CEO INTERESTS IN A SPIN-OFF

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ABSTRACT

Research on spin-offs has focused on the gains to stockholders at the announcement of a spin-off, and the probable reasons for these gains. The Corporate Chief Executive Officer (CEO) is credited for being involved in expansionary acquisition activity for personal gains rather than for stockholder wealth maximization. Then why do CEO's propose and plan to downsize their empire through a spin-off? This paper examines the CEO incentives to downsize through voluntary corporate spin-offs. It shows that the interests of the CEO of a firm and its stockholders do not always diverge and a gain for the latter also profits the former.

INTRODUCTION

Financial literature has suggested that managerial hubris plays a significant role in corporate governance, and managerial decision-making is not undertaken for the sole interest of the stockholders [4]. Corporate managers have been credited for being involved in expansionary merger and acquisition activity for personal gains rather than for the maximization of shareholder wealth [10]. Therefore, that Chief Executive Officers (CEO's) willingly propose, and plan, to downsize a firm through divestments seems, at first, to go against conventional literature.

The purpose of this paper is to examine the CEO incentives to divest corporate assets through voluntary spin-offs. It will establish that the interests of shareholders do not completely diverge with those of the CEO's, and that the latter also stand to gain in a spin-off. The gains or losses to CEO's can be either non-pecuniary or pecuniary. The Chief Executive Officer (CEO) for one will not experience any satisfaction from witnessing the corporate empire being cut down in size. A smaller company may imply, among others, a relatively smaller budget, fewer employees, a smaller geographical area of operation, and fewer corporate resources. All these are indicative of non-pecuniary losses. This paper will establish that gains in the form of higher compensation packages and increases in the value of CEO portfolio of insider stock are the incentives that would push an otherwise recalcitrant CEO to spin-off. Therefore, even though CEO's stand to lose some non-pecuniary benefits, gains in CEO welfare due to an increase in the present value of their future earnings and in the value of their stock of wealth will be ample incentives to encourage spin-offs.

LITERATURE REVIEW

Many researchers have all found positive stock gains for firms at the time of announcement of a spin-off [3][6][8]. A voluntary spin-off is a managerial decision approved by the shareholders of a firm. A spin-off will be proposed by the CEO and sanction granted by the stockholders, if and only if there is a gain for the shareholders and at least no loss for the CEO of the firm. Both these parties involved will approve the spin-off only if it is in their benefit to do so. CEO's know that their compensation, job security and reputation are linked to stock performance and will propose the spin-off only if there is a good chance of the spin-off being successful. CEO's who have sizable stockholdings not only will gain through an increase in the present value of their future compensation, but also will gain substantially through an increase in the value of their present stockholdings. The literature on spin-offs has not addressed the incentive for the CEO of a firm to voluntarily propose a spin-off. Roll [10] proposed a 'hubris theory' for mergers and acquisitions according to which the pride and the personal motives of the managers of the bidding firm are a major cause of the gains to the stockholders of the target firm. After all, downsizing a firm must lead to a loss of hubris and some of the non-pecuniary benefits to the CEO. For example, they might have a smaller budget, the firm ranking in terms of assets and profit might fall, or the executives might not be able to take business trips to far-flung operations and would almost certainly have a smaller staff under their command and control. Jensen and Meckling [4] state that the total compensation of the management of a firm is the sum of pecuniary or monetary benefits and the non-pecuniary benefits. A fall in a particular segment of the non-monetary portion either must be offset by a gain in some other section of non-monetary portion or must result in a gain in monetary compensation. Murphy [9] used a measure of compensation that focuses on six components: salary, bonus, salary and bonus, deferred compensation, ex-ante value of stock options, and total compensation, which includes fringe benefits and savings plans. He found that a 10% increase in the stock returns will increase executive salaries by 0.7%, bonuses by 14%, salary and bonus by 1.8%, deferred compensation by 4.9%. Murphy finds that though raw stock returns are the best predictor of changes in aggregate measures like salary plus bonus and total compensation, industry relative rates of return affect bonus and deferred compensation more strongly.

The self-serving management hypothesis states that the managers of a corporation take actions that yield greater remuneration to them but may result in losses to the shareholders. Benston [1] tests this hypothesis by examining the personal financial gains and losses of the managers of 29 conglomerates from 1970 to 1975. Benston finds that the salary and bonus are a small portion of executive remuneration and any gain or loss is swamped by the gain or loss in the changes in the value of managerial stockholding. Benston's analysis shows that there is a positive relation between managerial and stockholder wealth. Lewellen, Loderer, and Rosenfeld's [7] results support the hypothesis that managers' personal welfare affects the decisions they make. They "find a persistently positive relationship between the abnormal stock returns to bidder firms in completed *mergers* and the percentage of outstanding common company shares held by senior management"[7, page 211]. The literature on managerial compensation indicates the strong relationship between stock performances and compensation. To motivate managers to this end strong incentives are placed in the overall compensation packages. The literature on spin-offs indicates the positive stock reaction to voluntary spin-offs. Are the ensuing compensation and wealth gains also a reason that CEO's spin-off? This question is the prime focus of the paper.

METHODOLOGY AND RESULTS

Prior research has used samples drawn primarily from the 1980's and earlier. This study uses a more recent sample from 1980 to 1996; further, the sample requirements for this study are more restrictive than in the earlier ones. If the spin-off announcement was accompanied by other news, for example layoffs, the firm was dropped from the sample. An event study analysis was carried out to calculate the cumulative average abnormal returns CAAR for each firm. The annual compensation data for the CEO was also obtained separately from the Forbes annual executive compensation survey.

The first hypothesis tests the conformity of our data set with those in the earlier studies.

H_{o1}: *The gains to the shareholders of spin-off firms in the 1980-96 period are positive and significant.*
The three-day (-2 to 0) mean cumulative abnormal return using a market model estimated over days –240 to -30 was 4.075% (t= 4.96, p=0.001), the median value was 3.289%. The three day cumulative abnormal returns are greater than those found in the earlier studies. Further analysis of data showed that the cumulative abnormal returns in the 1990's was significantly greater than the return in the 1970's and the 1980's, periods that were used by the earlier studies. The number of spin-offs that were announced in the 1990's was also greater than the earlier periods. This is corroborated by the work of Johnson, Brown and Johnson [5] who working with a more recent sample, 1980 to 1991, found a slightly greater abnormal return than the studies using older data.

The second hypothesis tests whether firms in which CEO's have a greater stake in the form of a higher stock ownership have a greater cumulative abnormal return at the time of a spin-off.
H_{02}: *The relationship between the magnitude of the CAAR and the magnitude of CEO stock holdings is significantly positive.*
The average CEO ownership of the firm before the spin-off was 2.32% with a market value of 35.40 million dollars, and this ownership fell to 2.02% with a market value of 33.70 million dollars after the spin-off. The percentage of CEO ownership after the spin-off, like total managerial ownership, also seems to decline. The paired T-test with a test statistic of 1.51 and a p-value = 0.069 supports this statement.

A very broad definition of inside stock holdings would include not only the amount of actual stock held by the CEO, but also stock options which give the CEO the right to own shares in the future at a fixed exercise price. Therefore, the stock returns for firms involved in spin-offs will be greater for firms that have stock-based compensation plans.
H_{03}: *Firms in which CEOs have a large proportion of stock-based compensation will not have a positive CAAR at the announcement of a spin-off.*
There seems to be a weak positive relation between stock based compensation and CAAR, with the slope coefficient being 0.06 (t=1.99, p-value=0.05) before the spin-off. Therefore, a greater percentage of other compensation (that includes stock options) seems to have a positive influence on cumulative abnormal returns. The larger the percentage of other compensation in total emoluments, greater the stake of the CEO in stock performance, and consequently, the better the spin-off.

Increase in total CEO compensation is a good indicator of firm performance in the year following the spin-off as it would not be based solely on the stock performance of the firm. Increases in managerial compensation is dependent on a broader band of indicators of performance like increase in sales, gross profits, return on equity, comparative industry performance, etc. If firms realize substantive operating gains from the spin-offs then compensation figures should reflect these gains.
H_{04}: *Total CEO compensation in the period after the spin-off increases.*
The percentage change in total annual compensation before and after the spin-off was calculated for each CEO. This was reduced by the amount of the Conference Board percentage change for that broad group of industry to get an industry adjusted percentage change in total CEO compensation. The mean industry adjusted increase in total CEO compensation was 9.88% (t=2.71, p-value=0.004, median=1.60%). The percentage change in salary and bonus portion of CEO compensation was calculated every year since 1980 by using the approximately 800 firms that are published in the Forbes annual executive compensation surveys every year. The mean increase using the Forbes adjusted figures were 5.63% (t=1.56, p-value=0.061, median=1.98%). Therefore, CEO salary increases after the

spin-off when compared to both the broad industry-wide changes as given in the Conference Board publications and the broader Forbes annual executive compensation surveys.

CONCLUSIONS

This study arrives at three major conclusions.

1) The results of the event studies analysis show that stockholder returns at the time of announcement of a spin-off are almost equal in magnitude to those of the earlier studies. However, what is novel is that stockholder returns have been found to be greater than those of the previous years and have increased monotonically over time.

2) There was very strong evidence that the proportion of CEO stockholdings in a firm declined in the post spin-off period. CEOs also seem to take advantage of the opportunity offered, as an increasing CAAR was found to be associated with a greater decline in CEO holdings.

3) Total executive compensation in the post spin-off year decreases for the CEO of the firm. However, total executive compensation increases when it is adjusted for the lower sales and profits.

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