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Journal of Financial Economics 72 (2004) 259–290
JOURNAL OF Financial ECONOMICS
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A theory of corporate spin-offs☆

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Received 14 August 2001; accepted 3 May 2003

Abstract

We develop a new rationale for corporate spin-offs, and for the performance and value improvements following them, based on corporate control considerations. We consider a firm with multiple divisions, with incumbent management having different abilities for managing these divisions. If the incumbent loses control to a more able rival, it benefits all shareholders (including the incumbent) by increasing equity value, but involves the incumbent losing his private benefits of control. We show that a spin-off increases the incumbent's chance of losing control to such a rival. This, in turn, motivates the incumbent either to work harder at managing the firm (in order to avoid any loss of control), or to relinquish control of one of the firms resulting from the spin-off (either immediately following the spin-off, or subsequently in a control contest). We show that spin-offs will be associated with positive announcement effects and increases in long-term operating performance. Further, certain categories of spin-offs will exhibit long-term positive abnormal stock returns.
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JEL classification: G34; G32

Keywords: Spin-offs; Restructuring; Takeovers; Corporate control

☆The working paper version of this paper circulated under the title "Corporate control contests and the disciplining effect of spin-offs: A theory of performance and value improvements in spin-offs". For helpful comments or discussions, we thank Franklin Allen, Richard Arnott, Sris Chatterjee, Art Durnev, Espen Eckbo, John Finnerty, Chinmoy Ghosh, Gautam Goswami, Jayant Kale, George Kanatas, David Nachman, Vik Nanda, Tom Noe, Jun Qian, Steve Raymar, Fabio Schiantarelli, Susan Shu, Venkat Subramaniam, Bob Taggart, Hassan Tehranian, as well as participants at the August 2001 EFA meetings, the 2002 Asian Corporate Governance Conference, the 2002 FMA meetings, the 2003 WFA meetings, and seminars at Boston College, Boston University, Brandeis University, Fordham University, Georgia State University, McGill University, and Tulane University. Special thanks to the editor Bill Schwert, and an anonymous referee for several helpful suggestions. All errors remain our own responsibility.

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doi:10.1016/j.jfineco.2003.05.002

1. Introduction

In recent years, the number of corporate spin-offs has accelerated. While the motivation often given for such spin-offs is corporate focussing (or re-focussing), little is known about the precise source of any benefits from such corporate restructuring (see, e.g., Comment and Jarrell, 1995; Berger and Ofek, 1995, for examples of the corporate focus literature). The empirical literature has repeatedly documented that parent-company stockholders gain by spin-off announcements while bondholders are unaffected (see, e.g., Hite and Owers, 1983; Miles and Rosenfeld, 1983; Schipper and Smith, 1983). However, the precise source of such value gains is still a matter of considerable debate.

Recent empirical evidence, however, goes beyond showing the positive announcement effects of spin-offs on stock price. Cusatis et al. (1993) show that, in addition to the positive abnormal stock returns for parent firms on the announcement date, both spin-offs and their parents experience significantly positive abnormal returns for up to three years beyond the spin-offs' announcement date. Further, both spin-offs and their parents experience significantly more takeovers than do control groups of similar firms. Finally, they show that spin-off/parent combinations not reporting takeover activity within three years do not have positive long-term abnormal stock returns.

This paper develops a new rationale for the performance and value improvements arising from spin-offs which is consistent with this recent (as well as earlier) empirical evidence. We develop a theoretical analysis which demonstrates how spin-offs can increase the probability of a takeover by the right kind of (value-improving) management team. We show how such spin-offs can enhance the level of firm performance even in the absence of such a value-improving takeover by serving to discipline firm management. Finally, our analysis demonstrates that, while a spin-off will lead to positive abnormal stock-price returns on the announcement day, it will also lead to increases in operating performance and to abnormal stock price performance (on average) in the period following the spin-off for certain categories of firms.

We study a setting where, while management would like to increase equity value, incumbent firm management also derives private benefits from control. The firm has two divisions, and current management could have the same or differing abilities for managing these two divisions. Giving up control to a rival management team, while it can benefit equity holders (including the incumbent management) by increasing firm value, is costly to the incumbent in that it involves loss of control, and hence a reduction in the incumbent's control benefits. A spin-off increases the chance of loss of control to a potential rival in two ways. First, it increases the probability that passive investors will vote with the rival in a contest for the control of at least one division. In the joint firm, the incumbent's inferior ability (compared to the rival) in managing one division could be neutralized by superior ability in managing the other division. Second, it reduces the ability of the incumbent to use firm size strategically against the rival in a control contest. We will analyze the first effect of spin-offs in detail in our formal model, and will provide an intuitive discussion of the second

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