The growth in sales of the divested units in strategic management research

Business, Marketing

Companies might undergo a spin-off with the motive to improve the parent firm’s organizational, strategic and financial performance. Among those objectives, the growth of the divested units needsto be highlighted. Some of the first authors focusing on growth are Woo, Willard and Daellenbach(1992). In their article, the authors are taking a broad scope of criteria to analyze the performance ofspin-offs and one of them is the growth in sales of the divested units. While this criterion has oftenbeen used in strategic management research (Christensen & Montgomery, 1981; Hambrick, MacMillan& Day, 1982), it has not often been used in financial research. The authors believe that this indicatoris a good parameter to identify the ability of a unit to exploit the growth opportunities that it has beenoffered through the increased autonomy following a spin-off. Despite the theory, the authors did not find significant results demonstrating an increased growth forthe divested units.

In fact, the authors described them as extremely small in magnitude and notstatistically significant for the 3-year period following the spin-off. One of the factors that could explainthese results is that divestitures are often undertaken for the interest of the parent firm. To be moreprecise, companies undergo spin-offs for the following motives: divesting of unrelated business unitsor poor performers. When we take into consideration these motives motivating the parent firm, it isnot that surprising that the spin-offs have a limited impact on the growth of the divested units.

Refocusing on Core Activities

One of the most cited reasons for corporates to divest a part of their business is the refocus on coreactivities. The observation of restructuring cases with the aim to refocus on the core business wasalready observed in the early 1990's by Comment and Jarrell (1995). In an article published in 1999, H. Desai and P. C. Jain observe the use of two main methodologies to refocus on their core business, thefirst one is the sale of unrelated assets to external parties and the second is spinning off unrelatedbusiness divisions to its own shareholders. The sale of assets is generally motivated by the need forcash and is especially used by financially distressed firms (Shleifer & Vishny, 1992; Ofek, 1993; Lang &al, 1995); even though other motives also explain the sale of assets (high offer price by the acquirer, simple way to receive additional funds etc.). In comparison, the spin-off of an unrelated businessdivision is not motivated by the need of cash, but mainly by the objective of refocusing on coreactivities. H. Desai and P. C. Jain split the two types of transactions in two distinct groups to compare the stockmarket performance as well as the operating performance. The first group composed of the sale ofassets transactions is called the non-focus increasing spin-offs while the second group composed ofbusiness division spin-offs is called focus increasing spin-offs.

The authors expect to observe adifference in performance between both groups. They expect the focus increasing spin-offs to delivera better performance due to the opportunity of getting rid of the bad performing entities which areonly able to survive in diversified business through cross-

subsidies (Meyer & al. , 1992). The authors based their stock market performance results both on the short term and the long term(up to 36-month post announcement). Their results are as follows, “ the three-day” announcementperiod abnormal returns are significantly larger for the focus increasing spin-offs (4. 45%) than for thenon-focus increasing spin-offs (2. 17%)”. The stock performance returns for focus increasing spin-offsnot only perform better in the short term but are also significant in the long term with 11. 12%, 20. 77%and 33. 36% abnormal returns for holding periods of one, two and three years. While at the other handthe abnormal returns of non-focusing spin-offs are not statistically significant. Additionally, the authorsalso looked at the change in operational efficiency. They analyzed it by comparing the operational cashflow to the total assets. As for the stock market performance, the operating performance is better forcompanies that underwent a focus increasing spin-off.

Efficient Allocation of Capital

One of the many problems encountered by conglomerates is the efficient allocation of capital amongthe business units. This leads to the shareholders being often suspicious about badly functioninginternal markets for capital inside diversified groups with the cash flows of the most promising outfitsbeing invested to prop up badly performing units rather than to develop the star divisions. Gertner, Power and Scharfstein (2002) describe into more details the existence and functioning of internalcapital markets within companies. As described in their article, the importance of capital allocationamong the different business lines within a company is one of the

advantages that conglomeratesshould have. Since most investments are financed by the internally generated cash flows (MacKie -Masson (1990)), it is existential for companies to have an efficient capital allocation system in place. However, there are mixed views on how well internal capital markets function. The first groupcomposed of Alchian (1969) and Williamson (1970) concludes that internal capital markets are moreefficient than external capital markets as the persons responsible for the allocation of internal capitalknow better where the capital is required to finance investments. The second group composed ofMeyer, Milgrom, and Roberts (1992), Wulf (1997) and Rajan et al. (2000) argue that the internal capitalmarkets are ineffective due to the personal traits of unit managers. Each of them would like to seemore capital go to their own unit to be able to invest more and thus potentially improve its personalgains.

Despite the mixed views on the functioning of internal capital markets, it remains a fact that spin-offsare a great opportunity for the ex-ante spin-off entity to efficiently allocate capital between the newsubsidiary and the ex-post spin-off parent (Dittmar, 2004). In his research paper Dittmar (2004)observed how firms decide the initial capital structure for the new subsidiary. As stated by the author, spin-offs are a perfect moment to study these decisions as prior to the event the subsidiaries havelimited to no control to their capital structure since they are part of a larger entity. With the spin-off, the new stand-alone entity can raise new equity and has now control over the level of debt to be used. The results of Dittmar’s (2004) analysis demonstrates that the ex-ante spin-off entity often decides

toallocate a lower debt-to-value to the new spin-off subsidiary and thus a larger debt-to-value to the expostspin-off parent. The author even finds a significant difference between the two. Several firmcharacteristics are responsible for the leverage decision made by the analyzed companies. The firstobservation that the author makes is that leverage ratios are lower for smaller subsidiaries and this iseven more true when it is combined with high growth opportunities. A second observation he makesis that when the subsidiaries are of a relatively large size and that they have some high collateral value, the leverage assigned to the new subsidiary in this case is often higher than the one of the ex-postspin-off parents. Based on Dittmar’s (2004) article, it is clear that companies make strategic capitalstructure decisions through spin-offs and that these decisions are influenced by several factors such asthe size, the growth opportunities and the collateral value that is allocated to the new standaloneentity.

Leverage and Credit Rating

As stated before, spin-offs lead to a reallocation of capital between the ex-post spin-off parent and thenew standalone entity. This situation naturally leads to the necessity of a recontracting of therelationships among the various stakeholders of the firm (stockholders, bondholders andmanagement). As described by Maxwell and Rao (2003), this can potentially lead to a wealth transferfrom bondholders to stockholders. A transfer that is one of the strongest hypotheses explaining thestockholder gains on the announcement of a spin-off. This hypothesis has however never beenconfirmed due to the lack of empirical evidence on this matter. The

authors identify two potentialsources to this wealth transfer. First the loss of collateral and liquidation value which is due to theredeployment of assets among the different entities. Secondly, the bondholders could suffer a loss dueto the elimination of coinsurance provided by multiple operating units whose cash flows are notperfectly positively correlated (Maxwell & Rao, 2003). Prior to the analysis by Maxwell and Rao (2003), there was limited research on the matter and theexisting empirical evidence on a wealth transfer surrounding spin-offs was mixed.

At one end, bothHite and Owers (1983) and Schipper and Smith (1983) did not find any significant transfer of wealth onthe announcement of spin-offs, while Parrino (1997) fins a massive transfer from the senior securityholders to stockholders. All their studies demonstrated significant limitations; both studies publishedin 1983 lacked a sufficient sample size and access to bond price data while the study by Parrino (1997)was a case study solely based on the Marriott spin-off. The analysis made by Maxwell and Rao (2003) finds that bondholders on average suffer a negativeabnormal return of 88 basis points in the month of the spin-off announcement. They based theiranalysis on a sample of 80 spin-offs between 1976 and 1997.

The loss can be explained by; first, theloss of collateral to the new stand-alone entity and secondly, the increased financial risk in which theex-post spin-off parent results after the spin-off due to a higher leverage ratio in most cases. This newex-post spin-off context combined with the proved losses for the bondholders results in the firm beingmore likely to suffer from a credit rating downgrade than an upgrade (Maxwell & Rao, 2003).

Theaccumulated empirical evidence however lack to justify one observation that can be made at the timeof a spin-off announcement; how the aggregated value of the public debt and equity increases at thetime of a spin-off. This is one of the limitations of the previously explained wealth expropriationhypothesis (transfer from the bondholders to the stockholders) and demonstrates that there are otherreasons explaining a positive market reaction.