Cash Holdings, Dividend Policy, and Corporate Governance: A Cross-Country Analysis

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Cash is a liquid asset with little uncertainty about its value. For smaller, riskier companies, cash acts as a buffer against adverse outcomes. For companies with abundant investment opportunities, cash is a low-cost means of funding.

But controlling shareholders can more easily expropriate/divert/misuse cash than fixed assets. Moreover, corporate managers in mature companies can waste cash on value reducing projects, such as diversification into unrelated areas.

Companies with controlling shareholders in weak governance regimes will hold more than the value-maximizing level of cash. And such cash holdings are more vulnerable to future expropriation. So cash is valued at a discount in countries with weak investor protection. In contrast, dividends are valued more highly in such countries.

Companies that pay out a higher proportion of their earnings and cash flows should be worth more to minority shareholders. A dollar of dividends can be worth much more than a dollar to the shareholders because they expect the firm to keep paying that amount of dividends in the future.

In countries with better investor protection, cash contributes significantly more to firm value. In countries with high levels of corruption, each additional dollar of cash holdings was associated with an increase in firm value of just $0.33. In contrast, in countries with the least corruption, the next dollar of cash appeared to be worth $0.91. A dollar of cash built up over the most recent year was associated with a change in firm value of $0.29 in countries with a low minority shareholder rights index and $0.95 in countries with a high value of the index.

Companies that choose to borrow good governance practices from countries with better investor protection (say, by listing in those countries), have higher values than otherwise comparable firms. This "good governance" premium is inversely correlated with the protection enjoyed by minority investors.