Impact of Spin-off Restructuring Strategy on Parent Company: Evidence from India

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ABSTRACT

While the impact of divestitures on the stock return of parent companies has been extensively studied, adequate attention has not been drawn to the financial performance of the divesting firms. Previous research has found that demergers were associated with significant positive cumulative abnormal returns for the parent company. However, these studies have not identified whether the parent company performs better after the spin-off. This research work addresses whether the financial performance of the parent company improves after adopting the restructuring strategy through spin-off. The present study evaluated the performance of twenty spin-offs of Indian companies during a period of five years by using accounting and capital market indicators. The study reveals that corporate restructuring strategy does not improve the short-term performance of the divesting company.

Keywords: Demerger, Spin-off, Divestiture, Restructuring, Financial Performance

1. Introduction

Corporate restructuring revolves around the steps taken by a firm to redesign the ownership, assets, and claims. The channels of restructuring are mergers and acquisitions, alliances, leveraged buy-outs, joint ventures, spin-offs, and buyback of shares (Daru, 2016). Though major restructuring events are fuelled by mergers and acquisitions, fine-tuning of the company size by spinning off divisions within the company has risen to be one of the more frequently taken decisions.

Until the year 2019, 69 companies globally have recorded revenue greater than $100 billion. Breaking down these companies further, 33 had an American origin, and 18 had a Chinese origin (Fortune Global 500, 2019). Understanding a common trend among these companies, it can be observed that they do not have a historical background but have achieved such enormous growth by highly relying on technology and human capital along with the continuous revision of processes and operations. The growth of major Indian companies with establishments dating back to the colonial period was triggered by the policy restructuring in 1991. Motivation of the parent companies to divest subsidiaries is to achieve a clear strategic focus, optimize financial capital needs, strengthen subsidiary portfolio and enhance the value creation for stakeholders. In addition to these firm-specific factors munificent

macro environment factors such as growth of economy, increasing industry revenue, strong capital markets and cycle of stages of economic growth ((Pearce & Patel, 2022).

Demerger revolves around re-establishing the business by directing certain divisions or processes to operate independently or to be sold. The reason behind this strategic move may be to raise capital, avoid getting acquired or to have a better structure legally. This restructuring paves the way for companies to align their focus better, maintain a uniform strategic outlook, manage risk efficiently, and improve their value. Higher levels of specialization for human capital skills can be achieved owing to the company's narrowing down of products and services. These demergers can be further classified into spin-off, split-off, and carve-out.

This study focuses on the impact of demerger corporate restructuring transactions in general and spin-offs in particular on the parent company’s performance.

1.1. Spin-off

A spin-off is a divestiture that occurs when the equity owners of a conglomerate exchange value in their shares for an equal value of shares in a newly independent business created from the conglomerate’s resources (Pearce & Patel, 2022).

The business or division spun off from the parent business operates as a separate entity. Shareholders of the parent entity now hold shares in the parent company and the new business or division created individually.

1.2. Split-off

Under a split-off, the parent company's shareholders are given a choice. This choice is between continuing their shareholding in the parent company or can exchange their shares with equivalent shares in the newly formed subsidiary company.

1.3. Carve out

When a company undergoes a carve-out process, the parent company’s shareholders are not allocated any shares in the newly formed entity. The shares in the new entity are sold through an initial public offering (IPO). The parent company achieves cash inflows by opting for a carve-out. Frank and Harden (2001) analyzed the difference in equity carve-outs and spin-offs

This study focuses exclusively on the spin-off. Hence, it is essential to understand its intricacies in detail. It begins with the different types of spin-offs.

1.4. Pure Play

Under this type, all the shares in the newly formed entity are allotted to the parent firm’s shareholders and distributed as a special dividend. This form of corporate restricting facilitates focused growth and sustained value creation for all stakeholders over a period of

time. GMR Infrastructure Ltd. initiated the process to spin off its non-airport business into a separate entity to attract sector-specific global investors and unlock value for the current shareholders. GMR Infrastructure will be a pure-play airport company after the demerger[1] (Sharma, 2020).

Taiwan based United Microelectronics Corporation (UMC) pursued a spin-off strategy of vertical disintegration that led the transformation of UMC into a "pure-play" foundry[2].

1.5. Equity carve-out

This type involves a unique combination for the distribution of shares of the newly formed company. Among the shares of the new company, 10% of them are raised through IPO to generate funds, and the remaining 90% is allotted to the parent company's existing shareholders which is distributed as a special dividend.

Apart from the types, the reasons behind such a strategic decision also need to be considered. This would help understand the course of actions that would be taken by both the parent company and the newly formed entity. The reasons tend to be managerial, strategic alignment, risk management, legal compliance, tax benefits, profitability, and capital market factor.

Managerial reasons behind a company opting for a spin-off include building highly correlated offerings and achieving a higher level of uniformity in operations and other aspects. The reforms around restructuring the business divisions help achieve strategically aligned among all the divisions. The splitting of business with higher risk also helps in reducing the overall risk of the parent company and create a better structure legally, helping in achieving better tax cover also. Higher levels of management efficiency lead to better profitability and improve the shareholders' value in the company.

The rest of the paper is sequenced as follows. The second section describes the literature review on the impact of spin-offs. The third section describes the data and research methodology. The fourth section reports the main findings and discussions and compares the results with previous research, and finally, the fifth section concludes the research findings.

2. Literature Review

Analysis of the literature on restructuring, it is quite clear that most of the efforts are mainly based on technologically driven innovations. Daley et al. (1997) reported that focus-increasing spin-offs significantly improved operational performance post-spin-offs. It is also suggested that the spin-off decisions have been attributed to better accessibility of the capital

[1] GMR Infrastructure To Become Pure-Play Airports Company Post Restructuring https://www.bloombergquint.com/business/gmr-infrastructure-to-become-pure-play-airports-company-post-restructuring

[2] UMC Milestones - UMC

market to avoid competing for funds available with the parent company (Cooper, 1985). In general, spin-off tends to increase the company's valuation compared to the parent company thriving alone. This is even more economically efficient if the parent and the spin-off companies operate along different lines having minimum overlap in the revenue channels.

Companies sell non-core assets generally to create cash flow to repay debt (Desai and Jain, 1999). However, there exist main differences at the very base between spin-off and selling of assets. Spin-offs are generally not triggered by the need to raise cash which forms the core basis for selling assets, but by improving overall efficiency (Vijh, 2002). Also, spin-off entitles the new entity to operate as an entirely separate entity from the parent company. This paves the way for independent analysis that can be undertaken for both of these companies.

The literature analyzed has indicated historical patterns of abnormal returns for the parent company ranging from 2.9% to 3.3% upon the benchmark index during the event window on the spin-off announcement (Linn and Rozeff, 1985 and Copeland, Lemgruber, and Mayers, 1987). On further analysis, the main reason impacting the stock prices positively is the reduction of negative synergies with the company. This tends to realign the company's strategic focus on managerial implications like efficiency and profitability (Hite and Owers, 1983 and; Miles and Rosenfeld, 1984). This also helps recognize that situations sometimes contradict the philosophy of economics of scale. Some companies' business lines attract more investments than their revenue-generating capabilities owing to managerial costs of decision-making and resource management (Schipper and Smith, 1983). Spin-off also provides better clarity on the company structure to the investors helping people value the company accurately (Krishnaswami and Subramaniam, 1999). Also, announcement returns for focus-increasing spin-offs are significantly higher than those of non-focus-increasing spin-offs (Desai and Jain, 1999).

Literature also suggests that long-term excess returns have been recorded from 1965 to 1978 (Cusatis, Mikes, and Woolridge, 1993). On further analysis, most of these excess returns were contributed by companies acquired within three years of becoming publicly listed post spin-off. Also, the literature suggests that short-term excess returns have been recorded within the first 12 months post the stock issue to the public (Desai and Jain, 1999).

Spin-offs tend to give a better understanding of the company's structure and operations to the investors accounting for a main reason behind the positive announcement effects (Allen, Lummer, McConnell, and Reed, 1995). This consequentially paves the way to better information in the hands of the shareholders, improving the accuracy on the valuation of the firm (Habib, Johnsen, and Naik, 1997). From this, it is quite evident that spin-off is one of the best ways of raising capital based on the firm's valuation.

The literature holds detailed information on the stock returns analysis of the parent company after the spin-off. This paper focuses on the study of the parent company's performance post-spin-off through efficiency and profitability variables.

Table 1: Summary of empirical research analysing the impact of spin-off on the parent firm

Author	Sample Period	Sample Area	Sample Size	Major Finding
Bendre and Apte (2017)	2012-2017	India	24	Spin-off gives a positive return with a significant increase in average market capitalisation
Aggarwal and Garg (2018)	2010-2016	India	76	The positive announcement returns for the shareholders of the parent company on the announcements of Spin-offs. The announcement return is highest on day 0, and the cumulative AAR is highest on day +1
Vyas, Pathak and Saraf (2015)	2012-2014	India	51	There is a significant out-performance of the stock over the benchmark index post-demerger announcement which ranges from 1.74% average abnormal return for a demerger announcement to 0.16% average abnormal return ten days following the announcement
Chai, Lin and Veld (2018)	1999-2013	Australia	103	The announcement effect has been found to be significantly positive on the stock return of the parent company
McConnell, Sibley and Xu (2015)	2001-2003	USA	146	The parent companies' shares outperform their benchmarks by an impressive margin
Hollowell (2009)	1999-2002	USA	82	Spin-offs and their parent companies outperform market indices from the closing price on the first day of public trading to their four-year anniversaries
Singh and Bhowal (2009)	2006	India	5	Spin-off leads to enhancement in shareholders' wealth
Cooney, Finn and Karl (2004)	1994-2000	Australia	223	Demerger announcements produce positive abnormal returns for the parent company
Veld and Veld-Merkoulova (2004)	1987-2000	15 European Countries	156	Cumulative average abnormal return is significantly positive for the completed spin-offs
Liedgren, Olofsson and Zetterlund (2008)	1991-2004	Sweden	18	As stand-alone entities, Spin-off parts do not on average perform better. The impact is positive on the variables related to market expectations, and negative for the variables measuring profitability and efficiency.
Zomer et al. (2010)	1992-2006	Netherlands	25	Research Based Spin-off companies do not have a significant impact on the direction of the research conducted at the parent companies.

Source: Author's work

3. Methodology, Data, and Scope of the Study

3.1. Sample Selection & Data Collection

Saunders et al. (2003) emphasize the need to draw a meaningful sample to generate statistical inferences. The objective of this paper is to investigate the parent company's performance before and after the spin-off event. The following criteria were used to collect the sample.

i. Only "pure" spin-offs were included. In the given period, if there is more than one spun-off by the parent company, then those companies' data have also been excluded.
ii. Financial data was collected for seven years for the parent company, including 3 years belonging to pre-spin-off and three years belonging to post-spin-off. Four financial ratios namely Market adjusted Stock Return, Return on Assets (ROA), Annual Growth in Sales, and Market Price to Book ratio (P/B) were calculated. This timeframe of 3 years before and three years after the spin-off confirms that the data from the spin-offs are based on an average of three years, two years and one year would protect the results from short-term variations in the comparison between pre and post-spin-off performance.
iii. Year 0, the year of the spin-off, was excluded from the calculation, as its inclusion may result in distortion due to changes in reporting because of the demerger.
iv. Publicly traded Spin-offs completed during the financial year 2011 to the financial year 2015 in India were included, and the required data was collected through Bloomberg and BSE website.

There was a total of 95 Spin-off cases completed in India from the financial year 2011 to the financial year 2015. However, only those cases were included in the study, where there was only one spun-off by the parent company during the study period. This was done to eliminate the overlapping impact of multiple spin-offs on one parent company. This reduced the sample size from 95 cases to 67. Further, only those cases were retained in the analysis for which data was available for pre-spin-off and post-spin-off. This led to a reduction of another 45 cases. The criteria listed above excluded 73 spin-offs.

3.2. Variables

Financial ratios can be ascertained by using the information from the financial statements related to a company's operating performance and profitability margins, solvency indicators, and overall health of a business, to measure profitability, efficiency, and the risk of its business structure, etc. Financial ratios have extensively been used in empirical research studies to analyze the value created for shareholders. The advantage of ratio analysis is in its simplicity and the standardized measure of the financial data so that the influence of factors such as absolute size is controlled (Watson & Head, 1998; Gaughan, 1996). Empirical research in strategy and Finance has witnessed the use of financial ratios for establishing a broad framework for a company. Financial ratio analysis is frequently used as a more

straightforward comparison of similar companies of similar size and the players in the same industry (Gaughan, 1996).

To evaluate the performance four major financial ratios were used. These four ratios are:

i. Return on Assets (ROA): ROA is a profitability ratio. Profitability measures the operating success of a company. ROA measures the profitability for the given amount of investment. It measures how efficiently the company converts its assets to gain profit and generate value for its shareholders. ROA is an indicator of asset utilization and earnings power of the present operations.
ii. Sales Growth: An entity's financial performance from a short-term perspective can be gauged by observing sales (Gaughan, 1996). Every business aspires for sales growth to generate profits. An analysis of the change in average sales growth before and after the spin-off event is an indicator of how efficiently management was able to take advantage of the strategy of the spin-off to efficiently manage its operations.
iii. Market-to-book ratio (M/B): The market-to-book ratio is a market-based ratio. The ratio compares the market price of the company's stock with the accounting value of the company that is recorded in its accounts. An advantage of market-based ratios is that they assess the market's assessment of financial well-being of the firm as well a projection of the future ability to provide investors with a profitable return on their investment. If the M/B ratio is larger than 1, this means that the market is expecting the future growth for the company to increase. Management can be said to be successful if it has a ratio of over one since that demonstrates that the market believes in the business.
iv. Share price: The share price helps to understand the market assessment of the value of a company. As the market discounts the company in a timely manner and the valuation of the share price is continuously updated depending on the performance of the company. This measure is an important variable to understand market signals and whether the company has created or destroyed value during the period. If the market signals positive and significant improvement in share price it may be attributed to the expectation of better performance after a spin-off. However, a share price in absolute terms is not a good indicator of how the company has performed against the market. When there are positive market conditions, it is likely that all stocks are influenced in a similar manner. Therefore, instead of using the share price, the market-adjusted stock return is a better way to get comparability over different periods and to be able to examine whether the stock is doing better in comparison to the market (Gaughan, 1996).

3.3. Methodology

The average financial performance of parent companies prior to and post the spin-off event have been compared. The following pairs were analyzed to examine the change in the performance.

- One year before and after spin-off (-1, 1)
- One year before and two years after spin-off (-1, 2)
- One year before and three years after spin-off (-1, 3)
- Two years before and after spin-off (-2, 2)
- Three years before and after spin-off (-3, 3)
- Three years mean before and after spin-off (Mean [-3,-2,-1], Mean [1,2,3])

To obtain a comprehensive evaluation of the financial performance of the parent company, the calculations were based on four financial measures:

- Return on Asset (ROA)
- Sales growth
- Market-adjusted stock return
- Market-to-book ratio (M/B)

The normal distribution cannot be assumed as the sample for this study was relatively small. Kolmogorov-Smirnov Test was conducted to confirm. The non-parametric method was used to analyse the ratios as the required criteria of parametric tests were not observed. Thus, Wilcoxon signed-rank test was used to determine any significant difference between pre- and post-spin-off. To address the research question, the following hypothesis was formulated for each pair.

H_0: There is no significant change in the financial performance of the parent company pre and post-spin-off

4. Empirical Results & Discussion

The intent of this paper was to conduct a comparative analysis of the financial performance of parent companies before and after divestiture. It was hypothesized that parent companies perform better post-spin-off. The financial performance was analysed for the following variables:

i. Return on Assets (ROA): It is hypothesized that the profitability of the parent company increases after the spin-off. The data in Table 2 shows that the mean profitability in terms of return on assets decreases post-divestiture. The paired sample for comparison of means (-3, +3) depicts that ROA reduced by 2.68 percent during the post-spin-off period. A negative mean difference in ROA is observed for most (63 percent) of divesting companies. Contrary to the hypothesis, the profitability of parent companies decreases after the spin-off. However, the significance level is greater than the alpha of 5% in all the cases; therefore, the null hypothesis cannot be rejected.

Table 2: Wilcoxon signed-rank test of Return on Assets (ROA) ratio pre and post spin-off

Paired sample (pre, post)	Mean Ratio post-spin-off	Mean Ratio pre-spin-off	Mean difference	Positive: Negative	Significance
(-1,+1)	4.14	5.03	-0.89	9:13	0.263
(-1,+2)	4.96	5.03	-0.07	11:11	0.783
(-1,+3)	3.98	5.03	-1.05	10:12	0.548
(-2,+2)	4.96	6.29	-1.33	9:13	0.615
(-3,+3)	3.98	6.66	-2.68	8:14	0.123
Mean (-3,-2,-1), Mean(+1,+2,+3)	4.36	6.00	-1.64	10:12	0.263

Source: Author's work

ii. Market-to-Book Ratio: This ratio assesses the financial health of a company as well as a projection of the future ability of the company to generate investors with a reasonable return on their investment. The relevant data in Table 3 shows that the mean projection of future returns has improved after divestiture. The paired sample for comparison of means (-3, +3) reveals that the Market-to-Book ratio increased by 0.88 percent during the post-spin-off period. The positive mean difference in the market-to-Book ratio is observed for most (59 percent) of divesting firms.
As expected, the market assessment of parent companies improves after the spin-off.

Table 3: Wilcoxon signed-rank test of Market-to-Book ratio pre and post-spin-off

Paired sample (pre, post)	Mean Ratio post-spin-off	Mean Ratio pre-spin-off	Mean difference	Positive: Negative	Significance
(-1,+1)	3.00	2.30	0.70	12:10	0.506
(-1,+2)	3.07	2.30	0.77	14:8	0.158
(-1,+3)	3.17	2.30	0.87	12:10	0.322
(-2,+2)	3.07	2.87	0.20	12:10	0.615
(-3,+3)	3.17	2.29	0.88	13:9	0.211
Mean (-3,-2,-1), Mean (+1,+2,+3)	3.08	2.48	0.60	13:9	0.355

Source: Author's work

iii. Market Adjusted Stock Return: It is hypothesized that the stock return of the parent company increases after the spin-off. The data in Table 4 shows that the mean of market-adjusted stock return decreases post-divestiture. Except for the paired sample for comparison of means (-3, +3), all other paired samples depict a reduction in share price return during the post-spin-off period. However, the number of cases of positive mean difference is the same for paired samples of (-3, +3) and (Mean [-3, -2, -1], Mean[+1, +2, +3]) of divesting companies. This means over a period of time, stock return average out, and spin-off generates positive returns for the majority (55 per cent) of parent companies.

Table 4: Wilcoxon signed-rank test of Market Adjusted Stock return pre and post-spin-off

Paired sample (pre, post)	Mean Return post-spin-off	Mean Return pre-spin-off	Mean difference	Positive: Negative	Significance
(-1,+1)	0.18	4.84	-4.66	14:8	0.249
(-1,+2)	-0.01	4.84	-4.85	14:8	0.592
(-1,+3)	0.10	4.84	-4.74	11:11	0.445
(-2,+2)	-0.01	0.21	-0.22	8:14	0.408
(-3,+3)	0.10	0.05	0.05	12:10	0.783
Mean (-3,-2,-1), Mean(+1,+2,+3)	0.09	1.70	-1.61	12:10	0.808

Source: Author's work

iv. Annual Sales Growth Rate: It is hypothesized that there is an increase in the sales growth of the parent company post-spin-off. The data in Table 5 shows that the mean growth in terms of annual sales growth rate decreases post divestiture. The paired sample for comparison of means (-3, +3) exhibits a deterioration in sales growth by 101.8 percent after the spin-off. The negative mean difference in sales growth is observed for most (86 percent) of divesting companies.

Contrary to the hypothesis, the sales growth of parent companies diminishes after the spin-off. The significance level is significantly lower than the alpha of 5% for paired samples of (-3, +3) and (Mean [-3, -2, -1], Mean [+1, +2, +3]); therefore, the null hypothesis can be rejected for these pairs.

Table 5: Wilcoxon signed-rank test of Annual Sales Growth rate pre and post-spin-off

Paired sample (pre, post)	Mean Rate post-spin-off	Mean Rate pre-spin-off	Mean difference	Positive: Negative	Significance
(-1,+1)	0.73	5.35	-4.62	10:12	0.485
(-1,+2)	13.47	5.35	8.12	13:9	0.355
(-1,+3)	-3.80	5.35	-9.15	8:14	0.249
(-2,+2)	13.47	20.73	-7.26	5:17	0.013
(-3,+3)	-3.80	22.76	-101.8	3:19	0.002
Mean (-3, -2, -1), Mean (+1, +2,+3)	3.47	16.28	-12.81	4:18	0.006

Source: Author's work

Comparing the findings of this study's findings with previous studies examining the financial performance of the spin-off after the restructuring event of spin-off we observe that except few differences the findings are in sync with the existing studies (Woo, 1992). Woo (1992) examined 56 voluntary spin-offs in the American market and measured two financial performance-based variables namely Return on Assets and Sales Growth and two market-driven variables i.e. Market-to-book ratio, and Share Price in a time frame of two years before and three years post the spin-off event. Comparing these results with this study, one

can see that no significant change was established in this study for Return on Assets. However, a slight tendency towards decreased performance could be recognized due to a low-test statistic and a majority of negative differences in the frequency table. This study does not find statistically significant changes in financial performance after the spin-off event for the other measurements.

In another empirical research Desai (1999), two categories of spin-offs aiming at down scoping or downscaling are studied. Similar research designs exist between the above-mentioned two studies (Desai, 1999; Woo, 1992) in terms of similar time frames and financial measures, except for capital asset pricing alpha instead of the share price. In their study, actual significant financial improvements for one of their subcategories, spin-offs that are aiming at down scoping, were established for two of the financial measures. The present study has noticed similar positive performance in terms of the Market-to-book ratio. However, as stated earlier, our study cannot be compared to Desai et al. as we have not focused any attention on the classifications of spin-offs in categories. However, the similarities with findings related to the financial performance with the Woo et al. study give strength to draw conclusions on spin-offs and compare them to the findings in the American market. In general, conclusions can be made that in a time frame of three years post the spin-off event, no statistically significant change in performance can be seen. The findings are contrary to what the theory expects in the return on asset and sales growth measurements. One has to keep in mind that both of these studies have a concise time frame post the event, and the future development of the financial performance is therefore uncertain. The similar results of these two studies indicate that it should not be more beneficial to spin off a company on the American market than on the Indian market.

5. Conclusion

The study investigated the impact of the spin-off restructuring strategy on the financial performance of the parent company in India. The major hypothesis is that the financial performance of divesting firm improves after restructuring the business through a spin-off strategy. However, the empirical evidence could not validate this hypothesis.

The study reveals that the parent company's financial performance did not change significantly after the spin-off event. Even though there is no statistically significant change in performance-based variables different patterns for market-based measures are observed. The test statistics are relatively low as well as close to capital asset pricing alpha. The theoretical underpinnings suggest that the results should improve post the spin-off event but, in some cases, the performance trends were negative contrary to these expectations.

This may be attributed to the small size of the newly formed spin-off, which initially would not be able to affect the financial performance of the vast parent company remarkably. The deterioration in the sales growth rate is consistent with the prior research, which also concludes that divested units unrelated to their parents before spin-off reported a decline in

performance. To conclude, there may be strategic reasons other than financial reasons which are more beneficial for the parent company that leads to the formation of a new entity. The study has some potential limitations, such as a relatively small sample. This could lead to issues such as the reliability of this study; however, the criteria imposed were well-motivated and justified. Detailed future investigations are suggested to generalize the implications of this study.

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