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Internal capital markets and investment policy: evidence from corporate spinoffs ☆

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Abstract

We analyze changes in investment policy following 106 spinoffs between 1981 and 1996. Pre-spinoff, the sample firms are valued at a discount and invest less in their high q segments than do their single-segment peers. Post-spinoff, there is a significant increase in measures of investment efficiency and the diversification discount is eliminated. Furthermore, changes in excess value around the spinoff are positively related to changes in measures of investment efficiency. These findings support the view that (i) diversified firms allocate investment funds inefficiently, and (ii) by breaking up the conglomerate, spinoffs create value by improving investment efficiency.

JEL classification: G31; G32; G34

Keywords: Internal capital markets; Spinoffs; Diversification

1. Introduction

A large number of academic studies report that diversified firms are valued at a discount relative to portfolios of single-segment firms operating in the same industries. This diversification discount is fairly robust over time and exists both in

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the U.S. and in other developed economies.[1] Further, Comment and Jarrell (1995) show a systematic pattern of refocusing among U.S. firms since the mid-1980s. On average, this refocusing is associated with significant increases in shareholder wealth. Announcements of focus-increasing transactions such as asset sales, equity carve-outs, and corporate spinoffs are all met with positive stock price reactions.[2]

Although the existence of the diversification discount is not questioned, its interpretation remains controversial. Some argue that the evidence supports the view that diversified organizations destroy value. A particular version of this hypothesis is that diversified firms invest inefficiently, investing too much in some business units and/or too little in others. This hypothesis draws theoretical support from the models of Rajan et al. (2000) and Scharfstein and Stein (2000) and is consistent with the evidence in Scharfstein (1998) and Rajan et al. (2000). However, both Chevalier (2000) and Whited (2001) argue that the empirical results supporting the inefficient investment hypothesis can be explained by measurement error. In addition, studies by Campa and Kedia (1999), Graham et al. (2002), and Maksimovic and Phillips (2002) argue that the link between diversification and value is not causal, but rather is the result of endogenous firm choices.

We provide evidence on the inefficient investment hypothesis by analyzing changes in investment policy following corporate spinoffs. If the diversification discount is caused in part by inefficient investment policies in diversified firms, we expect that (i) the breakup of the diversified firm will significantly reduce the discount, (ii) diversified firms will invest inefficiently prior to a breakup but increase investment efficiency following the breakup, and (iii) the increase in value following the breakup will be positively related to changes in measures of investment efficiency.

Using a sample of 106 spinoffs completed by multisegment firms between 1981 and 1996, we report results that are broadly consistent with the inefficient investment hypothesis. Like previous studies of diversified firms, we find that prior to the spinoff, the sample firms trade at a significant discount to stand-alone firms. Following the spinoff, however, the diversification discount is eliminated.

We conduct several tests to determine whether a change in investment efficiency contributes to the change in value following the spinoff. First, we examine industry-adjusted levels of investment in individual segments. We find that prior to the spinoff, industry-adjusted investment is negative in the firm's high-q segments and statistically insignificant in the firm's low-q segments. Industry-adjusted investment is significantly higher in the firm's low-q segments than in its high-q segments. Following the spinoff, investment in high-q segments is significantly increased.

Second, we compute two measures of firm-level investment efficiency, the relative investment ratio (RINV) and Rajan et al.'s (2000) relative value-added (RVA)

[1] See Lang and Stulz (1994), Berger and Ofek (1995), and Servaes (1996) for evidence on the diversification discount in U.S. firms, and Lins and Servaes (1999) for international evidence.

[2] See, among others, Lang et al. (1994), John and Ofek (1995), and Dittmar and Shivdasani (2003) for evidence on the stock price reaction to divestiture announcements; Allen and McConnell (1998) for evidence on the stock price reaction to equity carve-outs; and, Hite and Owers (1983), Schipper and Smith (1983), Miles and Rosenfeld (1983), Vijh (1994), Allen et al. (1995), and Daley et al. (1997) for evidence on the stock price reaction to spinoffs.