

FLEXIBILITY AND DIVIDENDS

ABSTRACT

We develop a model of corporate dividend policy without agency or signaling considerations. The model is based on the idea that management will value operating flexibility when there is a possibility that shareholders may disagree with management and block management decisions. By reducing dividends and conserving cash, management increases its flexibility. This improves its ability to invest in projects that it believes are good for the shareholders in the long run but which shareholders would not provide the capital for because they think at the time these are value reducing. However, the cost of not paying dividends is that the current stock price is lowered. Management trades off these two aspects of dividends. Flexibility considerations help us understand various dimensions of dividend policy that are hard to make sense of with existing theories. Our theory generates numerous testable predictions that we confront with the data. The evidence is supportive of the model.