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Institutional trading, information production, and corporate spin-offs

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ABSTRACT

We use a large sample of transaction-level institutional trading data to analyze, for the first time in the literature, the role of institutional investors as producers of information around corporate spin-offs. Our results may be summarized as follows. First, there is a significant imbalance in post-spin-off institutional trading between the equity of new parent firms versus subsidiaries, suggesting that spin-offs increase institutional investors' welfare by relaxing a trading constraint. This imbalance in institutional trading is driven by differences in information asymmetry across the two spun-off firm divisions. Second, institutional trading around spin-offs has significant predictive power for the announcement effect of a spin-off and for post-spin-off long-run stock returns. Third, institutional investors are able to realize significant abnormal profits by trading in the subsidiary firm equity in the first quarter post-spin-off. Overall, we show that spin-offs enhance information production by institutional investors, who profit from this enhanced information production.

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1. Introduction

The objective of this paper is to study institutional trading around corporate spin-offs, and thereby analyze whether spin-offs increase the extent of information production about the divisions of firms undergoing spin-offs.[2] Practitioners and academics have argued that spin-offs help to "unlock hidden value". [3] Further, a number of empirical papers have documented positive abnormal returns for the equity of firms announcing spin-offs (spin-off announcement effect). However, the precise mechanism underlying such value gains from spin-off activity has long remained controversial. One possible mechanism underlying these value gains relates to increased information production by outsiders about the intrinsic value of the divisions of firms undergoing spin-offs (from before to after spin-offs). For example, Chemmanur and Liu (2011) show that, in a setting with asymmetric information between firm insiders and outsiders regarding a firm's intrinsic value, an undervalued firm can improve its stock price through a spin-off. They demonstrate that a spin-off will lead to an increase in information production by institutional investors about the divisions of the firm, so

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[2] The number of firms announcing spin-offs has increased recently. As noted by *Fortune* magazine in a recent article (November 7, 2011), there were twenty firms with equity listed on the NYSE or the NASDAQ announcing spin-offs in 2011 (till October), including such well-known names as Kraft, Conoco Phillips, Expedia, McGraw-Hill, and Sara Lee; this compares with only 13 such spin-offs in all of 2010 and only 12 in 2009.
[3] Many firms claim that the objective of their proposed spin-offs is to "unlock value". Consider, for example, the following article in the *Financial Times* (October 25, 2005) which noted, commenting on Cendant's proposed spin-off: "Cendant's planned split echoes moves by other large conglomerates such as Viacom, the media group, to spin off units in order to 'unlock value' for investors."

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that, in equilibrium, firm insiders with favorable private information (i.e., with undervalued equity) will choose to conduct a spin-off, increasing their firm's share price. However, there has been no empirical analysis so far on the role of institutional investors as producers of information about firms undergoing corporate spin-offs. We propose to fill this gap in the literature by making use of a large sample of transaction-level institutional trading data to conduct the first such analysis.

Some interesting questions that arise in the above context are the following. First, do spin-offs benefit institutional investors by relaxing the trading constraint that existed prior to the spin-off? Second, do institutional investors engage in significant information production in spin-off firms, thereby achieving an informational advantage over retail investors? In particular, is trading by institutional investors around spin-offs driven by the information advantage they possess about the new parent firm and its subsidiary, or is it driven solely by considerations of portfolio rebalancing based on the different characteristics of the new parent and subsidiary? Third, are institutional investors able to take advantage of any private information they possess about firms undergoing spin-offs to generate abnormal profits? To the best of our knowledge, these and related questions have not been addressed by the existing literature. We propose to answer these questions in the current study. Throughout this paper, we will refer to the pre-spin-off combined firm as “parent”; the new spun-off firm as “subsidiary”, and the parent firm post-spin-off as “new parent”. The “new parent” takes on the identity of “parent” and is traded under the same stock symbol and CUSIP. Therefore, when we refer to “parent equity/stock”, it could refer to the same equity before and after spin-off completion, except when we specifically need to refer to parent firm equity in the post-spin-off period, where we will refer to it as “new parent equity.”

Both the academic and practitioner literature has conjectured that breaking up a conglomerate into “pure play” companies may benefit institutional investors such as mutual funds in several ways, while simultaneously resulting in an increase in the share price of the firm conducting the spin-off. [4] The theoretical analysis of Chemmanur and Liu (2011) shows that, in a setting with asymmetric information between firm insiders and outsiders regarding the firm's true value, an undervalued firm can improve its stock price through a spin-off. A related model by Habib et al. (1997) indicates that in a setting where informed institutions have different levels of private information about the (new) parent versus subsidiary, a spin-off allows informed outsiders to trade to the optimal extent (and direction) in the two firms involved, whereas they are constrained to trade the combined firm under a single equity prior to spin-off completion. Nanda and Narayanan (1999) develop a model of corporate spin-offs in which spin-offs help outsiders disentangle the cash flows arising from the two divisions involved.

This empirical study is motivated by the above theoretical models driven by considerations of information production and informed trading by institutions around corporate spin-offs. These information-based models have several implications for institutional trading. First, they imply that spin-offs relax an institutional trading constraint existing prior to the spin-off. As such, institutional trading in the new parent and subsidiary will be significantly different from each other. Second, the difference in institutional trading in the equities of the new parent and the subsidiary will be directly related to the difference in the extent of information asymmetry characterizing these two firms, after controlling for differences in other characteristics between the two firms. Third, institutional trading in the parent firm will have predictive power for the short-term abnormal stock return upon a spin-off announcement (the “announcement effect” from now on). Fourth, institutional trading in the shares of the parent and subsidiary will have predictive power for the long-run equity returns from these two stocks as well as for the long-run operating performance of the two firms involved. Finally, if institutions indeed have private information, they should be able to generate abnormal profits from trading in the equity of the subsidiary.[5]

To test the above implications of information asymmetry-based models, we make use of a large sample of proprietary transaction-level institutional trading data. Our data includes transactions from January 1999 to December 2004, which were originated from 531 different institutions (with a total annualized trading principal of $4.61 trillion over all U.S. equities). The sample institutions engaged in about 16%, in terms of dollar value, of the CRSP reported trading volume in the shares of firms undergoing spin-offs. With this dataset, we are able to track institutional trading in the shares of these spin-off firms both before and after spin-off completion. For the post-spin-off subsidiaries, we break down institutional trading into two categories, namely, institutional share allocation sales (i.e., selling of shares allocated to the institutions' account through the pro-rata distribution in a spin-off), and post-spin-off institutional secondary market trading (i.e., buying and selling of shares by institutions in the secondary market after the spin-off). This allows us to analyze the trading pattern and profitability for these two categories of transactions separately.

Our paper develops a number of new results on the role of institutional investors as information producers around corporate spin-offs. These can be summarized as follows. The first set of results deals with institutional trading imbalance: we find a significant imbalance in post-spin-off institutional trading between new parents and subsidiaries. Thus, in the first three months immediately following the spin-off completion, over 46% of the trading by institutions in post-spin-off new parent-subsidiary pairs was originated in opposite directions (buy versus sell). Even for trading in the same direction, institutions concentrated their trading heavily in one firm (new parent or subsidiary) rather than trading symmetrically in both firms (*see* Fig. 1). We interpret this significant trading imbalance as evidence that spin-offs improve institutional investors' trading welfare by relaxing a trading

[4] For example, an article in the *Financial Times* (October 28, 2005) explicitly attributed a shift in (institutional) investor preference to the breakups of conglomerates: “But a new backlash against conglomerates suggests a more lasting shift in investor preferences may be taking place—driven in part by the growing influence of hedge funds and private equity houses. In public markets, big has rarely appeared less beautiful. In the U.S., the most visible sign is the break-up of companies such as Cendant, the sprawling leisure group behind Avis rental cars and the Orbitz travel website, which this week announced a four-way demerger to try to lift its flagging share price.”

[5] Given that the new parent takes on the identity of the pre-spin-off combined firm, it is difficult to cleanly identify the point in time at which the parent shares were acquired by institutions. Therefore, separating out institutional share allocation sales from pure post-spin-off trading, and, consequently, analyzing the profitability of institutional trading in the parent becomes problematic. On the other hand, given that the equity of the spun-off subsidiary is listed independently only after the spin-off, we are able to easily separate institutional share allocation sales from pure post-spin-off trading in the subsidiary firms' shares. Therefore, we confine our empirical analysis of the pattern and profitability of post-spin-off institutional trading to the equity of the subsidiary.

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