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Special Dividends: What Do They Tell Investors About Future Performance?

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Abstract

Previous research documents positive short-term stock returns at the announcement of a special dividend and evidence of increased earnings at the time of the dividend. This paper examines the long-run performance of firms paying special dividends to determine whether the stock returns and earnings performance continue to improve over the long run. We find that special dividend announcing firms have unexpectedly high earnings the year of the special dividend announcement; however these unexpected earnings decline significantly in the years following the special dividend. Special dividend paying firms also earn significant positive excess returns the year before the special dividend announcement. On average, investors cannot expect the stock and operating performance that precede a special dividend to continue following the announcement. © 2003 Academy of Financial Services. All rights reserved.

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1. Introduction

Special dividends are typically viewed in the marketplace as a temporary increase in a firm's payout because investors are not anticipating the dividend to occur again. However, Brickley (1983) finds a significant positive stock price reaction to the announcement of

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special dividends and documents that the firm's earnings improve following the special dividend announcement. His results indicate that special dividend announcements signal positive information about future earnings for the firm.

Why would a firm choose a special dividend as a means of distributing excess cash? Consider the three alternatives available to managers for distributing excess cash to shareholders. A firm could chose to initiate or increase dividends, repurchase shares, or pay a special dividend. The alternative selected will depend on expected future cash flows and the firm's prior share price performance. Jagannathan, Stephens, and Weisbach (2000) find that dividends are initiated or increased following "permanent" increases in cash flows. If the current cash flow level does not appear sustainable, a firm is unlikely to initiate or increase dividend levels because of the negative consequences that would occur if it were subsequently forced to decrease or suspend the dividend. Stephens and Weisbach (1999) and Jagannathan et al. (2000) find that firms are more likely to repurchase stock following a period of poor stock performance. Therefore, a firm would be reluctant to use share repurchase as a means of distributing excess cash following a significant run-up in the share price. As such, we expect firms to choose special dividends as a means of distributing cash in a setting characterized by temporary increases in cash flows and prior positive share price performance.

The decision to issue a special dividend reduces the potential for managers to squander excess cash either on executive perks or negative net present value projects (Jensen, 1986). Therefore, the use of a special dividend is unlikely to convey the same positive news as other distribution forms. Under the signaling theory (Miller and Rock, 1985), the choice to pay a special dividend rather than initiating regular dividends or announcing a permanent dividend increase may indicate that the current earnings performance level is unsustainable. Furthermore, the decision to distribute excess cash to shareholders via a special dividend rather than through share repurchase would suggest that managers believe the current share price is not undervalued.

We analyze long-run earnings and stock returns of firms announcing special dividends by calculating excess returns and unexpected earnings using matched firm techniques (Barber and Lyon, 1996; Barber and Lyon, 1997). We find no evidence that special dividends signal future earnings increases. Rather our evidence is consistent with increases in earnings and stock returns before the time of the announcement. A significant decline in unexpected operating performance follows the announcement for those firms already paying regular dividends. Our results indicate that for regular dividend payers, the reluctance to increase current dividends can be interpreted by investors as evidence that current performance levels are not expected to continue.

What are the implications of this study for investors? While investors earn superior returns holding special dividend paying stocks before announcement, the decision to issue a special dividend may indicate that these superior returns are unsustainable. Unlike the decision to initiate or increase regular dividends, special dividends do not signal good news in long-run operating performance. Furthermore, the choice of a special dividend, rather than a share repurchase, as a means of distributing cash is consistent with positive prior stock performance. Our results suggest that the positive market reaction upon announcement of a special dividend reflects a favorable market reaction to current cash flow levels or reducing the free

cash flow problem rather than a signal of positive future performance. On average, investors cannot expect the performance that precedes a special dividend to continue following the announcement.

The remainder of this paper is organized as follows. Section 2 provides a summary of the relevant literature and the implications on expectations about the long-run performance of firms announcing a special dividend. A description of our sample and research methodology is presented in Section 3. Our results are described in Section 4. The final section summarizes our findings and the implications for investors.

2. Literature review

Numerous studies document positive stock market reactions to announcements of positive dividend news such as initiations or increases in regular dividends, and negative stock market reactions to dividend decreases and omissions (e.g., Lang and Litzenberger, 1989; Michaely, Thaler, and Womack, 1995; Benartzi, Michaely, and Thaler, 1997). Lintner (1956) suggests dividend increases signal a permanent positive shift in earnings. Healy and Palepu (1988) find firms that initiate dividends exhibit increased earning levels in the year before, during, and two years after the dividend initiation announcement. According to Benartzi et al. (1997), firms announce dividend increases after earnings improvements and announce dividend decreases following earnings declines. However, the authors show that in the two years following a dividend announcement, earnings changes are unrelated to the sign and magnitude of the dividend change.

Special dividends are a one-time payment rather than the sustained increase in cash payment expected with a dividend initiation or dividend increase. Brickley (1983) examines stock price returns, dividend, and earnings patterns surrounding special dividend and dividend increase announcements. While he finds positive announcement returns, along with increased earnings and dividends for both samples, dividend-increasing firms exhibit greater announcement returns and increases in earnings and dividends than special dividend firms. Gombola and Liu (1999) examine the stock price reaction to special dividend announcements to distinguish between signaling, free cash flow, and wealth transfer hypotheses. They examine changes in analysts' *ex ante* earnings forecasts and find an upward revision in analysts' forecasts of earnings corresponding with the special dividend announcements. In addition, they find a positive relationship between the revision in the analysts' forecasts for the current year earnings and the stock price reaction to the announcement of a special dividend. These results indicate that analysts believe special dividends are signaling increased future earnings.

Share repurchases are often compared to special dividends. They represent an alternative vehicle for firms to make one-time cash distributions to shareholders. Ikenberry, Lakonishok, and Vermaelen (1995) examine long-run return performance of firms announcing open market share repurchases. They investigate whether the market fully incorporates the information conveyed in a repurchase announcement. Ikenberry et al. find that the market under reacts to share repurchase announcements and show that a four-year buy and hold strategy, started after the repurchase announcement, significantly outperforms a control portfolio.

To distinguish between information signaling and free cash flow theories of dividend signals, Lang and Litzenberger (1989) test market reaction based on investment opportunities. They find low Q firms have greater market reactions, but their evidence is consistent with both theories. Howe, He, and Kao (1992) perform similar tests on a sample of share repurchases and special dividends. They do not find a difference in the stock market reaction between the two groups based on Tobin's Q. Overall, Howe et al. find results consistent with the information-signaling hypothesis rather than the free cash flow hypothesis. Gombola and Liu (1999) also test Lang and Litzenberger's conditional signaling hypothesis. They find a greater stock price reaction to the announcement of special dividends for low Q firms, as well as significant upward revision in analysts' earnings forecasts for low Q firms. Gombola and Liu reject both the free cash flow and wealth transfer hypotheses as an explanation for the stock price reaction to special dividend announcements since neither hypothesis would predict this upward forecast revision.

Special dividends are less prevalent than they used to be according to DeAngelo, DeAngelo, and Skinner (2000). They show that 61.7% of NYSE firms paid special dividends in the 1940s, while only 4.9% of NYSE firms paid special dividends in the first half of the 1990s. DeAngelo et al. suggest that the reason for the decline in special dividends is that these distributions previously were not useful signals of information to the investors, since historically most firms paid special dividends as predictably as regular dividends. Because investors viewed the special and regular dividends as substitutes, firms gradually embedded specials into their regular dividend. DeAngelo et al. find that the only special dividends that have survived through time are large distributions whose size can send a signal to stockholders.

3. Data and methodology

We initially identify 1,459 special dividend announcements between 1975 and 1996 from the Center for Research in Security Prices (CRSP). Our sample is composed of the NYSE firms examined in DeAngelo et al. (2000) as well as NASDAQ and AMEX firms. We include all dividends classified as either "extra" or "special." For simplicity we refer to either type as a special dividend for the remainder of the paper. We eliminate financial institutions, real estate investment trusts (REITS), mutual funds, limited partnerships, and distributions for the purpose of recapitalization, settlement of shareholder litigation, and takeover defenses. We eliminate the firm from our sample if they paid another special dividend in the prior or following three years. This is done to avoid the predictability of special dividends documented by DeAngelo et al. (2000), and capture only unexpected special dividends (Brickley, 1983). Fifty-three firms with major announcements during the 60-day event window, including dividend initiations, dividend increases, or share repurchases, are also eliminated. This leaves a sample of 416 "clean" special dividend announcements by industrial firms. The number of firms per year announcing an unexpected special dividend is provided in Table 1.

We calculate excess returns surrounding the announcement date for comparison to previous studies. We use the declaration date as listed on CRSP (variable DCLRDT) as the announcement date. This represents the date the board of directors declares a distribution.

Table 1
Frequency distributions of special dividend announcement sample by year, 1975-1996

Year	Frequency	Percent of sample
1975	63	15.1
1976	64	15.4
1977	32	7.7
1978	30	7.2
1979	30	7.2
1980	21	5.1
1981	13	3.1
1982	6	1.5
1983	8	1.9
1984	11	2.6
1985	8	1.9
1986	3	0.7
1987	10	2.4
1988	21	5.1
1989	18	4.3
1990	10	2.4
1991	6	1.5
1992	10	2.4
1993	11	2.6
1994	10	2.4
1995	17	4.1
1996	14	3.4
Total	**416**	**100**

The sample excludes financial institutions, mutual funds, utilities, REITs, limited partnerships, and distributions for the purposes of recapitalization, settlement of shareholder litigation, and takeover defenses. The sample includes only special dividend announcements by firms that do not have other special dividends in the prior and following three-year period. The sample excludes firms with major announcements in the 60-day period surrounding the special dividend, including dividend increases, dividend initiations, and share repurchases.

Excess stock returns are returns that are greater than zero, adjusted for risk of the stock and the overall stock market. The excess return calculation follows standard event study methodology (Mikkelson and Partch, 1988). CRSP is our source for daily returns and the equally weighted market index. Excess returns for each firm are calculated using daily returns from 30 trading days before the special dividend announcement through 30 trading days after the announcement date. The excess return for firm i on day t, ER_{it}, is calculated as:

$$ER_{it} = R_{it} - a_i - b_i R_{mt}, \quad (1)$$

where R_{it} is the return on firm i for day t. Parameter a_i and b_i are the estimated Ordinary Least Squares market model intercept and slope coefficients for firm i estimated using a 250 trading days period, beginning 31 trading days after the announcement date. R_{mt} is the market return representing a CRSP equally weighted market index for day t. We calculate averages across firms for five cumulative periods of comparison, as well as, excess returns on a daily basis from 10 days preannouncement to 10 days postannouncement, AD −10 through AD +10.

We perform long-run analysis on stock returns using methodology from Barber and Lyon

(1997). The buy-and-hold abnormal return (BHAR) is used in the long-run return analysis. The BHAR for each sample firm is calculated as:

$$BHAR_{iT} = \prod_{t=1}^{T} [1+R_{it}] - \prod_{t=1}^{T} [1+E(R_{it})] \quad (2)$$

where R_{it} is the return on the sample firm and $E(R_{it})$ is the return on the matched firm. The BHAR is calculated for the three years before and after the announcement.

Using data from either the Compustat tapes or Standard & Poor's Research Insight, matched firms for long-term stock return performance are selected from all firms with market values of equity between 70% and 130% of the announcing firm. The matched firm selected has the closest market to book value of equity ratio at the end of the year before the announcement. The market to book ratio for each firm is calculated as the total market value of common stock divided by total book value of stock the year before the special dividend announcement date. Market value of equity is measured as the closing price the year before the special dividend announcement times the number of shares outstanding. We verify that all matched firms did not announce a special dividend during the eight-year period in which they are included in our tests. This process resulted in 393 firms that had the necessary CRSP data for both the announcing firm and the matched firm the year following the announcement.[1]

Following the methodology in Barber and Lyon (1996), long-run operating performance is measured as the Return on Operating Assets (ROA). ROA is calculated as Operating Income (OIBD) over average Operating Assets (OpAs).

$$ROA_{j,t} = \frac{OIBD_{jt}}{(OpAs_{j,t} + OpAs_{j,t-1})/2} \quad (3)$$

OIBD is defined as Operating Income before Depreciation, while OpAs represents total assets less cash and marketable securities. To compute average operating assets, we take the average between the prior year-end's operating assets and the current year's operating assets. We obtain income statement and balance sheet data from either the Compustat tapes or S&P Research Insight.

Excess ROA is the difference between $ROA_{j,t,}$ the return on assets for the sample firm and the average return on assets for its matched portfolio, $Avg(ROA_{k,t})$. $ROA_{k,t}$ is the return for any matched firm that meets the size and performance based criteria described below.

$$\text{Excess } ROA_{j,t} = ROA_{j,t} - Avg\,(ROA_{k,t}) \quad (4)$$

To test differences in unexpected earnings, we calculate changes in excess ROA.

$$ChgROA_{t,t+n} = \text{Excess } ROA_{j,t+n} - \text{Excess } ROA_{j,t} \quad (5)$$

Excess $ROA_{j,t+n}$ is the Excess ROA n years following year t for firm j. This variable measures changes in excess performance over time as prescribed by Barber and Lyon (1996). We examine differences in changes in Excess ROA between the special dividend firm and its matched portfolio for an eight-year period surrounding the announcement. We also test

Table 2
Average announcement period excess returns for the sample of special dividend issuing firms

Trading interval	Excess return as a percentage (%) (N = 416)
AD − 30 to AD − 2	0.77 (1.22)
AD − 10 to AD − 2	0.81* (1.92)
AD − 1 to AD + 1	3.93*** (8.34)
AD + 2 to AD + 10	0.39 (1.15)
AD + 2 to AD + 30	−0.26 (−0.46)

The null hypothesis is that the average prediction error equals zero. AD is the announcement date of the special dividend. Student's t statistics are in parentheses.

*,***Significantly different from zero at the 0.01 and 0.10 level, respectively.

for differences in unexpected earnings depending on whether the sample firm was paying regular dividends at the time they announce a special dividend. We segregate the special dividend sample into regular and nonregular dividend payers at the time of announcement and test differences across groups using the Wilcoxon rank-sum test.

For earnings performance, we use the matching technique described in Barber and Lyon (1996) for small firms with high performance. A matched portfolio is selected for each announcing firm on the basis of preannouncement year operating performance. All firms in the matched portfolio must be a nonspecial dividend payer and within 30% of market value of equity of the announcing firm. Furthermore, to be included in the matched portfolio, a firm must have operating performance within the range of 90% to 110% of the operating performance of the special dividend firm in the year before the special dividend announcement. Although DeAngelo et al. (2000) match by industry, Barber and Lyon (1996) show that a performance and size match, without regard to industry, is the only unbiased matching technique in small firms with high performance. Small firms with high earnings performance, before the special dividend, characterize our sample.[2]

Many firms have missing earnings data, particularly in the early years of our sample. From our original sample of 416 special dividend firms, the maximum sample size for the operating performance tests is 349 firms in the year before the announcement.

4. Results

4.1. Announcement returns

Table 2 presents average announcement period excess returns for five comparison periods surrounding the announcement. Similar to Brickley (1983), we do not find significant abnormal returns in either the 29-day period before or after the special dividend announcement (AD −30 through AD −2 and AD +2 through AD +30). On the other hand, we find significant excess returns in the three days surrounding the announcement (AD −1 through AD +1) and in the nine-day period preannouncement (AD −10 through AD −2). The

Table 3
Average announcement period excess returns Days −10 to + 10 for the sample of special dividend issuing firms

Trading day	Excess return as a percentage (%) (N = 416)	Student's t statistic
AD − 10	0.09	0.64
AD − 9	−0.02	−0.13
AD − 8	0.04	0.24
AD − 7	−0.04	−0.27
AD − 6	0.19	1.35
AD − 5	0.27*	1.79
AD − 4	−0.06	−0.47
AD − 3	0.38**	2.39
AD − 2	0.04	0.24
AD − 1	0.36**	2.31
AD 0	2.22***	6.94
AD + 1	1.27***	5.49
AD + 2	0.31*	1.79
AD + 3	0.08	0.60
AD + 4	0.26*	1.82
AD + 5	−0.07	−0.49
AD + 6	−0.15	−1.12
AD + 7	0.01	0.10
AD + 8	0.23	1.50
AD + 9	−0.02	−0.18
AD + 10	−0.11	−0.83

AD is the announcement date of the special dividend.
***,**,*Significantly different from zero at the 0.01 level, 0.05 level, and 0.10 level, respectively.

three-day announcement period excess return of 3.93% is similar to that documented by both Brickley (1983) and Howe et al. (1992).

In addition to the five trading intervals reported in Table 2, Table 3 presents excess returns on a daily basis from AD −10 to AD +10. We find somewhat significant returns three and five days preannouncement and two and four days postannouncement. Although there is some evidence of leakage, when compared to excess returns reported for the three-days surrounding announcement (AD −1 through AD +1), these excess returns are relatively low. Most information is revealed on either the declaration day or the following day, AD 0 and AD +1, respectively.

4.2. Long-run excess returns

Table 4 reports long-run excess returns for various periods in the three years surrounding the announcement of a special dividend. We dropped 23 firms with incomplete CRSP data from the full sample of 416 firms. Long-run excess returns are measured initially for 393 firms, although only 288 firms have the full six years of excess returns data available.[3] Our results indicate that special dividend announcements follow significant excess returns in the year before the announcement. We find that special dividend issuers earn an average of

Table 4
Cumulative long-run excess returns of firms offering a special dividend

Excess returns for firms offering special dividends			
Year Relative	Mean (%)	Median (%)	N
Year −3	1.11	2.50	315
Year −2	−5.57	0.20	352
Year −1	16.78***	14.16***	387
Year +1	1.99	4.39**	393
Year +1,2	3.06	−0.35	381
Year +1,2,3	6.76	9.12	358

Excess returns are calculated as the difference between the holding period returns of a firm announcing a special dividend and a matched firm.

***,**Significantly different from zero at the 0.01 level and 0.05 level, respectively. Significance tests are performed using *t* tests for means and signed-rank tests for medians.

16.78% more than the matched firms do in the year before announcement. Average stock returns in the three years following the announcement do not differ significantly from those of the matched sample. Although median excess returns are significantly higher in the year following announcement, the three-year postannouncement period return of the median special dividend firm return is not significantly different from the matched sample. These results contrast with an average abnormal four-year buy and hold return of 12.1% following share repurchase announcements (Ikenberry et al., 1995).

4.3. Long-run operating performance

We present median and mean annual ROA for the four years surrounding the special dividend announcement year in Table 5. Although we also test for differences in mean ROA between the special dividend and a matched portfolio, we focus on differences in medians because earnings data are skewed. The median special dividend firm has significantly greater ROA than a matched portfolio in the year of the dividend issue. The issuing year ROA represents an operating performance peak for special dividend firms. In the two years after the special dividend announcement, special dividend firms continue to outperform a matched portfolio, exhibiting higher mean and median levels of ROA.

Given the announcement of a special dividend represents an operating performance peak, we would expect changes in excess ROA to be positive leading up to the announcement and negative following the announcement of a special dividend. In Table 6, we report changes in excess ROA for the four years surrounding the special dividend announcement. Firms announce special dividends when they exhibit significant increases in operating performance as compared to a matched sample. Excess ROA significantly increases from each of the four years preannouncement to the announcement year. However, this higher performance deteriorates after the announcement. Significant decreases in excess median and mean ROA three and four years occur after the announcement.[4]

Table 5
Return on Operating Assets (ROA) of firms announcing a special dividend versus a matched sample

Return on operating assets (ROA)					
Year relative	Special dividend sample		Matched sample		*N*
	Median (%)	Mean (%)	Median (%)	Mean (%)	
Year −4	15.53	17.12	14.98	16.75	314
Year −3	15.83	17.29	15.61	18.10	327
Year −2	16.21	18.51	16.39	18.80	343
Year −1	17.06	20.54	16.36	19.93	349
Year 0	18.82***	22.32***	16.00	18.86	322
Year 1	17.84**	20.41***	15.48	17.34	300
Year 2	16.39**	18.64**	14.62	16.33	283
Year 3	15.54	17.81*	14.27	16.34	258
Year 4	15.23	16.71	14.35	16.33	231

ROA is operating income before depreciation divided by average operating assets. Operating assets are total assets less cash and marketable securities. Average operating assets are the average taken between the end of the prior year operating assets and the current year operating assets. Years reported are relative to the year of the dividend announcement.

***,**,*Significantly different from the matched sample at the 0.01 level, 0.05 level, and 0.10 level, respectively. Significance tests are performed using *t* tests for means and signed-rank tests for medians.

4.4. Regular versus nonregular dividend payers

The information content of the special dividend announcement may be different depending on whether the issuing firm already pays a regular dividend. In Table 7, we split our special dividend sample based on whether the issuing firm pays a regular dividend. We classify any firm that paid an annual, semiannual, or quarterly dividend in the year before the special dividend as a regular dividend payer and all other firms as nonregular dividend payers.

Table 6
Changes in excess ROA surrounding a special dividend announcement

Change in ROA	Median (%)	Test-Statistic	Mean (%)	Test-statistic	*N*
Year −4 to Year 0	1.64	2.48**	2.92	2.91***	279
Year −3 to Year 0	2.37	3.72***	3.79	3.83***	295
Year −2 to Year 0	2.35	4.90***	3.79	4.87***	314
Year −1 to Year 0	1.97	4.79***	2.87	4.58***	319
Year 0 to Year 1	−0.35	−1.27	−0.33	−0.53	296
Year 0 to Year 2	−0.32	−1.18	−1.32	−1.67*	278
Year 0 to Year 3	−1.12	−2.50**	−2.19	−2.57**	253
Year 0 to Year 4	−1.95	−2.74***	−3.28	−3.05***	226

Excess ROA is the difference between the special dividend ROA and the matched sample ROA. ROA is operating income before depreciation divided by average operating assets. Operating assets are total assets less cash and marketable securities. Average operating assets are the average taken between the end of the prior year operating assets and the current year operating assets. Year 0 is the year of the special dividend announcement.

***,**,*Significantly different from zero at the 0.01 level, 0.05 level, and 0.10 level, respectively. Significance tests are performed using *t* tests for means and signed-rank tests for medians.

Table 7
Median changes in excess ROA when the sample is segregated by whether the special dividend-announcing firm currently pays a regular dividend

Time period	Regular dividend payers	Non-regular dividend Payers
Year 0 to Year 2	−0.53% ($N = 166$)	−0.18% ($N = 112$)
Year 0 to Year 3	−2.09%** ($N = 152$)	−0.75% ($N = 101$)
Year 0 to Year 4	−2.03%** ($N = 139$)	−1.86%* ($N = 87$)

ROA is defined as operating income before depreciation divided by average operating assets. Operating assets are total assets less cash and marketable securities. Average operating assets is the average taken between the end of the prior year operating assets and the current year operating assets.

**,*Significantly different from zero at the 0.05 level and 0.10 level, respectively, using the Wilcoxon rank-sum test.

As shown in Table 7, for regular dividend payers the decision to pay a special dividend is associated with a significant decrease in cumulative excess ROA three years and four years postannouncement. This result is consistent with dividend paying firms choosing special dividends when earnings receive a temporary positive shock. The excess ROA of nonregular dividend payers following special dividend announcements is lower in magnitude and significance than the regular dividend payers. For regular dividend payers the decision to pay a special dividend, rather than permanently change their current payout level, is evidence that the current high level of performance is temporary.

5. Summary and implications

The positive market reaction to the announcement of a special dividend indicates that investors view the decision as good news. In the year before the announcement, investors in special dividend paying firms earn a significantly positive excess return relative to a matched sample. Similarly, earnings performance significantly increases from prior years to the year of the special dividend. Our results indicate firms announce special dividends after periods of temporary increases in operating performance and positive stock performance.

What does the announcement of a special dividend tell investors about future performance? Unlike regular dividend increases and share repurchases, special dividend announcements indicate current excess performance rather than expected improvement in long-run performance. While there is some evidence that median stock performance is higher in the year following the special dividend announcement, this increase is much smaller in size than those documented following dividend increases and share repurchases. We find no evidence that operating performance improves following the special dividend announcement. On average, investors cannot expect the significant stock return and operating performance that precedes a special dividend to continue after the announcement.

Notes

1. We dropped 23 firms from the long-run tests because of incomplete data on CRSP.
2. Matching with respect to industry is appropriate in DeAngelo et al (2000), because

their sample is limited to NYSE firms. On the other hand, our sample consists of all firms listed on CRSP and Compustat that pay a special dividend. The median asset size in our sample is less than half that of the median firm listed on Compustat in the corresponding years of the sample.

3. As a robustness check we perform the same test for the sample of 288 firms for which a full six years of excess returns data is available. There are no qualitative differences in the results.
4. As a robustness check, we perform the same test for the 202 firms with complete data over the nine-year period. The results show no qualitative differences.

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