CHAPTER 12: THE FIRM LIFE CYCLE THEORY OF DIVIDENDS

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Introduction

The firm life cycle theory of dividends is based on the notion that as a firm matures, its ability to generate cash overtakes its ability to find profitable investment opportunities. Eventually, the optimal choice is for the firm to distribute its free cash flow to shareholders in the form of dividends.

According to the firm life cycle theory of dividends, a young firm faces a relatively large investment opportunity set but is not sufficiently profitable to be able to meet all its financing needs through internally generated cash. In addition, it faces substantial hurdles in raising capital from external sources. As a result, the firm will conserve cash by forgoing dividend payments to shareholders. Over time, after a period of growth, the firm reaches the maturity stage in its life cycle. At this point, the firm’s investment opportunity set is diminished, its growth and profitability have flattened, systematic risk has declined, and the firm generates more cash internally than it can profitably invest. Eventually, the firm begins paying dividends to distribute its earnings to shareholders. The extent to which a mature firm distributes earnings to shareholders instead of investing them internally is a function of the extent to which the interests of its managers are aligned with those of its shareholders.

The life cycle theory of dividends predicts that a firm will begin paying dividends when its growth rate and profitability are expected to decline in the future. This is in sharp contrast to the signaling theory of dividends, which predicts that a firm will pay dividends to signal to the market that its growth and profitability prospects have improved (i.e., that dividend initiations and increases convey “good news”).

The empirical evidence on dividend initiations and changes generally supports the life cycle theory of dividends but is contrary to the signaling theory. Benartzi, Michaely, and Thaler (1997) find that dividend increases are not
followed by an increase in the earnings growth rate, while dividend reductions are associated with an improvement in the growth rate. Grullon, Michaely, and Swaminathan (2002) find that firm profitability declines after a dividend increase and rises after a dividend decrease.

Bulan, Subramanian, and Tanlu (2007) find that firms initiate dividends after reaching maturity in their life cycles. Initiators are firms that have grown larger, are more profitable, have greater cash reserves, and have fewer growth opportunities than do noninitiators at the same stage in their life cycles. They also find that no significant improvement in profitability or growth occurs around the initiation. DeAngelo, DeAngelo, and Stulz (2006) find that the probability that a firm pays dividends is significantly related to the mix of (internally) earned capital and (externally) contributed capital in its capital structure. Firms with a greater proportion of earned capital are more likely to be dividend payers. The evidence on the change in systematic risk around dividend changes is ambiguous. While Grullon et al. (2002) find that firms that increase dividends experience a decline in systematic risk, Bulan et al. (2007) find that systematic risk does not decline after dividend initiations.

The remainder of the chapter provides a discussion of the theory and empirical evidence in greater detail. The chapter begins with a brief overview of the theory of the firm’s life cycle and how dividends fit in the life cycle, followed by the empirical evidence on dividend policy as it relates to the life cycle theory. The chapter concludes with an assessment of the theory vis-à-vis the evidence and provides a discussion of avenues for future research.

The Life Cycle Theory of the Firm

Mueller (1972) proposed a formal theory that a firm has a relatively well-defined life cycle, which is fundamental to the firm life cycle theory of dividends. His main focus is on the agency problem within the firm, namely, the question of whether the managers of a firm maximize shareholder value or pursue growth for the firm’s own sake and overinvest in assets contrary to shareholder interests. However, he clearly recognizes the implications of the analysis for dividend policy and discusses the empirical evidence on shareholder preference for dividends in this context. Thus, studying the life cycle theory of the firm as proposed by Mueller is meaningful.

Drawing on the work of Knight (1921) and Schumpeter (1934), Mueller (1972) posits that a firm originates in an attempt to exploit an innovation involving a new product, process, or marketing or organizational technique. In its initial stages, the firm invests all available resources in developing the innovation and
improving its profitability. The firm’s growth is likely to be slow until it successfully sorts out “teething issues” and establishes a foothold in the market. Thereafter, the enterprise will grow rapidly, as it enters new markets and expands its customer base before any major competition can arise. The agency problem is either absent or not significant at these initial stages for three reasons. First, the firm faces so many opportunities for profitable investment that the pursuit of growth is also consistent with the pursuit of profits. Second, unable to meet all its financing needs through internal cash generation, the firm is forced to tap external capital markets and is therefore subject to market monitoring and discipline. Third, the entrepreneur or manager still retains a sufficiently high fraction of the firm’s shares for his or her interests to be well aligned with those of the other suppliers of capital.

After a while, competitors begin to enter the market, adopting and improving on the pioneering firm’s innovations. As existing markets become saturated and new markets harder to find, the growth of the firm begins to slow down. To maintain growth and profitability, the firm needs to generate innovations. However, as the firm grows as an organization, its ability to process information deteriorates, and the risk-taking incentives of the average manager diminish. These factors place a limit on the ability of a large firm to grow through innovations. As a result, the firm eventually reaches a point at which it lacks profitable investment opportunities for the cash generated from its existing operations. At this mature stage, a shareholder-value-maximizing firm would begin distributing its earnings to its shareholders. Eventually, when all the existing operations of the firm are on the verge of becoming unprofitable, a value-maximizing firm would liquidate all assets and distribute the proceeds to its shareholders. However, when the managers of a firm do not pursue strict value maximization but are rather interested in expanding the size of the firm to reap perks and other rewards, the distribution of earnings to shareholders will deviate from the optimal policy.

In summary, under the life cycle theory proposed by Mueller (1972), the typical firm will display an S-shaped growth pattern, with a period of slow growth at start-up leading to a period of rapid growth and eventually to maturity and stagnation or slow growth. The next section discusses corporate dividend policy in this framework.

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**Dividends in the Firm’s Life Cycle**

Mueller (1972) also traces the implications of the life cycle theory of the firm to dividend policy. As previously discussed, the optimal dividend policy at a value-maximizing firm in his framework is to retain all earnings in the rapid...
growth phase and to pay out 100 percent of the earnings at maturity. Using a static
discounted cash flow model of equity valuation provides one means of
understanding this optimal dividend policy.

A Simple Static Model of Optimal Dividend Policy

Consider a highly simplified constant growth model of a firm of the type
found in many valuation textbooks, such as that of Bodie, Kane, and Marcus
(2005). The firm is infinitely lived and is fully equity financed. The number of
shares outstanding is normalized to one for ease of exposition. The firm’s return
on assets in place is equal to its return on equity (ROE). In every period, the firm
has access to a set of fresh investment opportunities with expected return equal to
ROE. To focus on the payout decision, we abstract from external financing issues
by assuming that the firm does not access external capital.

Let $E_0$ denote the equity base at the end of year 0. In year 1, the firm earns
an amount $e_1$ given by $(ROE)(E_0)$. Assuming a constant payout ratio of $d$, the
dividend amount for year 1, denoted by $D_1$, is $de_1$, and the amount of retained
earnings for the period is $(e_1 - D_1)$.

The firm invests the retained earnings in new assets that provide a rate of
return of ROE. Hence, total earnings for year 2 are $e_2 = ROE(E_0 + e_1 - D_1) = e_1 +
ROE(1 - d)e_1 = (1 + g)e_1$, where $g$ is the growth rate of earnings, given by

$$g = (e_2 - e_1)/e_1 = ROE(1 - d). \quad (12.1)$$

Extending this logic, the earnings of the firm in year $t$ are $e_t = e_1(1 + g)^{(t - 1)}$, and the dividend amount paid in year $t$ is $D_t = de_1(1 + g)^{(t - 1)}$. The value of the
firm at time 0, given by the present value of future dividends, is therefore equal to
$V_0 = \sum D_t/(1 + k)^t = \sum de_1(1 + g)^{(t - 1)}/(1+k)^t$, where the summation is from $t = 1$ to
infinity.

Assuming for a moment that $g < k$, and substituting for $g$ from Equation 1,
the value of the firm is given by

$$V_0 = de_1/(k - g) = de_1/(k - ROE(1 - d)). \quad (12.2)$$

Equation 12.2 relates the value of the firm to its dividend policy. Based on
Equation 12.2, when $ROE$ is greater than $k$, the value of the firm increases as the
payout ratio $d$ decreases. (However, to be consistent with the assumption that $g < k$, this applies only for $d > 1 - k/ROE$.) When $ROE$ is less than $k$, the value of the
firm increases with the payout ratio. Thus, the optimal dividend policy is to
maintain a 0 percent payout ratio when $ROE > k$ and a 100 percent payout ratio
when $ROE < k$. 
The intuition for this optimal policy is exactly the same as that which underlies Mueller’s (1972) argument that a value-maximizing firm should maintain a zero payout ratio at the initial stages and increase the payout to 100 percent upon reaching maturity. Essentially, when the firm’s investments promise a rate of return (ROE) higher than the firm’s cost of capital (\(k\)), the firm should reinvest all of its earnings in new assets. This is likely to be true for young firms that are in the process of expanding the market for their innovations. But when the expected return on the firm’s investments is less than the firm’s cost of capital (\(k\)), the optimal policy for the firm is to pay out all of its earnings to shareholders. This is likely to be true for firms that have exploited all profitable opportunities for their innovations and reached maturity in their life cycles.

The model of the firm described, though static and highly simplified, is useful in understanding the differences in dividend policy between young firms and mature firms. When combined with a description of the factors driving the changes in the investment opportunity set (i.e., ROE or marginal return on investment), and the cost of capital as a firm matures, the model will provide a complete life cycle–based explanation of dividends.

In the context of Mueller’s (1972) life cycle theory of the firm, one explanation for the decline in the marginal return on investment as a firm grows larger is based on the hypothesis that the ability of an organization to process information and maintain risk-taking incentives declines as the firm matures. The change in cost of capital as a firm grows requires a more detailed analysis, which follows in the next section.

Cost of Capital over the Firm’s Life Cycle

The cost of capital that a firm faces will vary over its life cycle as a result of changes in risk, information asymmetry, and the extent of the agency problem.

Risk

Grullon et al. (2002) present evidence supporting the hypothesis that the systematic risk of firms declines around dividend increases. They explain the decline as caused by a decline in the number of growth options, including compound options, held by the firm. This is, of course, a joint explanation for a reduction in both the cost of capital and the return on investment with maturity. Therefore, it does not, by itself, explain why firm maturity should shift dividend policy in the direction of higher payouts. A better understanding of the link between maturity and payout policy requires analysis of the changes in the level of
information asymmetry and the extent of the agency problem over the firm’s life cycle.

**Information Asymmetry**

When a firm is young and relatively unknown, substantial information asymmetry exists between its insiders and outside investors. As a result, raising capital from external sources is costly. At the same time, the firm’s investment needs are likely to exceed the cash flow from its operations, which implies that its financing comes from external sources at the margin. As a result, the firm faces a high cost of capital. As the firm becomes more established and well known, investors gain better knowledge about its assets and its management, and the level of information asymmetry decreases. Correspondingly, the firm’s cost of external capital decreases. In the context of dividend policy, this implies that as a firm matures, its management has less need to conserve cash for potential future projects and is, therefore, in a better position to make dividend payments.

**The Agency Problem**

The assumption that a firm derives its dividend policy from the objective of shareholder-value maximization may be appropriate for a small entrepreneur-managed firm in which the manager holds a substantial fraction of the firm’s shares and the suppliers of capital are able to monitor the manager closely and take steps to prevent value-destroying activities. However, the professional managers who are employed at large corporations typically do not hold large fractions of the company’s stock. In addition, the diffused nature of shareholding at a large corporation implies that the average shareholder may not have the power to control the management effectively. Mueller (1972) notes that this separation of ownership and control in large corporations implies that managers of these firms may have lower incentives to maximize shareholder value than the entrepreneur-manager. He hypothesizes that managers of large corporations will consequently aim to maximize firm size and growth rather than market value, and will therefore invest more and pay lower dividends than a shareholder-value-maximizing management. (Jensen and Meckling (1976) provide a detailed treatment of this agency problem.)

Mueller (1972, p. 208) links dividend policy to the firm’s life cycle, stating that the “freedom to pursue growth, and the management-stockholder conflict that accompanies it, appear only over time as the firm expands and matures.” On a similar note, Jensen (1986) observes that the shareholder-manager conflict is particularly severe in firms with large free cash flow (i.e., cash flow in excess of investment opportunities), coining the phrase “agency cost of free cash flow” to
denote this problem. The management of a firm with a large free cash flow may be tempted to waste the cash by awarding itself excessive perks and benefits. Another potential problem with high levels of free cash flow is “tunneling.” That is, at firms that are part of a business group controlled by one main shareholder, the controlling shareholder may be tempted to divert cash flow from firms in which he or she has low cash flow rights to firms in which he or she has high cash flow rights.

DeAngelo and DeAngelo (2006) and DeAngelo et al. (2006) characterize the agency cost of free cash flow as a cost associated with retention, which becomes progressively more severe as the firm becomes mature. Grullon et al. (2002) also recognize that the agency problem becomes important in the mature stage of a firm’s life cycle. One view is that the agency cost of free cash flow is more usefully considered a part of the cost of capital of the firm. In an efficient market, investors will incorporate the possibility that the management might waste a portion of the returns on the firm’s investments (whether the wastage occurs through consumption of perks by the management or diversion of profits through tunneling) and demand a correspondingly higher expected return or yield on the firm’s securities when the agency cost is higher. Whether the agency cost is viewed as a cost of retention or an element of the cost of capital, the implication for the life cycle theory of dividends is the same—as a firm matures, it generates more cash than can profitably be invested, and the optimal dividend policy becomes one of investing less and paying out more to shareholders.

Finally, the exact point at which a firm may shift from being a non-dividend payer to a dividend payer may depend on various factors, including the severity of the agency problem, its corporate governance, and the market for corporate control. DeAngelo et al. (2006) emphasize this, and in support, they present evidence that there is no cutoff or trigger point based on the ratio of retained earnings to total assets beyond which a firm would necessarily start paying dividends.

**Empirical Evidence**

This section provides a discussion of the empirical evidence in support of the life cycle theory of dividends. Early empirical studies on dividend policy in the life cycle context attempt to compare the rates of return on dividends and retained earnings at young and mature companies and industries. According to Mueller (1972), shareholders’ preference for dividends over retained earnings (especially in mature industries), documented in many studies, indicates that shareholders tend to believe that firms overinvest for the sake of growth and maintain dividend levels below optimum. Grabowski and Mueller (1975) take a similar static
approach, focusing on a comparison of the market valuation of retained earnings and dividend payments in mature companies against nonmature companies. These studies do not address the question of whether firms delay initiating dividends beyond the optimal point, and only indirectly deal with the question of whether firms pay lower dividends than optimal after initiation. As discussed here, subsequent studies address these questions more directly by examining the market reaction to dividend initiations and dividend changes.

Life Cycle Factors and the Propensity to Pay Dividends

Until recently, few studies directly tested the firm life cycle theory of dividends. Most studies focused on other theories of dividend policy, such as the signaling and clientele hypotheses, with most of the evidence being contrary to the predictions of those theories. The recent interest in the life cycle theory of dividends may perhaps be traced to Fama and French’s (2001) study of the dividend payment behavior of publicly traded U.S. firms. They investigate the patterns and determinants of payout policy over the 1926–1999 period. Their results point to life cycle factors playing a major role in the decision to pay cash dividends. In particular, their findings show that dividend-paying firms are large and highly profitable. These firms have retained earnings that are sufficient to cover their capital investments. On the other hand, firms that have never paid dividends are small and not as profitable as dividend-paying firms. These firms have many investment opportunities that require external financing because their capital spending is far greater than their earnings. Thus, dividend-paying firms have the characteristics of mature firms, while firms that have never paid dividends have the characteristics of young, fast-growing firms.

Furthermore, Fama and French (2001) find that dividend payment propensity decreased in the latter decades of their sample and attribute this, in part, to a surge in new listings after 1978, with the new lists being dominated by firms with strong investment opportunities, low profitability, and high growth rates (i.e., firms in the early high-growth phase of their life cycles). In summary, this study shows a significant relationship between the overall patterns of dividend payment and firm characteristics that determine a firm’s life cycle stage.

DeAngelo et al. (2006) attempt to explicitly test the life cycle theory of dividends by analyzing the relationship between dividend payment propensity and the mix of earned and contributed capital. They measure the mix of earned and contributed capital by the ratio of retained earnings to total equity or total assets of the firm. They assert that this ratio is a good proxy for a firm’s life cycle stage because it captures the extent to which a firm relies on internally generated and external capital. When firms are in their high-growth phase, they rely heavily on
external sources to finance their investments because their earnings capacity is low. Therefore, this ratio will be low for young high-growth firms. In contrast, firms in their mature stage will have high cash flows and few investment opportunities, and will largely be self-financing. Hence, for mature firms, this ratio will be high. The authors test the firm life cycle theory of dividends by relating dividend payment propensity to the mix of retained earnings to contributed capital.

Using a sample of publicly traded U.S. firms in the period 1972–2002, De Angelo et al. (2006) find support for the theory. They document a positive relationship between the proportion of dividend-paying firms and the ratio of retained earnings to total equity and total assets, after controlling for firm characteristics such as profitability, growth, firm size, leverage, cash balances, and dividend history. Thus, a firm is more likely to be a dividend payer when its main source of financing is internally generated earnings. They also find similar results for dividend initiations and omissions.

Denis and Osobov (2008) extend the evidence to five other countries, namely, Canada, United Kingdom, Germany, France, and Japan. In those five countries as well as in the United States, they find that the propensity to pay dividends is strongly associated with the ratio of retained earnings to total equity. However, Megginson and von Eije (2008) report no such association between the ratio of retained earnings to total equity and the propensity to pay dividends in their study of dividends and repurchases at firms listed in fifteen European Union countries. But they do find that firm age, size, and past profitability are positively related to the propensity to pay dividends as predicted by the life cycle theory.

Skinner (2007) studies corporate payout policy including dividends and repurchases and finds that firms are increasingly using repurchases in place of dividends to payout cash flow. He finds that for a large group of firms that payout earnings through dividends and repurchases, the level of repurchases is driven by earnings over two- or three-year windows, which is supportive of the life cycle theory. However, the annual relationship is weaker, leading Skinner to suggest that managers time repurchases within those windows on the basis of other considerations, such as taking advantage of a low stock price, offsetting dilution associated with employee stock options, managing reported earnings, and distributing excess cash.

**Life Cycle Factors and Dividend Changes**

Grullon et al. (2002) propose that firm maturity and the accompanying decline in systematic risk has important implications for dividend policy. Echoing the arguments discussed in the previous sections, they state that firm maturity is associated with high cash flows but fewer investment opportunities. At the same time, there is a decline in the systematic risk of the firm, as the number of growth
options, including compound options, held by the firm have decreased. Consequently, as a firm matures, its earnings growth would slow down and its systematic risk and profitability (return on assets) would decline. This, in turn, brings about a reduction in the reinvestment rate (the reinvestment of retained earnings) of the firm and an increase in dividend payout. Thus, an increase in dividend payout signals the transition of the firm from a high-growth phase to a low-growth phase, or the mature phase, in its life cycle. The announcement effect of dividend changes, specifically the positive stock price reaction to dividend increases, is then explained by the change in systematic risk rather than profitability.

To test their maturity hypothesis, or what is essentially the firm life cycle theory of dividends, Grullon et al. (2002) use a sample of New York (NYSE) and American (AMEX) stock-exchange-listed firms that increased or decreased their dividends during the period 1967–1993. One of their main findings is the existence of a relationship between dividend changes and changes in risk. They show that systematic risk declines for dividend-increasing firms and increases for dividend-decreasing firms. In addition, they find a significant relationship between the positive announcement effect associated with dividend increases and the decline in the firm’s systematic risk. In terms of profitability, Grullon et al. find that the return on assets of dividend-increasing firms declines after the dividend increase. In summary, their evidence supports the firm life cycle theory. Dividend increases signal a decline in risk and profitability as the firm has reached a more mature stage in its life cycle.

Life Cycle Factors and Dividend Initiations

Empirical tests of the traditional signaling theories of dividends rely on the information content of a change in dividend policy. If, indeed, dividend increases or decreases represent significant changes in firm characteristics, then there should be even more significant changes in firm characteristics around dividend initiations since initiations, by definition, occur only once in the firm’s life cycle. This is the premise behind Bulan et al.’s (2007) analysis of the timing of dividend initiations in a firm’s life cycle. They study how firm characteristics evolve over time as a firm moves toward dividend initiation. The authors estimate a firm’s propensity to initiate a dividend as a function of firm characteristics relative to other firms that are at the same stage in their life cycles but that have never paid dividends. Their data cover publicly traded U.S. corporations during the period 1963–2001.

Bulan et al. (2007) find evidence supportive of the firm life cycle theory of dividends. Dividend initiators are firms that are larger, more profitable, and have higher cash balances but fewer growth opportunities than firms in the same life
cycle stage that have never paid dividends. Thus, dividend initiators are mature firms. They find further evidence of firm maturity in the type of payout policy that firms adopt. Prior work by Jagannathan, Stephens, and Weisbach (2000) and Guay and Harford (2000) shows that firms use stock repurchases to pay out volatile cash flows but use regular cash dividends to pay out permanent cash flows. Their evidence shows a positive relationship between repurchasing activity and the probability of initiating a dividend (i.e., repeated repurchases indicate that a firm is moving toward maturity as its cash flows stabilize). The firm ultimately pays out its excess cash flows in the form of cash dividends.

Contrary to Grullon et al.’s (2002) evidence for dividend increases, Bulan et al. (2007) do not find evidence fully supporting the risk-signaling aspect of the life cycle theory of dividends. While firms that initiate dividends are mature firms, they show that the event of dividend initiation itself does not signal a change in the firm’s life cycle characteristics. They find that there is no significant difference in sales growth or risk in the pre- and postinitiation periods. In addition, Bulan et al. report no evidence that life cycle factors account for the positive market reaction to dividend initiation announcements. Instead, their findings indicate that firms choose an opportune time to initiate a dividend upon reaching maturity. This opportune time to initiate a dividend depends on the market sentiment for dividend-paying stocks measured by Baker and Wurgler’s (2004) dividend premium.

### Dividend Initiation in the Life Cycle of a Firm: The Case of Microsoft

Microsoft Corp.’s announcement of its first cash dividend on January 16, 2003, illustrates the maturation of the firm and the timing of its dividend initiation. Microsoft had its initial public offering (IPO) in 1986 and initiated dividends 17 years after its IPO. Figure 12.1 depicts the change in some key variables for the company over the period, specifically, the growth rate of sales, return on assets (profitability), ratio of cash to assets, and ratio of capital expenditures to assets. Each variable is industry-adjusted by subtracting the industry mean.

As Figure 12.1 shows, Microsoft grew faster than the industry average in the period until 1993. However, since then, Microsoft has grown more slowly than the average. The company’s profitability was volatile in the first half of this period but appears to have stabilized after 1995. While the company was spending more on capital expenditures (relative to assets) than the industry average until the mid-1990s, Microsoft has since been spending less than the average firm in the industry. Finally, the company has held a much greater level of cash than the industry average. All these indicators point to maturation of the company around 1995. Thus, Microsoft had the characteristics of a dividend payer, but it did not
declare a dividend for another eight years. Consistent with the empirical evidence, Microsoft initiated a dividend when it was already mature. The company’s maturation, however, did not coincide with its dividend initiation.

**Figure 12.1: The Case of Microsoft**  [fig1201.tif]

These panels present (clockwise from top left) sales growth, return on assets, cash to assets, and capital expenditures to assets for Microsoft Corporation from 1986 to 2002. All measures are industry adjusted using Microsoft’s major industry group (SIC code 73 or Business Services).

One possible explanation for the timing of Microsoft’s initiation is the reduction in the tax rate on dividends. At that time, investors anticipated a tax cut, although it had not yet been passed into law. Another possibility is the market sentiment for dividend-paying stocks measured by Baker and Wurgler’s (2004) dividend premium. In the years 2001 and 2002, with the stock market downturn, there was a sharp rise in the dividend premium, with the premium being positive in 2002. Following this change in sentiment, Microsoft initiated dividends in January 2003.

**Conclusions**

The firm life cycle theory of dividends relates the optimal dividend policy of a firm to where a firm is in its life cycle. The basic model presented in this chapter encapsulates the essence of the theory. A firm determines its optimal dividend policy by the relationship between its ROE and its cost of capital ($k$), which, in turn, is determined by the firm’s life cycle stage. A young firm in its high-growth stage has many profitable investment opportunities but low cash flows. Thus, the firm’s $\text{ROE} > k$ and the optimal payout ratio is zero. A mature firm has high cash flows but far fewer investment opportunities. Therefore, the firm’s $\text{ROE} < k$ and the optimal payout ratio is 100 percent. The theory predicts that the trade-off between the costs and benefits of raising new capital in relation to its investment opportunity set determine changes in dividend policy. More specifically, the theory predicts that a firm will begin paying dividends when it transitions from a high-growth phase to a mature (slower-growth) phase in its life cycle. A decline in the firm’s growth rate, profitability, and risk usually indicates this transition. Hence, a change in dividend policy signals a life cycle change within the firm.

Overall, the empirical evidence favors the firm life cycle theory of dividends in terms of dividend payment propensity and life cycle characteristics. Firms in the early stages of their life cycles rarely pay dividends, while firms in the mature stage are likely to be dividend payers. Moreover, the decision to pay...
the first regular cash dividend is usually made contingent on having reached maturity. Other factors not predicted by this theory seem to determine the exact timing of the dividend initiation. The evidence is more ambiguous on the signaling aspect of the theory that changes in dividend policy signal that a firm has transitioned from one life cycle stage to another.

Consequently, there is much room for future work. How can researchers reconcile the evidence that dividend initiation does not signal life cycle changes but dividend increases (and decreases) do? In our view, dividend initiation represents a much more important change in dividend policy than does the increase or decrease of an existing dividend rate. Hence, precisely how different are they in a life cycle context? How can researchers characterize this difference? The evidence presented on dividend initiations also suggests that other factors and other theories outside of a life cycle explanation account for the positive announcement effect of dividend initiations. Might these same factors also be present for dividend increases or decreases after controlling for the firm’s life cycle? For example, in related work, DeAngelo et al. (2008) find that the decision by firms to issue seasoned equity reflects both market timing and life cycle motives. Perhaps a richer, more unified (and of course more complex) theory of dividend policy with the life cycle framework as its backbone can generate more of the empirical regularities that are observed in the literature.

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