***
ROE	-0.0043**
GROWTH	-0.0177**
LIQUIDITY	-0.0081**
COVRATIO	-0.0420*
INFLATION	0.0879***
Constant	-0.0981
Fixed Effects	Yes
No. of observations	715
No. of groups	46
F-value	4.52
R <sup>2</sup> within	0.4211

Note: \*, \*\*, \*\*\* indicate significance at the 10%, 5%, and 1% levels respectively. PoR is defined as the ratio of total dividends to operating profits. SIZE is measured as the natural logarithm of total assets. LEVERAGE is defined as total book value of debt divided by total assets. ROE is used to proxy for profitability. GROWTH is measured as the annual growth in assets. LIQUIDITY is measured as the quick or acid test ratio. COVRATIO is defined as the ratio between earnings before interest and taxes (EBIT) and total interest expenses. Expected Inflation is measure as the annual inflation rate.

### 3.3. Effect of growth opportunities on the relationship between dividend policy and cost of debt

Several studies contend that the asymmetric information problem is more severe for firms with significant growth opportunities (Fama & French, 2005; Frank & Goyal, 2003). The argument is that managers of high growth firms have privileged information about the firms' investment opportunities and expected future cash flow to be provided by firms' existing assets (Smith & Watts, 1992). Similar to other studies, we use growth of the firm to proxy for the level of information asymmetry (Clarke & Shastri, 2000; Varici, 2013). Hence, Equation 1 is re-estimated with the sample divided into two groups - one group with above median growth of the entire sample and the other group with below median growth of the entire sample. The results show that the earlier findings hold only in high growth firms. Table 3 reports a significant negative coefficient of PoR for high growth firms and an insignificant coefficient of PoR for low growth firms. The analysis documents that the negative relationship between dividend payout ratio and cost of debt is more pronounced in firms with higher information asymmetries. This finding is consistent with other studies (Choi, Mao & Upadhyay, 2008; Farooq & Jabbouri, 2015) that show that the value relevance of dividends is larger for high growth firms subject to greater information asymmetry.

**Table 3.** Effect of growth on the relationship between dividend policy and cost of debt

	High Growth	Low Growth
PoR	-0.0058***	-0.0283
SIZE	-0.0032**	-0.0024*
LEVERAGE	0.0133**	0.0019**
ROE	-0.0012*	-0.0019*
GROWTH	-0.0405**	-0.0176*
LIQUIDITY	-0.0027***	-0.0035**
COVRATIO	-0.0731**	-0.0082***
INFLATION	0.0431***	0.0672**
Constant	0.0796	0.2004
Fixed Effects	Yes	Yes
No. of observations	364	351
No. of groups	25	21
F-value	7.55	4.66
R <sup>2</sup> within	0.4251	0.3041

Note: \*, \*\*, \*\*\* indicate significance at the 10%, 5%, and 1% levels respectively. PoR is defined as the ratio of total dividends to operating profits. SIZE is measured as the natural logarithm of total assets. LEVERAGE is defined as total book value of debt divided by total assets. ROE is used to proxy for profitability. GROWTH is measured as the annual growth in assets. LIQUIDITY is measured as the quick or acid test ratio. COVRATIO is defined as the ratio between earnings before interest and taxes (EBIT) and total interest expenses. Expected Inflation is measure as the annual inflation rate.

### 3.4. Effect of size on the relationship between dividend policy and cost of debt

Existing studies show that larger firms enjoy greater analyst coverage (Bhushan, 1989) and more institutional ownership (McNichols, 1990; Chung and Zhang, 2011), which make them subject to external monitoring. The level of information asymmetry and agency costs of equity is lower when external monitoring is exercised. In the same line, Jin (2000) and Yoon and Starks (2004) assert that the reaction of small firms' stock prices to dividend announcements is higher than the reaction of larger firms. This implies that the signalling power of dividend decreases as the size of the firm increases. Eddy and Seifert (1988) argue that the bigger the size of the firm the greater is the publicly available information on the firm and the lower is the level of information asymmetry between insiders and outsiders. The level of information asymmetry would determine the value of the additional information contents embedded in dividends payment.

In this analysis, the sample is divided into two groups - one group with above median size of the entire sample and the other group with below median size of the entire sample. Equation 1 is re-estimated for the two subsamples. The results, reported in Table 4, show that the earlier findings hold only for smaller firms subject to greater information asymmetry. Investors of small firms have scarcity of information. Hence, the incremental information embedded in dividend payments is more valued by these investors. This finding is consistent with prior results reported by Farooq and Jabbouri (2015) and Lang, Lins, and Miller (2004).

**Table 4.** Effect of size on the relationship between dividend policy and cost of debt

	Large firms	Small firms
PoR	-0.0022	-0.0093***
SIZE	-0.0039**	-0.0062**
LEVERAGE	0.0077***	0.0066***
ROE	-0.0048**	-0.0032*
GROWTH	-0.0502**	-0.0435*
LIQUIDITY	-0.0037***	-0.0020***
COVRATIO	-0.0072*	-0.0019**
INFLATION	0.0654***	0.08923***
Constant	0.4381	0.8745*
Fixed Effects	Yes	Yes
No. of observations	328	387
No. of groups	20	26
F-value	4.57	6.71
R <sup>2</sup> within	0.3107	0.4275

Note: \*, \*\*, \*\*\* indicate significance at the 10%, 5%, and 1% levels respectively. PoR is defined as the ratio of total dividends to operating profits. SIZE is measured as the natural logarithm of total assets. LEVERAGE is defined as total book value of debt divided by total assets. ROE is used to proxy for profitability. GROWTH is measured as the annual growth in assets. LIQUIDITY is measured as the quick or acid test ratio. COVRATIO is defined as the ratio between earnings before interest and taxes (EBIT) and total interest expenses. Expected Inflation is measure as the annual inflation rate.

## 4. SUMMARY AND CONCLUSION

Prior literature contends that, in emerging countries, a high dividend payout ratio signals lower agency problems, and information asymmetries. Lower risks should be associated with a lower cost of borrowing. Another strand of literature provides evidence that a high dividend payout ratio reflects agency cost of debt between shareholders and creditors. Hence, higher risks for creditors result in a higher cost of debt. The empirical evidence reported in this study for non-financial firms listed on the Casablanca Stock Exchange shows that high dividend payments reflect a low level of agency costs of equity and low information asymmetries. Corporate lenders focus on the agency costs within the firm and appear less concerned with agency costs of debt. Hence, creditors demand lower return for providing their capital to high dividend-paying firms. The study shows that the negative relationship between dividend payout ratios and cost of debt is more pronounced in firms with higher information asymmetries.

Given the strong economic ties between financial markets and the real economy, this research is expected to have a predominant social impact as well (Bekaert & Harvey, 2000a; Henry, 2000b). Bekaert and Harvey (2003) argue that the impact of a lower cost of capital and the following economic growth in emerging markets "can be measured not just in dollars -- but in the number of people that are elevated from a desperate subsistence level to a more adequate standard of living".

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