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Corporate divestitures: Spin-offs vs. sell-offs

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ABSTRACT

We investigate the determinants of the choice between two forms of corporate divestitures—spin-offs versus sell-offs. We hypothesize that the choice is driven by the pre-divestiture market valuation of divesting firms relative to their intrinsic value, the pre-divestiture performance of the assets being divested relative to their full potential, and the prevailing degree of investor optimism or pessimism about the market at the time of divestiture. Our hypotheses generate testable predictions regarding the announcement effects of divestitures and the post-divestiture operating performance of divesting firms. Our empirical findings using a sample of 378 spin-offs and 4192 sell-offs from 1980 to 2011 are as follows. First, firms with lower market valuations relative to their intrinsic value are more likely to spin off their assets. Second, assets which underperform relative to their full potential are more likely to be sold off. Third, spin-offs are more likely during periods of investor optimism. Fourth, spin-offs are associated with more positive announcement effects than sell-offs. Finally, firms which sell off their assets exhibit better post-divesture long-term operating and stock return performance compared to those which spin off their assets.

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1. Introduction

When firms decide to divest assets, they may totally relinquish their ownership or retain partial ownership. In the former case, firms may choose to divest assets either through spin-offs or sell-offs. Although existing literature provides significant insights on why firms employ spin-offs or sell-offs, numerous questions remain regarding the factors driving the choice between these two forms of divestitures, as well as the differences in the performance of firms divesting through spin-offs and sell-offs.[1] We address several such questions in this paper. Specifically, we examine how the pre-divestiture under- or overvaluation of divesting firms, the pre-divestiture performance of the assets being divested, or investor sentiment at the time of divestiture impact the choice between spin-offs and sell-offs. Further, we study the differences between the post-divestiture long-term operating and stock return performance, as well as the announcement effects of firms divesting assets through spin-offs and sell-offs.[2]

Although suitable for direct comparison in the sense that both spin-offs and sell-offs allow a firm to fully release ownership and control of its assets, these two forms of corporate divestitures are quite different from each other. In a spin-off a certain asset (a

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[1] Prior literature demonstrates that firms sell off assets to increase focus (Dittmar and Shivdasani, 2003; John and Ofek, 1995), obtain cheap financing (Lang et al., 1995), and rid themselves of poor fit (Hite et al., 1987) or low productivity (Maksimovic and Phillips, 2001) assets. Prior literature also shows that firms spin off assets to relax regulatory and tax constraints and increase managerial efficiency (Schipper and Smith, 1983), allow parent firms and spun-off units to specialize in areas they have a comparative advantage as well as to facilitate future mergers (Cusatis et al., 1993; Hite and Owers, 1983), cater to different clienteles who may wish to invest either in the spun-off units or the parent firms (Vijh, 1994), mitigate information asymmetry (Gilson et al., 2001; Krishnaswami and Subramaniam, 1999), increase focus (Daley et al., 1997; Desai and Jain, 1999), improve the allocation of capital (Gertner et al., 2002), or transfer wealth from bondholders to shareholders (Maxwell and Rao, 2003; Parrino, 1997).

[2] Several of the papers mentioned above investigate the post-divestiture performance of firms which either spin off or sell off assets. However, to the best of our knowledge, there are no studies directly comparing the post-divestiture performance of such firms.

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unit, division, or subsidiary) of a firm is split off from the parent firm into a separate publicly traded company. Shares of this new independent firm are distributed to the existing shareholders of the parent firm on a pro rata basis.[3] Usually, a spin-off has no tax consequences for the divesting firm which treats the newly created shares as a stock dividend to its existing shareholders. On the other hand, in a sell-off a certain asset of the divesting firm is sold off for cash or securities to another firm or entity. Sale proceeds are taxable to the parent firm which may use them for other corporate purposes or distribute to its shareholders.

Existing literature identifies several factors affecting the choice between spin-offs and sell-offs. Khan and Mehta (1996) show that the likelihood of spin-offs (relative to sell-offs) increases with the operating risk of the assets being divested. In Maydew et al. (1999) the likelihood of sell-offs decreases as the incremental net tax cost of choosing a sell-off instead of a spin-off increases.[4] Nixon et al. (2000) find that firms with smaller boards of directors and separate offices for CEOs and those that are not financially distressed are more likely to spin off larger units. Powers (2001) shows that firms in need of cash are likely to sell off badly-performing divisions, while firms which do not need cash are likely to spin off average-performing divisions. Chen and Guo (2005) find that firms with low revenue growth and those with low book-to-market ratios are more likely to spin-off larger units during periods of low investor sentiment, while firms with high capital expenditures, high book-to-market ratios, and lower dividend yields are more likely to sell off smaller units. Finally, Bergh et al. (2008) show that less (more) diversified firms are more likely to spin off assets in their primary (secondary) and related (unrelated) business lines.

This paper makes several contributions to the literature on a divesting firm's choice between spin-offs and sell-offs. To begin with, we study the effect of a firm's pre-divestiture under- or overvaluation relative to its intrinsic value on its decision to spin off or sell off its assets; this effect has not been studied before in the literature.[5] Specifically, we hypothesize that overvalued firms will be more likely to sell off their assets to lock in higher market valuations, while undervalued firms will be more likely to spin off their assets. We design several proxies that capture divesting firms' equity under- or overvaluation by comparing their intrinsic value estimates to their pre-divestiture market values. Our empirical findings indicate that undervalued (overvalued) firms are more likely to spin off (sell off) their assets and the pre-divestiture market valuation of asset sellers is significantly greater than that of firms spinning off assets.

In another contribution to the literature, we study the differences in the post-divestiture operating and stock return performance of firms divesting assets through spin-offs and sell-offs. The existing literature studies the post-divestiture performance of firms which either spin off or sell off assets, but not both.[6] We hypothesize that firms are more likely to sell off assets which underperform relative to their full potential and to spin off assets with better performance closer to their full potential. This is because the after-tax proceeds from the sale of underperforming assets are likely to be higher (assuming that the competition among potential asset buyers will allow the parent firm to sell off its assets at the highest price reflecting their full value potential) than the value commanded by the same underperforming assets in the market if spun off (which is likely to be the same or somewhat better than their low pre-divestiture value). On the other hand, assets which perform relatively better are likely to command a higher value in the market if spun off (which is likely to be the same as their relatively higher pre-divestiture value or even higher) compared to the lower after-tax proceeds these assets would generate if sold off (due to the dissipating effect of taxes). Thus, firms which sell off underperforming assets are likely to realize greater improvement in their post-divestiture long-term operating performance compared to firms which spin off better-performing assets. Our empirical results provide support for this hypothesis and indicate that firms which divest assets through sell-offs realize significantly better long-term post-divestiture operating performance compared to firms which divest assets through spin-offs. Furthermore, our empirical findings show that firms which divest their assets through sell-offs also realize better post-divestiture stock returns compared to firms divesting through spin-offs.

We also study how the under- and overvaluation of divesting firms, as well as the relative underperformance of assets being divested discussed above influence the announcement effects of spin-offs and sell-offs.[7] First, we hypothesize that, if spin-offs (sell-offs) signal divesting firms' undervaluation (overvaluation), then, all else the same, the announcement effects of spin-offs (sell-offs) will be positive (negative). Second, if firms are expected to sell off their underperforming assets at a premium over their pre-divestiture value, the announcement effects of sell-offs will be positive; on the other hand, if the better-performing assets divested through spin-offs are expected to command the same (or higher) value after divestiture as before divestiture, the

[3] This is substantially different from a carve-out where the parent firm retains the majority of the shares in the new company and sells the rest in a public offering.

[4] For sell-offs the net tax cost is the difference between the direct tax cost (or benefit) incurred from a sell-off minus the estimated premium that the sold-off asset receives over its pre-sale value. For spin-offs the net tax cost is the difference between the tax cost (benefit) the parent firm avoids (gives up) by choosing a non-taxable spin-off instead of a taxable sell-off minus the premium the spun-off asset would have commanded if it was sold off instead.

[5] Krishnaswami and Subramaniam (1999) conjecture that spin-offs reduce the degree of information asymmetry faced by divesting firms and, therefore, firms which are undervalued due to information asymmetry are expected to experience positive announcement effects when they spin off their assets. Their empirical results provide support for this conjecture. However, since they do not explicitly measure undervaluation, they do not establish its direct link with a divesting firm's decision to spin off its assets. In this paper, we consider not only the effect of undervaluation but also the effect of overvaluation on the firm's choice of divestiture type, directly measure the degree of pre-divesture under- or overvaluation (relative to intrinsic value), and use it to infer the firm's divestiture choice.

[6] John and Ofek (1995) find that firm operating performance improves with focus-increasing sell-offs. Daley et al. (1997) find a significant improvement in post-divestiture operating performance for firms spinning off cross-industry units, but none for firms spinning off own-industry units. Desai and Jain (1999) document significantly positive post-divestiture stock return and operating performance for firms implementing focus-increasing spin-offs, but not for firms implementing non-focus-increasing spin-offs. Cusatis et al. (1993) find that firms divesting through spin-offs experience positive post-divestiture long-term excess stock returns. McConnell et al. (2001) find positive post-divestiture excess returns for spin-off parent firms as well; however, they acknowledge that such positive performance is driven by extraordinary performance of one outlier observation.

[7] Prior literature has found positive announcement effects for both spin-offs (Allen et al., 1995; Hite and Owers, 1983; Krishnaswami and Subramaniam, 1999; Miles and Rosenfeld, 1983; Schipper and Smith, 1983; Vijh, 1994) and sell-offs (Alexander et al., 1984; Borisova et al., 2013; Clayton and Reisel, 2013; Hite et al., 1987; Jain, 1985; Lang et al., 1995). However, the only paper which directly compares the announcement effects of spin-offs and sell-offs is Rosenfeld (1984), who uses a small sample of spin-offs and sell-offs to show that the announcement effects of spin-offs are significantly larger than those of sell-offs. Rosenfeld (1984), however, does not provide an explanation for the documented differences in the announcement effects between the two divestiture forms.

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