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Impact of Organizational Change on Corporate Performance: The Case of Spin-Offs

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Editorial:

One of the most challenging and interesting areas in corporate finance research is the effect that various changes in the organizational structure have on the financial performance of the corporations. The standard assumption in finance textbooks is that shareholders have the ultimate control over the company actions; the managers merely do all they can in order to maximize shareholders' value. Therefore, we can expect that any corporate restructuring (mergers and acquisitions, spin-offs and sell-offs, staff layoffs or new international ventures) will be made with shareholders' best interests in mind and should be accompanied, on average, by positive stock market reaction. For this reason, it is remarkable to see that numerous studies keep producing results, conflicting with this theory. For example, multiple articles on mergers and acquisitions showed that, instead of the predicted gains, shareholders of the acquiring firms often lose out in such transactions. Moeller et al. [1] show that the shareholder losses for the US firms that announced acquisitions between 1998 and 2001 amounted to a staggering \$240 billion.

Similarly to acquisitions, spin-offs constitute a very interesting example of corporate restructuring. A spin-off is a type of corporate restructuring, in which a firm separates one of its divisions into a self-standing company. Shares in this new company are then distributed free of charge to the shareholders of the parent firm. This is a very popular way to restructure a corporation. For example, only in the first 10 months of 2011, 59 spinoffs with the total market value of \$98 billion have been completed in the US [2]. Empirical research on the European spin-offs shows that share prices of the firms announcing a spin-off increase with 2.62% as a result [3]. The cumulative average abnormal return for companies that use the spin-offs to increase their industrial focus is 3.57%, while this return is only 0.76% for firms that divest related businesses. This suggests that the markets prefer corporations to focus on their core businesses rather than diversify into unrelated activities.

Other research on US and international spin-offs confirms these findings [4]. Apart from industrial focus, the following factors are found to affect the shareholder value created by spin-offs: tax advantages, regulatory advantages, and relative size of a spin-off. Predictably, those spin-offs, that take advantage of tax system or favourable regulatory environment, result in the best outcome for the shareholders. On the other hand, information asymmetry between managers and market participants does not seem to play a role in the wealth effects of spin-offs.

Another remarkable feature of the interaction between the capital markets and the corporate change is that the capital markets (at least, in Europe) are shown to be efficient as they immediately react to the information contained in the spin-off announcements [3]. While the overall market reaction to a spin-off announcement is generally positive, there is no significant long-run excess return in the period after the spin-off, compared to the return on a matching portfolio. This proved the validity of the efficient market hypothesis for the case of corporate restructurings.

The recent financial crisis has highlighted the fact that it is not only shareholders who matter for a well-functioning economy. A critical role of the debtholders in providing financing for the firms cannot be underestimated. In this context, study of Veld and Veld-Merkoulova [5] sheds some light on the impact of corporate decisions on the value of corporate debt. Although it is clear from other studies that spin-offs benefit stockholders, the theoretical predictions with regard to the impact of spin-offs on the bondholders are less obvious. On one hand, if spin-off increases the total value of the firm, bondholders might also benefit from this value increase. On another hand, diversified companies tend to have lower risk due to the coinsurance that arises when the cash flows from the different divisions are not perfectly correlated. This lower firm asset risk results in a higher value of the corporate debt securities, including bonds. When a firm spins off a business division, unrelated to its main business, this coinsurance is reduced. The resulting loss of diversification may lead to a higher total risk of the firm, and consequently to a value transfer from bondholders to stockholders. These two possible effects on the value of corporate debt are tested in Veld and Veld-Merkoulova [5], who finds no evidence of the negative effects of spin-offs. On the contrary, bond returns on spin-off announcement day are positive and significant. The firm value increase more than compensates for the possible wealth transfer effect, and as a result the bondholders' wealth is not reduced after a spin-off. Thus, it can be concluded that spin-offs bring an increase to the total value of the companies, possibly due to the efficiency gains and better management, rather than redistribute the wealth from debtholders to the shareholders.

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