GENERAL ARTICLE

Corporate Restructing Through Spin-off: Enhancing Shareholders Value

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Abstract

Growth is always essential for the existence of a business concern and the mantra for the current competitive world is Survival of the fittest. Due to the changing business scenario over the last few years, the ways left for the corporate to survive in the intensely competitive world is to think and acts beyond its competitors. So they have to discriminate themselves on the basis of innovation, creativity and new ideas in order to survive and create value for their owners, or else in the long run their competitors activities will compelled them to shut down their business. One of the ways is to go for corporate restructuring either by any form of the business combination such as Consolidation, Mergers and Acquisitions, Take-over etc or even the companies can go for different form of corporate downsizing such as Spin-Off, Split-Off, Split –Up, Equity Carveouts etc. My paper will focus on why the companies go for Spin-off?

Introduction

The corporate restructuring is compared to medical surgery, as it is a method of treatment for sick companies based on the professional analysis. Just as the aim of medical surgery lies in the recuperation of a patient, similarly the aim of a corporate restructuring is the therapy of a distressed company. As the patient needs a hospital to be recovered, the sick company requires a restructuring vehicle to be rehabilitated. Corporate restructuring means the series of process to restructure asset structure, financial structure, and corporate governance, helping the survival and the growth of a corporation. Although the extent of corporate restructuring includes a distressed company as a target in a narrow term, it includes an inefficient company as a target in a broader term.

In the present competitive environment, one of the most fascinating strategies in the hands of the companies will be either Spin-Off or Split-Off or Split –Up, Equity Carveouts etc.

- Spin-Off: It has emerged as a popular form of corporate downsizing in the nineties. Under it a new legal entity is created to takeover the operations of a particular division or unit of the company. The shares of the new unit is distributes on pro rat basis among the existing shareholders. In simple sense, we can say that the share holding pattern of the new unit will be just similar to the parent

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company. The share of new unit are listed and traded separately on the stock exchanges. For example, Air India formed Air India Engineering Services Limited by spinning off its engineering department.

- Split-Off: under it the new company is created to takeover the operation of the existing division or unit. A portion of the parent company shares are exchanged for the share of the new company. Simply we can say that a section of the shareholders will be allotted shares in the new company by redeeming their existing shares. The logic is to reduce the equity base of the parent company reflecting the downsizing of the firm.
- Split –Up: As the name indicates it results in complete breakup of a company into two or more new companies. All the units are converted into separate companies and the parent company ceases to exist. The shareholder of the new companies is distributed among the existing shareholders of the firm.
- Equity Carveouts: It is a sort of corporate reorganization, in which a company creates a new subsidiary and IPOs it later, while retaining control. Usually, up to 20% of subsidiary shares is offered to the public. The transaction creates two separate legal entities—parent company and daughter Company— with their own boards, management teams, financials, and CEOs. Equity carve-outs increase the access to capital markets, enabling carved-out subsidiary strong growth opportunities.

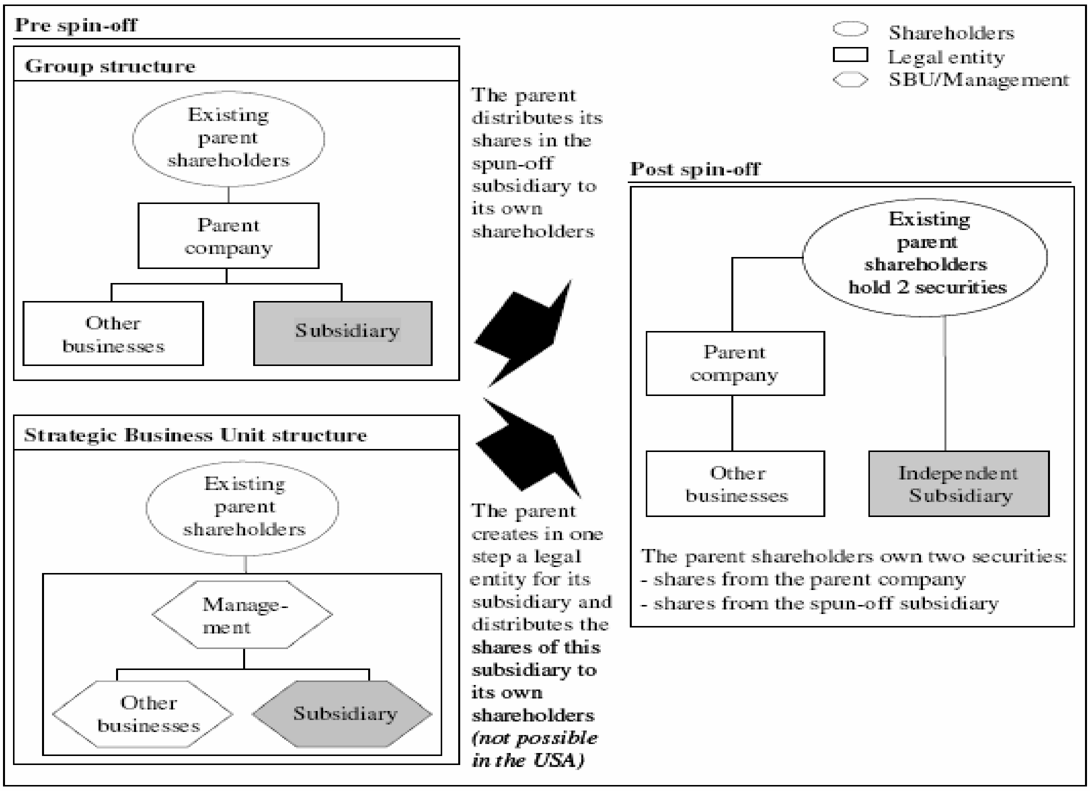
Alternative Types of Corporate Restructuring

Type of restructuring				Description	Example
Restructuring options	Organizational restructuring				
	Ownership restructuring	Private transactions	Joint Venture	• Venture capitalist as JV partner for developing business or • Integration to exploit synergies of mature businesses	• Sony – Philips • Nissan – Renault
			Trade sale	• Sell part or all of business to strategic/financial investor	• Vitamins of Roche • Adams Confectionery of Pfizer
			LBO/MBO	• Sell to investor or management team who finances significant portion of purchase price	• Vivendi – Universal
		Public transactions	Carve-out	• Sell portion or all shares of subsidiary through IPO in the equity market	• Siemens – Infineon • Telefonica – Terra • Sulzer – Sulzer Medica (1st step)
			Spin-off (split-up)	• Parent firm distributes shares of the spun-off subsidiary to parent shareholders	• Novartis – Syngenta • Sulzer – Sulzer Medica (2nd step)
			Split-off	• Parent company's shareholders are offered shares of a subsidiary in exchange for parents' shares (exchange offer)	• Sara Lee – Coach
			Tracking stocks	• Separate class of parent stocks distributed to shareholders through a spin-off or sold through a carve-out	• Alcatel – Alcatel Optronics

Spinoffs

A spinoff occurs when a subsidiary becomes an independent entity. The parent firm distributes shares of the subsidiary to its shareholders through a stock dividend. Since this transaction is of dividend distribution, no cash is generated. Thus, spinoffs are unlikely to be used when a firm needs to finance for expansion or deals. The subsidiary becomes a separate legal entity with a distinct management and board. These are basically done for separating a healthy operation. In most cases, spinoffs unlock hidden shareholder value. For the parent company, it sharpens management focus. For the spinoff company, management doesn't have to compete for the parent's attention and capital. Once they are set free, managers can explore new opportunities. Investors, however, should beware of throw-away subsidiaries the parent created to separate legal liability or to off-load debt. Once spinoff shares are issued to parent company shareholders, some shareholders may be tempted to quickly dump these shares on the market, depressing the share valuation.

The figure given below clear us about the situation before and after a spin-off. If the parent company is organized in a group structure before the transaction, the spin-off consists mainly of the distribution of shares in the spun-off subsidiary to its own shareholders and the concurrent listing of the subsidiary shares on a stock exchange. If the parent firm has a SBU structure before the transaction, the parent firms can create a legal entity for its subsidiary and distribute the shares of this subsidiary to its own shareholders in Germany and Switzerland in one step. In USA the steps are totally reversed, parent firms first have to create a separate legal entity for the subsidiary, before the shares of this subsidiary can be distributed to the parent company shareholders.



Distinctive Feature of Spinoff

- The shareholders of the parent company used to take part in the transaction directly.
- Parent company doesn't raise any cash from the transaction of its independent company.
- A scale of Spin off is generally larger than a sell-off or equity carves-out.
- Spin - offs are not taxed so long as shareholders in the parent company are given atleast 80% of the shares in the new company. If less than 80% of the shares are distributed, the value of the distribution is taxed as a dividend to the investors.

Some Recent Examples of Spin off

- ArcelorMittal appoints directors ahead of steel division spin-off: The global giant Arcelor Mittal has spin off its stainless and specialty steels business into Aperam, a new created company, in a bid to unlock value for shareholder. The extraordinary general meeting of shareholders of Arcelor Mittal held in Luxembourg approved… the spin off of Arcelor Mittal's stainless and speciality steels business into Apernam, a newly created company.
- JSW Steel Said to Consider Spin Off of Coal, Iron Ore Assets: JSW Steel Ltd., India's third-largest producer, is considering putting its overseas coal and iron ore assets into a unit for a share sale to fund expansion, two people familiar with the plans said.
- Pantaloon Retail to spin off Big Bazaar: Pantaloon Retail Ltd, India's largest listed retailer, said its board had approved spinning off its Big Bazaar and Food Bazaar operations and related formats into a wholly-owned subsidiary to raise funds**.** Pantaloon, the flagship company of Kishore Biyani's Future Group, runs 119 Big Bazaar stores in more than 70 cities across India, and plans to have 275 stores by 2014.
- In 2001 Thermo Electron spun off its healthcare and paper machinery systems divisions as two new companies, Viasys and Kadant, respectively.
- In 2001 Canadian Pacific Ltd. Spun off its oil and gas, shipping, coal mining and hotel businesses as four new companies traded on the Toronto Stock exchange.
- Pepsi/Tricon :Pepsi originally wanted to establish a captive channel for fountain beverage business, but found they needed to alleviate competitive barriers to expanding that business (many more restaurant chains)
- Sears Roebuck spun off Allstate, its insurance subsidiary, in 1995.
- In the 1998 the Brazilian government completed privatization of Telebras, the Brazilian national telecommunication company.
- Whitman Corporation/Hussman/Midas: Conglomerate discount, conflicts among management of divisions, No synergies between bottlers/heavy industry/auto service

Factors to be Considered during Spin-off Restructuring Strategies

- **Organization:** The new spin-off company may require a complete restructuring because of the lack of certain capabilities provided by the former parent company (i.e., a human resources department). Failure to immediately address a need such as this can be very costly. For example a case may be where the new spin-off company started asking craft or production type employees to temporarily fill positions that they were unqualified for and incapable of filling. The employees felt it was a contest to see who was going to rise to the top the fastest. Their false assumptions about promotions leads to destructions and finally resulted in some major failures in large system conversions. The company finally stopped, reassessed and got things back under control. Most of the people involved were either thrown out from the company or back in their proper place after twelve months. The experience was very costly to the company and set them back at a critical time. The lesson was not to place employees in positions that they are knowingly unable to perform. If outside resources are needed, get them.

- **Never forget the customer: There** can easily be a tendency for the spin-off company to be simultaneously addressing so many issues that they sometimes forget their customer. The customer may not have idea about their situation and if at all they know they are least concerned about it. What they want is just regular service. The companies should not leave them "blowing in the breeze" while dealing with internals matter. If the companies do so then they will be losing their customer as they will not remain their customers in the long run.

- **Selling off the company:** Financial need has caused many new spin-off companies to consider selling their most significant assets. Their financial requirements are generally immense and this is the easiest way to find a quick therapy. These decisions should not be made in rapidity and in desperation. Selling off the primary revenue creator will more than likely destroy the company's profitability and will even cause more severe financial problems. A long-range plan must be prepared so that planning is not a day-to-day event.

- **Is company planning changing and evolving:** Spin-off exist for various reasons. The reason may be it involves technology changes, over diversification, bad financial decisions or any other situations etc. The question should always be asked, "If something was wrong with the previous way of running business, then what need to be happening so that the spin-off company survives and grows in the near future?" Some companies will be able to rise to this challenge and some will try to continue without making necessary changes. Regardless of ones position in the spin-off company, one need to remain aware of the situation, identifying the actions that indicate failure in the future, and should be able to protect ones best interest.

Reasons for Undertaking Spin-off

Spin-offs occur when a parent company distributes all or most of its holdings of stock in a subsidiary to the parent's shareholders based on the basis of their holdings in the parent company, i.e. on a *pro rata* basis. So, the subsidiary company is no longer owned and controlled by the parent company and there are two distinct publicly traded companies. Prior to the spin-off, shareholders only own the parent company's stock, but after the spin-off they own both the parent as well as subsidiary companies shares. In these transactions, the assets of the subsidiary companies are not revalued. The transaction is considered to be a stock dividend.

Spin-offs can be in two in two forms such as: voluntary and involuntary. Voluntary spin-offs capitulate benefits to the stockholders of the parent company, because companies lean to spin off successful subsidiaries that are not core companies and thus not essential to the parent companies. There may be a number of reasons for spinning off subsidiaries companies such as to improve the value of a subsidiary or to take advantage of tax benefits. But involuntary spin-offs is usually a result of complaints made by the federal and state regulatory agencies. For example, the Federal Trade Commission or the U.S. Department of Justice might file complaints against a parent company for antitrust violation if it acquired a competitor and thereby eliminated a substantial amount of competition. AT&T's divestiture of Lucent Technology (formerly Bell Laboratories) in 1996 is an example of a voluntary spin-off, whereas CBS Inc.'s divestiture of Viacom International, Inc. to comply with the Federal Communications Commission's rules is an example of an involuntary spin-off.

Companies may have a variety of motivations for spin-offs, such as management reasons, capital market factors, tax benefits, marketing factors, risks, and regulatory/legal reasons. Spin-offs can improve management problems of both the parent companies as well as spun-off companies, because both kinds of companies often have different lines of business and different business environments. Since the parents companies are generally of large diverse operations, they cannot offer the kind of management, financial and resource support that the subsidiary needs for continuous growth. Infact, parent companies mostly focus their attention and resources on their core operations. Thus the spin-off allows the spun-off company to negotiate management, finance, and resource issues with its own board of directors and to make decisions for it. The benefit that Parent Company gets from this transaction is that it can concentrate more on its most chief operations unencumbered by the spun-off company.

Furthermore, spin-offs may effect after major shifts in the economic environment affecting corporations and their subsidiaries. While a combined organizational structure may have been optimal in the past, the separation of operations may now be appropriate. In particular, management synergy may be fictional for firms in distinct businesses. Spin-offs enable managers to focus on the specific operating and financial characteristics of the subsidiary rather than being overly worried about the impact of subsidiary decisions on the performance of the parent company.

Sometimes parent company decides to spin-off their subsidiaries because they believe that all their lines of business are not perfectly valued in the capital market. Spin-offs facilitate each company to attain capital consistently based on its own operations and each company can raise capital according to the way capital markets affect each company's business. In short, the motivation in this case for spinning-off a company is to give investors a clear view of each company's business operations. The spin-off might attract new investors to the spun-off company and it might improve the parent company's value because the undervalued subsidiary is no longer associated with it.

In some cases, many portfolio managers prefer to be in "pure play" companies. Investment professionals may be concerned in one or the other of a company's basic businesses, but not in both. To the same extent the financial markets are incomplete; spin-offs provide investors a wider range of investment opportunities appealing to different classes of investor.

Sometimes the parent companies and their subsidiaries often are engaged in unrelated business lines as a result of which they have different business risks, which affect operating earnings. Parent companies sometimes spin-off subsidiaries to protect both companies from each other's risks, which generally stabilizes the earnings of the parent company. The spin-off of a riskier subsidiary allows each company to finance its expansion based on its own growth rates and projections.

Marketing concerns also motivates the parent companies to spin off its subsidiaries. The first and foremost concern is that consumers and suppliers will think that the parent company is not committed to its core line of business as it has an unrelated subsidiary. The second concern is the association of lines of business that are perceived as being ill-assorted Hence, having various business lines may cause confusion among the customers, investors, and suppliers who perceive a company as offering conflicting products or services.

Another vital reason for corporate spin-offs is to get the advantage of tax benefits. Tax advantages can be achieved by the creation and spin-off into natural resource royalty trusts or real estate investment trusts. As long as these entities pay out 90 percent of their earnings to shareholders, they are tax exempt, permitting the parent company to shield income from taxes.

At last, laws and regulations may cause companies to spin-off subsidiaries voluntarily or involuntarily. As previously mentioned, laws and regulations sometimes lead to involuntary spin-offs when complaints are filed to federal and state agencies. Nevertheless, parent companies sometimes spin off their subsidiaries to split up regulated and unregulated companies or to avoid legal hurdles associated with ownership of certain kinds of companies. A spin-off in such scenarios allows the unregulated companies to operate and expand unfettered by regulation.

Spin-Off Procedures

After a company decides to spin-off its subsidiary, it generally begins to prepare a work plan, which provides systematic information leading up to the completion of the spin-off, the projected dates for each step, and the parties responsible for the timely completion of each step. A spin-off also involves the preparation of a plan of reorganization, which act as the agreement between the parent and subsidiary companies. Consequently, both boards of directors must approve of the plan of reorganization. This plan should also include information on the relationship between the parent and subsidiary companies during and after the spin-off process and it should indicates any transfers of assets or liabilities from one company to another if any. If the company being spun off is going to be deeply restructured, the plan of reorganization should also go into substantial detail describing the intended changes. The plan also provides information on the number of shares to be distributed and the key dates for distribution and payment.

The parent company also must prepare a registration statement, which specifies the shares to be distributed in the spin-off. These shares generally are registered with the Securities and Exchange Board of India (SEBI) and all shareholders who will receive shares of the spin-off company are sent a copy of the registration statement. Much of the information in this statement is the same as that in the proxy statement.

Impact of Spin-Offs

Even in some cases, parent companies spin-off their subsidiaries in order to increase the value of both parent and subsidiary companies. Nevertheless, different studies report have different results from companies involved in spin-offs. Studies by the investment firm Oppenheimer and Co. indicate that companies increase their value at the time of the spin-off announcement, and it also show that value may languish or decrease after a certain period. According to one such study of 19 spin-offs, 16 companies experienced increased value at the time of the announcement, 1 company's value decreased, and 2 companies' value did not change. However, only 11 companies and the companies they spun off had increased in value six months after the spin-off, whereas eight declined—although the combined value each company and the company it spun off still was greater than it was at the time of the spin-off announcement.

Other studies produced similar findings. Constantinos Markides found in his 1995 study *Diversification, Refocusing and Economic Performance* that spin-off announcements are accompanied by increases in share prices and that share prices of highly diversified or unprofitable companies showed the most dramatic increases. Over a longer period of time, Markides reported that spin-offs led to greater profitability for highly diversified companies. Moreover, in another 1995 study, Robert Comment and Gregg Jarrell examined companies involved in spin-offs over a three-year period and discovered that companies that spun-off subsidiaries performed about 7 percent better than companies that diversified.

However, other studies present a different view of spin-off effects. A Clarus Research Performance Database study of spin-offs by the world's 500 largest companies between 1996 and 1998 indicated that companies involved in spin-offs tended to underperform the market by 17 percent two year after the spin-off announcement. This study suggests that spinning a subsidiary off will not lead to an increase in value in and of itself. Instead, the Clarus Research Performance Database study revealed that the companies whose value increased implemented restructuring and refocusing initiatives in addition to the spin-offs. Spin-offs fail to increase share prices alone because they are basically dependent on enormous factors other than the spin-off.

Shareholders Value gains form Spin-off

As per the study of Cusatis, Miles and Woolridge held in 1993 states that the spin-off decision creates value with the combined values of the parents and the offspring exceeding the value of parent alone prior to Spin-off. As per the study of Daley, Mehrotra and Sivakumar held in 1997 states that superior shareholder value performance was reflected in the post-spinoff profitability. The change in median return of assets form the year before (of the parent) to the year after spinoff (parent plus offspring), adjusted for various benchmarks such as industry or similar size is 3% for focus increasing spinoffs and 0% for focus decreasing spinoffs.

The study of Desai and Jain when they extended their evaluation to 3years post spinoff states that the abnormal returns for focus increasing spinoffs were significant at 11%, 21% and 33% over one year, two years and three years while for the focus decreasing spinoffs the corresponding returns were at 1%, 8% and 14% over one year, two years and three years. They also confirmed the superior performance of focus increasing spinoffs measured by operating cash flow return on assets. Moreover the improvement in the profit performance and shareholders value are positively related.

The study of Thomas Chemmanur and Debarshi Nandy: How is value created in Spin-Offs? states that On average firms which are involved in a spin-off are bigger than non-spin-off firms; non-spin-off firms on average have 30 plants, while spin-off plants have 55; average plant sales for non-spin-off plants is $33.5 million, while for spin-off plants it is about 40% higher ($47.7 million).

Conclusions

Normally a giant organization spin-off their underperformed business in a separate company in order to reduce burden on parent company by way of removing underperformed business from the Balance Sheet. It is always good for an organization to Spinoff underperformed business to enhance their fund raising capacity and simultaneously increases company's market value.

However there are instances where large organizations Spinoff their business as it becomes very difficult to generate maximum return from each business due to uniqueness of each business and their growth depends upon industry cycle and economic environment of that particular industry.

There is a lot of example where Spinoff business in a growing industry has provided exceptional growth which was not possible in a consolidated mode. Spinoff provides an opportunity and focus, which provides an optimum utilization of fund.

I would like to share a successful spin-off example of Tyco International. Chris Coughlin, CFO and Ed Breen, CEO of Tyco International were responsible for company's turnaround from scandal-scarred history under former CEO to a company with moderate growth and strong capital structure.In 2006 the board has decided to spin off Tyco's health care business (now Covidien) as well electronic business into a separate company. Today original Tyco International is of $ 20 billion.

A number of studies show that spin-offs outperform the market as well as their former parents. Stocks of spin-off companies outperformed peers and the Standard & Poor's 500 index by about 10% per year in the first 3 years of independence, according to a study published in 1993 by Penn State's Patrick J. Cusatis, James A. Miles, and J. Randall Woolridge, ***Restructuring Through Spinoffs***, which examined 25 years of stock market history. That study also found parent companies of spin-offs also outperformed peers, by more than 6% yearly after the spin-off.

A 1999 McKinsey study of 168 large ownership restructurings, where the parent company had revenues of more than $200 million at the time of disaggregation, also showed that spin-offs substantially outperformed the market. The McKinsey study of outfits spun off between 1988 and 1998 showed that they put up a two-year annualized total return to shareholders of 27%, vs. 14% for the Russell 2000 and 17% for the S&P 500.

SARAH LEE'S SWEET MOVE. One successful spin off is Coach. In October 2000, Sara Lee spun off this luxury accessories business. Coach stock has soared more than 950% since then, vs. the S&P 500 index's 16% drop in the same period. Coach has expanded market share, increased its number of stores, and grown its Japanese joint venture, becoming one of the top accessories brands in Japan, a key market for luxury products.

By spinning off from Sara Lee, S&P thinks that Coach was able to unlock shareholder value. That's generally the reason companies choose to pursue spin-offs. For example, an outfit may separate a fast-growing segment to highlight its value. On Cendant's Oct. 24 investor conference call, CEO Henry Silverman described his reasons for pursuing a spin-off: "We anticipate that the separation of the four businesses will facilitate a clearer understanding and fairer market valuations of these businesses."

Spin-offs also help companies focus on individual businesses. A good example was the spin-off of Expedia by IAC/InterActiveCorp, in August, 2005. IAC CEO Barry Diller's pitch to shareholders was: "Separating the company into two businesses will allow IAC to do what it does best, and Expedia to pursue its pure mission as a travel company."

Overall one cay says that whether it is the Short term of Long term, shareholders gain much more from spinoffs that increase the parent companies' focus. Further the gain seems to be driven by the underlying improvement in operating performance of both the parents and their offspring.

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