

PRODUCTIVITY AND STOCK PRICE REACTION TO SPIN-OFF DECISION

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Abstract

In corporate governance, spinoff decision is made either to focus on a specific area of business or to get rid of businesses with low profit margin. Separation of some management assets for a better management of existing assets referred to as a spin off. The spun off or subsidiary company is formed by issuing new shares to the existing shareholders while losing some original or parent company shares. By doing so, shareholders' value might be lost. With a sample of 65 companies spun off since 2009, this paper analyse the stock price movements of the spun off and the parent company and productivity in terms of turnover of the spun off company. From the analysis, there has been an increase in both productivity and stock price. This paper also emphasizes how corporate governance in spin off decisions can protect shareholders' value.

Keywords: Spin Off, Turnover, Stock Price, Corporate Governance, Shareholders

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1 Introduction

A spin off decision is nothing but a formation of a new company by sale or distribution of shares of a parent company. The new company, which we often refer to as spunoff or subsidiary is formed by the assets of parent company. The assets include employees, technology, clients, furniture and financial assets. The shareholders receive a certain amount of shares in the subsidiary company equivalent to what they had in the parent company. After that the shareholders can buy or sell either company shares independently. Usually, a spin off decision is made by a company with several businesses. A spin off decision is made either to narrow down to a specific business and leave out other relatively irrelevant businesses or to get rid of low profit margin business.

This decision is made so that both companies after separation can focus on their own narrowed-down business and increase profits mutually. But in the case of spin off the company is risking the value of the shareholders. The shareholders are forced to take a risk of getting new shares of the spunoff company. The productivity in terms of turnover and efficiency of the new company is unknown and it's like investing in a start-up, making the shareholders' value at risk.

Major task of corporate governance is to protect shareholders value. This paper mainly focuses on whether shareholders get benefited by the spin off decision made by 65 companies since 2009 on the basis of two parameters, 'stock price and

productivity', and come to a conclusion whether shareholders' value is protected by a spin off decision.

First section of this paper gives a brief introduction about what is spin off, why it is done and what is the risk of doing so. Second section of this paper covers the review of related papers and journals which gave lots of insight about the study. Third section describes the results of the analysis. The last section concludes the study and gives further scope for research in this area.

2 Literature review

Wei et al. (2010) researched whether shareholder structure alters the interest of investors. The research of corporate governance regards the separation of ownership and control as a basic proposition. Wei et al. (2010) prove that the transformation of different shareholding structures constantly harms or protects the interests of investors.

Bistrova and Lace (2011) emphasize that accounting frauds, research and development cost cuts, agency problem-these factors tend to lead to short-term gains, while providing poor long-term performance to equity investors and created as mode. According to the model, the key elements, which succeed maximum long term return of the company, are plausible corporate governance structure, high earnings quality and high innovative potential.

Wang (2013) states that while controlling shareholders who don't have trading rights, they may engage in expropriating activities that would

compensate for the lack of trading rights but don't care too much about stock volatility. The findings of Wang (2013) show the scope of agency problems, test the value of trading rights and provide evidence that supports for the changes in corporate governance of companies.

Ma and Zhou (2013) highlight the relation between information quality and information disclosure. It finally concludes by saying good corporate inside governance can play positive role and enhance the positive correlation.

Shrivastava and Rao (2015) explain the cause for spinoffs is due to two reasons. One is synergies and the other is dissonance within the team. Some find it necessary to team up with others to create synergy and some find it difficult within a team. But in both cases they need a compliment for their work and knowledge.

Nokolowa (2014) explains spinoff made by an employee with innovation and information about the new wing of operation in a business. Developing an idea in a spinoff allows the parent firm to offer a performance-based contract, which mitigates the adverse selection problem but also decreases the firm's incentives to invest in the project. Even they do so because they don't want to lose the idea or talent.

Lin and Young (2014) examine whether firms manage earnings before pursuing corporate spinoffs with a sample of 226 completed spinoffs between 1985 and 2005 a significant positive relation is found between income-increasing earnings management and the announcement period returns for focus-increasing spinoffs.

Rubera and Tellis (2014) compare the performance of 145 spinoffs and 121 buyouts companies that occurred in the United States between 1996 and 2005, divested to commercialize innovations. This study provides three critical findings: i) spin offs have higher profits in the two years after divestiture; afterwards, buyouts have higher profits; ii) strategic emphasis (investment in R&D versus marketing) is the mechanism that explains the diverging profitability of spinoffs and buyouts over time; this occurs through two routes: a one-step mediated effect via strategic emphasis; a two-step mediated effect via strategic emphasis and radicalness.

Dahl and Sorenson (2014) find that entrepreneurs with industry experience came from younger, smaller, and more profitable parent firms, and that they recruited more experienced employees, worked harder, and placed less value on having flexible hours. The recruitment of more experienced employees and the greater effort exerted appeared to

account for at least some of the performance advantage associated with prior industry experience.

Tahn and Walkar (2006) find it with the sample of 102 spin offs from year 1985-1997, post spinoff, relative valuation measures increase a significantly greater extent than for peer firms. These findings are consistent with the view that agency problems are a contributing factor in firms maintaining value destroying diversification strategies.

Chemmanur et al. (2014) research paper shows that post spinoffs there must be an evident increase in productivity of the spunoff company. Those plants which are not acquired either by parent company or other companies are said to have more productivity.

3 Analysis and findings

The 65 sample has been taken for this study. These are the companies spun off since August 24, 2009. Every company are listed in different stock exchanges all over the world mostly in United States and Europe. The companies are still running and are traded independently in stock markets like NASDAQ and NYSE. The samples are collected from website, <http://www.stockspinoffs.com/recent-spinoffs/> and the data for these samples are collected from <https://in.finance.yahoo.com/q/hp?s=ASPS> and <https://in.finance.yahoo.com/q/is?s=ASPS&annual>

This study checks whether shareholders' value are protected by analysing two important parameters: I) to analyse whether the shareholders get benefits from the stocks of the spunoff company or not; and II) to analyse whether the productivity of the spunoff company increases after spin off.

I. To analyse whether the shareholders get benefits from the stocks of the spunoff company or not

The spunoff company's value is unknown at the beginning. Even then the shareholders are convinced to take the new company shares by compromising the parent company shares. So share price is an important parameter in concluding shareholders' value protection. In this research paper, we analyse with two year data for parent company, one year before the spinoff and one year stock price of parent company from the date of spin off. For the parent company the average of stock price before the spinoff and average of stock price after the spinoff are calculated. By the difference we ensure whether the return is positive or negative. The calculation is as follows:

$$\text{Parent company return} = \text{Average closing price of one year after spin off} - \text{Average closing price one year before spinoff}$$

If the result is positive, then the shareholders are considered as benefitted by the share price

movements and corporate governance body's decisions on spinning off really helped the parent company to focus on a narrowed business.

If the result is negative, then the shareholders are considered not benefitted by the share price movements and corporate governance body's decision on spinning off didn't help the parent company in the short run.

Coming to the spunoff company, the calculation is a bit different, because we need to only check, if there is a hike in stock price after the spinoff, or not.

$$\text{Spun-off company return} = \text{Maximum price of the stock in a year since spinoff} - \text{average price of the stock for the first month}$$

If the result is positive, then the shareholders are considered as benefitted by the share price movements and corporate governance body's decisions on spinning off really helped the subsidiary company to focus on a narrowed business.

If the result is negative, then the shareholders are considered not benefitted by the share price movements and corporate governance body's decision on spinning off didn't help the subsidiary company and the shareholders.

The calculation is done so because, average of the first month gives the base price of the new stock irrespective of volatility and highest price is found for one year considering the fact that the spunoff company took enough time to give profits.

After finishing these calculations for the whole sample, we find out number of companies giving positive returns to shareholders and number of companies giving negative returns to the shareholders. The next step is to find the percentage of returns, because the companies in the sample are listed in different stock markets all over the world. By seeing negative return companies' percentage and positive return companies' percentage we come to a conclusion that shareholders' value is protected or not by the spinoff decision.

However, there are limitations in the method used most important is the negligence of volatility. We neglect volatility knowing and assuming the fact that volatility always increases with many announcements but not limited to dividend issuing, stock splits, national budgets, bonus shares, etc.,

II. To analyse whether the productivity of the spunoff company increases after spin off

Most of the company takes spinoff decision to get rid of the less productive business or businesses in mature state (no more growth can be expected from the business). Shareholders of the parent company are sometimes given the shares of less productive business and spun off. Shareholders' value is affected and put in risk. Thus productivity is a huge factor to be considered while ensuring shareholders' value protection. Here we only analyse the productivity of the spun off company because that

If there is an increase in stock price, then the shareholders are considered benefitted. If there is a continuous decrease in the stock's value, then shareholders are considered not benefitted. For the spunoff company, we analyse one year data of stock price from the date of spinoff. The average of first month close price of the stock and maximum value of the stock in the year are calculated. By the difference we ensure whether the return is positive or negative. The calculation is as follows:

is the point where shareholders' value is at risk. Two year revenue is taken and checked whether the revenue is increased after spinoff or not. Same procedure as the stock price returns is followed for concluding that shareholders' value is protected or not. First we find out number of positive and negative productivity. Next we find the percentage growth in revenue. By analysing the positive productivity percentage and negative productivity percentage, we come to a conclusion whether shareholders' value is protected or not by the spinoff decision.

If the second year productivity > first year productivity, then the shareholders' value are considered to be protected and corporate governance body's decisions on spinning off really helped the subsidiary company to focus on a narrowed business.

If the second year productivity < first year productivity, then the shareholders are considered not benefitted and corporate governance body's decision on spinning off didn't help the subsidiary company and the shareholders.

The calculations are done so because the productivity difference of two years shows exactly whether the company is growing, irrespective of seasonal sales.

4 Conclusions & Limitations

4.1 Conclusions

i) Due to spinoff the parent company stocks prices are so volatile and the results we got from the analysis is that out of 65 companies thirty three companies' stock price is going down at an average of 35% for the next one year and thirty two companies' stocks are going up by an average of 37% for the next one year. Also almost half of the companies' stocks are decreasing for one year from the date of spinoff. This indicates that a spinoff doesn't help the parent company in the short run. This drastic fall of parent companies' stock price is mainly due to reduction in assets that is given to the spun off company.

ii) Due to spin off the subsidiary company stock prices are also volatile but the results we got

from the analysis is that out of 65 companies, none of the companies' stock price is going down. Instead, all the 65 companies' stock prices are going up by an average of 70%. Normally, 70% increase in a stock price within a year is something abnormal. Thus the shareholders are getting abnormal returns from the spinoff decision made by the corporate governance system. This also indicates that the spinoff decision helped the spinoff company to focus on the specific narrowed business that too it is evident within one year.

iii) Due to the spinoff, let us see what happens to the productivity of the spinoff company. From the sample of 53 companies, forty six companies are showing increase in productivity within the immediate next year. Seven companies' productivity decreased at an average of 8% in the first year which implies that those companies didn't go well in the first few years or spinoff decision failed and there is no productivity after that. But other than that 45 companies (after rejecting any abnormal returns, here altisource residential corp. with increase of 4244% over first year), which showed increase in productivity increased with an average of 56% which is far more than the 8% decrease of failed spun offs. This indicates that shareholders' value is protected by the corporate governance system most of the time while taking a spinoff decision.

4.2 Limitations

- Almost thirty two of the parent companies' stock price went down due to asset loss to spinoff company but there is no data evidence to prove that and is beyond the scope of this paper.
- Also we don't know what support other than financial support is given by the parent company to spun off company which increased the productivity and share price. All we proved is spun off company got both better productivity and an increasing productivity with stock data and income statements.
- Productivity is proved to be increasing with only first two years of data from income statement. What happened to the company in the long run is not discussed.

All we tried to prove is the shareholders are given shares of the new company which has a potential to grow.

- And due to the data being recent data is not available for 65 samples for productivity but got only 53 companies' productivity data.

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