Effects of Spinoffs and Layoffs on Corporate Performance

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Paper 1

- Corporate focus and value creation: Evidence from spinoffs
  - Journal of Financial Economics (1997), p.257-281
  - Daley, Mehrotra ,Sivakumar

Research Question

- Does increase corporate focus create value for shareholders?

Literature Review

- Considerable literature confirms that there are values created from spinoffs
  - Spinoffs create value - Miles & Rosenfield(1983) ; Kudla &McIntish (1983); Hite & Owen 1983; Schipper & Smith (1983)
  - Tax benefits driven - Schipper & Smith (1983) ; Davidson & Mc Donald (1987)
  - Spinoffs involving regulated firms - Schipper & Smith (1983) ; Hit & Owens (1983)

Spinoffs

- What is spinoffs?
  - Asset sale/divestures involving assets outside the core business of a firm
  - No cash is involved

- Mode of spinoffs
  - Through creation of subsidiary to hold the asset and then distributes the shares to shareholders to create an independent company

Types of Spinoffs

- There are 2 types of spinoffs
  - Cross-industry spinoffs
  - Own industry spinoffs

Hypothesis

- Corporate Focus Hypothesis

- Incentive Alignment Hypothesis

Data Source

- 93 firms examined in Schipper & Smith (1983) article up to 1981
- Wall Street Journal Index for all spinoffs after 1981
- Supplemented with cases discussed in Kudla & McInish (1988) and Vijh (1994)
- 85 firms (25 for own-industry spinoffs and 60 for cross-industry spinoffs) out of the initial samples satisfying the authors criteria were finally used for the study
- 5-year window starting 2 years prior to and ending 2 years following the spinoffs

ROA As Performance Indicator

- To document operating performance changes separate from the effects of tax and bonding
- One time charges are excluded

Results

- Changes in return on assets (ROA) around the time of spinoffs to measure performance
- Significant increases in ROA for the cross-industry spinoffs found
- No significant improvements for own-industry cases

Defining the Benchmarks

- Following the procedures outlined in Barber & Lyons (1996) to set 3 benchmarks to account for industry, size and performance differences
  - Median Return on Assets in same 2 digit SIC code
    - ? AROA = Median (? AROAj)
  - Median Return on Assets of firms with asset value within 20% of the spinoff firm in same 2 digit SIC code in the same fiscal year
  - Median Return on Assets of firms with ROA within 20% of the spinoff firm in same 2 digit SIC code in the same year

Results

	Cross- industry Spinoffs	Own-Industry Spinoffs
Medium Return on Assets	3.0% (p = 0.05)	0.0% (Insignificant)
Industry Adjusted Return	3.0% (p = 0.01)	-1.3% (Insignificant)
Size Adjusted Return	2.8% (p = 0.10)	-2.4% (Insignificant)
Performance Adjusted Return	3.1% (p = 0.05)	-0.2% (Insignificant)

Bonding a Rival Theory?

- Market sometimes discount firm value due to potential inter-division subsidies
- Bonding is a pre-commitment by managers against subsidies to poorly performing units
- Literature on asset sales provide evidence that bonding affects share prices
  - Price effect significantly larger when proceeds from asset sales committed for dividends or debt repayment

Bonding a Rival Theory?

- Since spinoffs do not involve any cash proceeds, the research raise the questions

- When is bonding likely to be valuable?
  - Frequency of Capital Issuance

- Do they see increase use of alternative bonding mechanism around the time of spinoffs?
  - Book leverage and Dividends

Bonding a Rival Theory?

- Frequency of capital issuance
  - No significant change in frequency of capital issuance post spinoffs
- Book leverage and dividends
  - No significant increase in book leverage or dividends
- Bonding against inter-division subsidies is not the reason for the spinoffs

Tracing performance improvements

- Where do the performance improvements come from?
  - Parents and subsidiaries individually or both?
  - In equity carve-outs, value comes from the subsidiary (Schipper & Smith 1986)
  - Value of selling firms increases only if unrelated assets are sold, supporting the Corporate Focus Hypothesis, and value comes from the parent (John & Ofek 1995)
- Only parents of cross-industry spinoffs experience significant increase in ROA hence support for Corporate Focus Hypothesis

Conclusion

- Results support the Corporate Focus Hypothesis
  - Cross-industry spinoffs experience ROA improvements while none at own-industry spinoffs
  - Only parents of cross-industry spinoffs experience ROA improvements while none at subsidiaries
- Spinoffs is not a bonding mechanism to prevent cross-subsidies of weak divisions

Paper 2

- Layoffs, shareholders' wealth, and corporate performance
  - Journal of Empirical Finance 8 (2001), p.171-199
  - Chen, Mehrotra, Sivakumar, Yu

Research Questions

- What happens to firm performance after layoffs?
- Do layoffs affect corporate performance and shareholders’ wealth?

Literature Review

Year	Research Topic	Authors
1991	Significant negative stock price reaction to layoff announcements as layoffs reduce organization effectiveness by undermining employee morale.	Worrell et al
1993	Negative stock price reaction due to declining demand.	Lin, Rozeff
1997	Both US and Japan experience negative stock price effects.	Lee
1997	Negative stock price if due to demand decline, but positive stock price if due to efficiency improvements.	Palmon et al
1998	Significant negative market reaction to layoff announcements but little impact on CEO pay.	Hallock

Layoffs

- Why layoffs?
  - Declining product demand
  - New capital or technology that displaces workers
  - Cut cost or undertake strategic asset redeployment
- Two views on effects of layoffs
  - Firms as a nexus of contracts – changes to suboptimal contracts, so positive impact
  - Breach of implicit contracts – increase future contracting costs and undermine employee morale

Data Source

- Wall Street Journal Index
- 1990 to 1995
- 349 layoff announcements
  - 302 different firms from 45 industries
  - More layoff announcements in 1991 and 1992 due to the economic downturn
- Excess return calculated by comparing
  - 2-day announcement date return for day -1 and day 0
  - 2-day return for CRSP valued weighted index

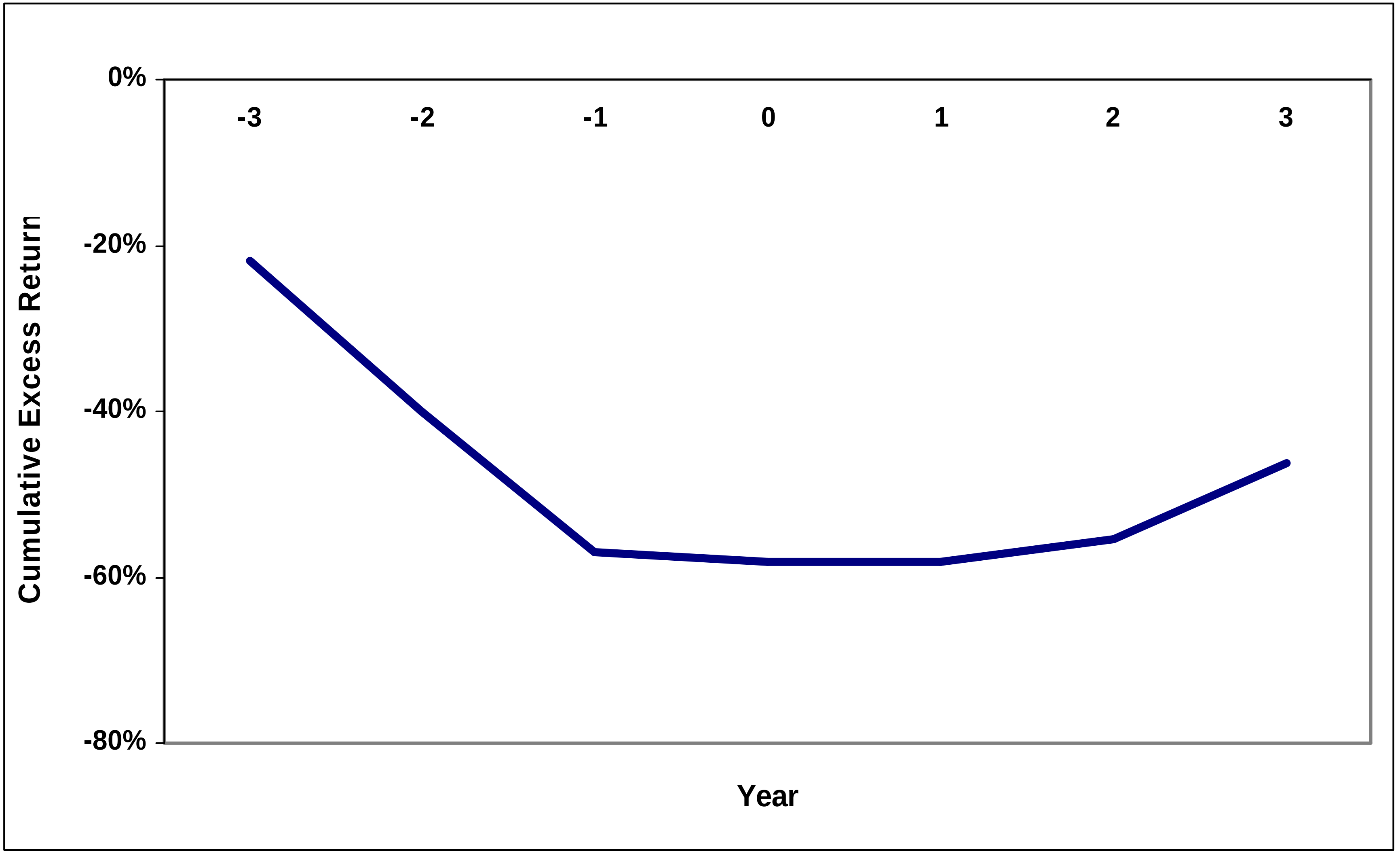
Results

- Cost cutting, demand decline, and low prior earnings caused significant negative stock price reaction
- Restructuring caused insignificant negative stock price reaction

Reason for layoffs	Sample size	Mean Excess Return	Medium Excess Return
All layoffs	349	-0.012 ***	-0.005 ***
Cost cutting	128	-0.011 **	-0.007 *
Demand decline	**89**	**-0.024 *** **	**-0.014 *** **
Low prior earnings	91	-0.012 **	-0.005
Restructuring	107	-0.005	-0.005

* 10% significance level, ** 5% significance level, *** 1% significance level

Stock Stopped Declining



Firm Performance

- Operating performance - ROA
  - Declining ROA from years -3 to 0
  - Statistical significant improvements in ROA from years 0 to 3
- Profitability – CGS/Sales and S&A/Sales
  - General improvements in profitability measures after layoff announcements
- Efficiency – Sales/employee and capex/employee
  - General improvements in efficiency measures after layoff announcements

Firm Performance

- Improvements due to firms specific factors or market conditions?
  - Compare to similar firms with no layoff announcements
  - Improvements in firms with layoff announcements significantly stronger, especially in year 0 to 3

Firm Performance - Caveats

- Improved operating, profitability and efficiency measures after layoff announcements
  - Causation?
  - Layoff announcements most likely part of restructuring / improvement programs that include streamlining of operations and refocusing of corporate resources

Change in Corporate Focus

- Does firms that announced layoffs also changed their corporate focus?
  - Mean number of business segment declined from 2.52 to 2.17 from year -3 to +1 (reduction statistically significant)
  - Herfindahl index increases after layoff announcements (statistically significant)
    - Sum of the squared ratio of segment i sales to total sales across n segments within the firm
    - Bounded between 0 and +1
    - Higher values indicating higher focus

Effects of Other Factors

- Regressed 2 day excess return against
  - Percentage of layoff
  - Demand decline
  - Cost reduction
  - Restructuring
  - Low earnings
  - Headquarter staff being layoff
  - New management in previous 12 months
  - Acquisition in previous 12 months
  - Increased focus

Effects of Other Factors

- Regressed 2 day excess return against
  - Change in industry-adjusted ROA
  - Change in industry-adjusted capex per employee

- Significant negative relationship between excess return and demand decline
- Other reasons for layoffs are not significantly related to layoff announcement period return

Conclusions

- Negative stock market response, especially when layoff due to demand decline; insignificant negative response due to restructuring
- Performance turn around
  - Firms that announced layoffs performed poorly in the previous 3 years
  - However, these firms improve their operating performance in the 3 years subsequent to the announcements

Conclusions

- In the 3 years after the layoff announcement
  - Operating performance based on ROA improved
  - Profitability based on CGS/Sales and S&A/Sales improved
  - Efficiency based on Sales/Employee and Capex/Employee improved
- Increased corporate focus
  - Number of business segments reported declined
  - Herfindahl index increased

Conclusions

- Medium employment level returns to pre-announcement level after 3 years
  - Initial reduction in employment level and capital expenditure consistent with management desire to cut costs and improve earnings performance
- Turnaround in firm performance supports the view that suboptimal labor contracts should be revised