Available online at www.sciencedirect.com
SCIENCE DIRECT®
ELSEVIER
Journal of Corporate Finance 11 (2005) 253–275
Journal of CORPORATE FINANCE
www.elsevier.com/locate/econbase

Dismantling internal capital markets via spinoff: effects on capital allocation efficiency and firm valuation

Chris R. McNeil[a], William T. Moore[b,*]

[a] Black School of Business, Penn State Erie, Erie, PA 16563, USA
[b] Moore School of Business, University of South Carolina, Columbia, SC 29208, USA

Received 1 January 2002; received in revised form 1 April 2003; accepted 1 June 2003
Available online 27 August 2003

Abstract

We investigate the linkage between changes in firm value and changes in capital allocation efficiency resulting from dismantling internal capital markets via spinoffs. We find no evidence of wholesale misallocation of capital pre-spinoff. On the average, excess value increases following spinoffs. Furthermore, changes in excess value are positively linked to changes in capital allocational efficiency following spinoff. We find that spinoff announcement returns are greater (smaller) when the parent allocates capital to the unit to be spun off in a seemingly less (more) efficient manner. Divested division capital expenditures move toward industry levels after spinoff, regardless of their relative investment opportunities.

JEL classification: G31; G34
Keywords: Capital budgeting; Restructuring

1. Introduction

Spinoffs and other forms of divestiture dismantle existing internal capital markets; that is, the agents and mechanisms within a firm that influence the intra-firm allocation of capital and the monitoring of capital productivity. There are opposing views regarding the influence of these markets on firm value. Potential benefits include more effective monitoring, alleviation of capital budgeting constraints, and "winner picking" (see,

* Corresponding author. Tel.: +1-803-777-4905; fax: +1-803-777-6876.
E-mail address: aardvark@moore.sc.edu (W.T. Moore).

0929-1199/$ - see front matter
doi:10.1016/S0929-1199(03)00060-9

e.g., Alchian, 1969; Stein, 1997). Alternatively, internal capital markets may reduce incentives for division managers to exert effort, allow managers of poorly performing divisions to expropriate rents from other divisions or otherwise misallocate capital by subsidizing poorly performing divisions(e.g., Meyer et al., 1992; Scharfstein and Stein, 2000).[1]

We investigate the effects of dismantling internal capital markets via spinoff on the efficiency of capital allocation and firm value, and we hope to add a few more findings to what is quickly becoming a vast body of knowledge. Gertner et al. (2002) find that the association between capital expenditure levels and investment opportunities of divested divisions strengthens post-spinoff when the parent and divested division operate in unrelated industries and, furthermore, that this effect is more evident in the case of spinoffs with higher announcement returns. Burch and Nanda (in press) document that post-spinoff improvement in excess value (EV) is greater when the spinoff reduces the diversity of investment opportunities among the parent's business segments. Ahn and Denis (in press) document a positive relationship between change in excess value and change in investment efficiency.

Our study contributes to the literature on spinoffs and internal capital markets in the following ways. We begin by examining divested divisions to determine whether their capital investment behavior changes. There is little evidence of systemic misallocation of capital to these divisions before spinoff. On the average, relative to their respective industries, these divisions spend about the same post-spinoff. However, those that were receiving capital subsidies while housed in parent firms decrease spending, while those that were being rationed by parents tend to increase expenditures, regardless of relative investment opportunities. Both efficient investment patterns (i.e., subsidizing high q and rationing low q divested divisions) and inefficient investment patterns (i.e., rationing high q and subsidizing low q divested divisions) tend to go away after spinoff.

We then measure changes in the allocational efficiency (AE) of capital expenditures before and after spinoffs at the combined firm level (i.e., parent plus divested division). In some cases, we find major improvements, and in some, we observe deterioration, but the average change is near zero. However, changes in allocational efficiency appear to be linked to pre-spinoff levels of efficiency. That is, firms that we categorize as inefficient before the spinoff appear to become more efficient in the aftermath. Our data also reveal that firms judged to be efficient allocators pre-spinoff tend to become *less* efficient afterward, thus, some spinoffs result in deterioration of allocational efficiency.

Next, we turn to effects on firm value first measured by changes in excess value, where excess value is the difference in market value of the combined firm and a portfolio of stand-alone firms operating in the same segments (Berger and Ofek, 1995). We find that median changes in excess value are positive (as do Burch and Nanda, in press), and that they are positively linked to changes in allocational efficiency of capital expenditures (consistent with Ahn and Denis, in press).

Finally, we find that spinoff announcement returns, a second measure of change in value, are related to the parent's policy of investment in the division to be divested. We

[1] Additional theoretical developments concerning internal capital markets include Williamson (1981), Gertner et al. (1994), Rajan et al. (2000) and Maksimovic and Phillips (2002).