Equity Restructuring via Tracking Stocks:

Is There Any Value Added?

Abstract

In a tracking stock restructuring, the parent company issues a stock that tracks the earning performance of one of its divisions or subsidiaries. We study the effect of such an equity restructuring on the parent stock value. Parent stock response is insignificant in the short- and long-run. Thus, unlike equity carve-outs and spin-offs, issuing tracking stock does not create value, on average.

Tracking stocks, also called targeted stocks, are a class of the parent company stock that tracks the earnings performance of a division or a subsidiary of the parent firm. Although the first tracking stock was issued back in 1984 by General Motors, tracking stocks have not been popular until the booming stock market of the 1990's. From 1984 to 1993 there were only 7 tracking stock announcements, and since then there were 47 more, the peak year being 1999 with 19 tracking stock announcements. At the end of 1999 the total market value of outstanding tracking stocks exceeded $100 billions.

Tracking stocks are different from other forms of equity restructuring such as carve-outs and spin-offs – see Chemmanur and Paeglis (2001). In both carve-outs and spin-offs a new corporation is created with a new and separate board of directors, and the division (or subsidiary) assets are transferred to the new corporation. In a carve-out, the parent corporation uses an IPO to sell a stake in the division or subsidiary, yet keeps a majority interest in the issued firm. In a spin-off, the parent corporation distributes all subsidiary/division shares to shareholders as dividend.

In contrast, the issuance of tracking stock does not create a new corporation. The tracked subsidiary or division does not have a separate board – it is controlled and managed by the parent firm. In addition, the tracking stock assets remain an integral part of the parent firm, as there is no physical separation between the parent firm and the targeted division. Tracking stock shareholders receive dividends from the earnings of the tracked division, which are reported separately from the earnings of the parent corporation. Tracking stock shareholders also receive voting rights in the parent corporation. Thus, tracking stocks are the mildest form of equity restructuring, with minimal business and operational changes.

Tracking stocks have not fared well after their issuance. Billett and Vijh (2002) show that tracking stocks underperform various benchmarks by 15%-20% (20%-40%) in the two (three) years after their issuance. This evidence contrasts with the post-issue excess returns of spin-offs, which are known to be positive, and of carve-outs, which are known to be insignificant. Billett and Vijh (2002) also find, in a rather small sample, that parent stocks have insignificant excess returns after the tracking stock issuance.

We focus on the parent stock performance, trying to understand what (if at all) they gained from the tracking stock restructuring. First, we extend the sample period till the end of 2000, which increases the parent stocks sample from 19 in Billett and Vijh (2002) to 32. It is possible that our larger and most updated sample would facilitate more reliable inferences on the short and long run excess returns of parent stocks.

Second, we extend the sample in the direction of firms that announced but did not eventually issue tracking stocks. These 22 firms are a natural control group for our 32 firms that issued tracking stocks. We find that firms that cancelled a planned tracking stock issue severely underperform in the two-years after the tracking stock announcement. In contrast, parent firms that issued tracking stocks achieve a "normal" stock performance in the two years after. Thus, firms that issued tracking stocks might have avoided severe performance shortfalls in the subsequent years.

Why Issue Tracking Stocks?

The Finance literature has suggested several possible answers to the question of: how can tracking stock issuance generate value for parent-stock shareholders?

Information Explanations. Tracking stock issuance can alleviate the problems generated by the asymmetric information between the firm and its shareholders. After the issuance, investors receive information on both the parent firm and its tracked division. Hence, they know more on what happens inside the firm, and can more accurately assess firm value.

Empirical tests examine the asymmetric information argument by looking at analyst coverage and earning forecast accuracy. Zuta (2000) and Chemmanur and Paeglis (2001) find that the number of analysts following the firm increased after the tracking stock issue, but D' Souza and Jacob (2000) show that the change in number of analysts is statistically insignificant. An increase in number of analysts could improve public available information about the firm. For example, it could increase the accuracy of future earning forecasts. Unfortunately, direct tests such as Chemmanur and Paeglis (2001) and Billett and Vijh (2002) do not find any improvement in earning forecast accuracy after the tracking stock issuance. Thus, it is unclear how much of the information asymmetry can be solved by tracking stock issuance, and this motivation appears weak.

A second information-based motive is that the tracking stock issue unveils the firm's true value. Many corporations argue that they are undervalued, and issue tracking stocks to show the market their undervalued asset. By doing so, these firms hope to gain by unlocking their "hidden value". Evidence on the "hidden value" proposition is mixed. In support of the "hidden value" proposition, it is found that parent stocks respond positively to an announcement of a tracking stock issue. The positive announcement excess return is about 2%-3% - see Logue, Seward and Walsh (1996), Billett and Mauer (2000), and Harper and Madura (2002). However, the

longer term perspective is gloomy, as the post-issue performance of tracking stocks is significantly negative, and the post-issue performance of parent stocks is neutral. Hence, it is unclear whether or not there was any hidden value that was unlocked.

The Diversification Discount Motive. Berger and Ofek (1995) document a diversification discount of about 15% for U.S. conglomerates. Zuta (2000) argues that issuing tracking stocks can solve some of the diversification-induced problems. Thus, tracking stock issues may create value by reducing the diversification discount. Billett and Mauer (2000) examine the diversification motive, and conclude it cannot explain the positive revaluation (positive excess return) on tracking stock announcement. Hence, the diversification-discount motivation remains unsupported.

Investor Clientele. The tracked division is sometimes from a different industry than the parent firm. For example, the tracked division might be a growth company, whereas the parent firm is a more traditional (slowly growing) "value" company. In such a case, the tracked stock may attract some new investors, who value it most, leading to an increase in the conglomerate overall market value.

There is evidence that the tracking stock attracted new investors. For example, a year after U.S. West issued its Media Group tracking stock, new investors owned more than 86% of the Media Group stock. Thus, the new clientele argument is pertinent. The clientele effect is also consistent with the positive response to tracking stock announcements. However, it cannot explain the negative post-issue performance of tracking stocks.

Agency Perspectives. The tracking stock discloses the division performance, affording incentive (pay for performance) plans for the division executives. This should improve managerial input in the division and increase division value. On the

other hand, Hass (1996) and Harper and Madura (2002) argue that the tracking stock may be a source of friction because the parent's Board of Directors, which also controls the tracked division, may sacrifice some of the division's value for the sake of maximizing the parent's value. Billett and Vijh (2002) present newspaper reports on severe conflicts between tracking and parent stock shareholders, which led the authors to conclude that in some cases tracking stocks create more problems than they solve.

The agency approach is consistent with the accumulated evidence. The positive announcement response may be due to the initial hopes for improved managerial input, while the later negative excess returns may reflect the new agency problem that emerged – conflicts of interest between parent and tracking stock shareholders.

Harper and Madura (2002) test the agency explanation. They find that the announcement response is more positive when the parent firm is larger, less leveraged, and underperforming. All of these firm characteristics are indicators for relatively heavy agency problems. Hence, firms that are more prone to agency problems appear to benefit more upon announcing a tracking stock issue, which leads Harper and Madura (2002) to conclude that the agency explanation is supported.

Other Motivations. Tracking stocks were also issued as a "currency" for acquisitions. In some cases, acquisitions were accomplished only after target shareholders were offered the choice between the acquirer's stock and a cash payment plus a tracking stock that follows the target's performance.

Finally, some tracking stocks were probably issued because of parent firms' "fad-following" behavior. Some parent firms simply joined the tracking stock

bandwagon. Issuing tracking stocks during the hot market of the late 1990's (i.e., at peak prices) was definitely a clever strategy that served well parent stock shareholders.

In this context, we realize, that the negative post-issue performance of tracking stocks can also be explained as a consequence of their "peak price" issue, after which came the inevitable rough landing. Post-issuance negative excess returns are observed in other equity issues as well. If the post-issue underperformance of tracking stocks is a typical equity issue phenomenon, then some of our previous explanations (the investor clientele effect, and the unlocking of hidden value argument) regain credibility, and remain plausible alongside the agency explanation.

Market Response to Tracking Stock Announcements

Tracking stock announcements are collected from the Wall Street Journal Index, and the Dow Jones Newswire. Daily and monthly stock returns are downloaded from the CRSP data base, and accounting information is from the Disclosure CD-ROM, the National Automated Accounting Research System (available on Lexis/Nexis), and 10k reports. The final sample comprises 54 tracking stock announcements in 1984 through 2000.

Table 1 presents the parent stock response on announcement of a tracking stock issue. Like several previous studies (e.g. Harper and Madura, 2002) we observe statistically significant excess returns on day -1, 0, and 1 relative to the announcement. Thus, we use days -1 through 1 to estimate the announcement response.

The average raw return in days -1 to 1 is 1.6% in the overall sample, 2.0% in the sample of firms that had no confounding news (in the week before and after the

announcement), and 1.6% in the sample of firms that eventually issued tracking stocks.

[Inset Table 1 about here]

Excess returns are estimated in three ways: 1) Net of Market method, i.e., as $R_i - R_M$, where R_i is the return on the stock and R_M is the return on the value-weighted index of NYSE-AMEX-NASDAQ stocks; 2) Market model method, using the standard event study methodology, with the value-weighted market index and a parameter estimation period from day -315 to day -61 relative to the announcement; 3) Net of matched-firm method, i.e., as $R_i - R_{Match}$, where R_i is the return on the stock and R_{Match} is the return on the firm in the same industry (4-digit SIC code) that is closest in total equity capitalization to the announcing firm.

The announcement excess returns in Table 1 are statistically significant. The net of market and market model methodology estimate a positive revaluation of 1%-1.7%, while the net of matched firm method assessed a positive response of 3%-5%. These findings are consistent with previous evidence on the announcement response. Also noteworthy, the positive revaluation result is robust to the exclusion of firms that did not eventually issue tracking stocks – see the last column in Table 1, and to the exclusion of firms that had confounding news in the week before or after the tracking stock announcement – see the middle column in Table 1.

Table 1 also presents stock returns and excess returns in days -5 through 5 relative to the tracking stock announcement. This window is chosen since we note some short-term stock price drifts before and after the announcement. The net of market and market model methodology assess a slightly negative, yet statistically insignificant, response in days -5 to 5, while the matched-firm methodology estimates

an insignificant positive response in that interval. In any case, the (-5, 5) window results serve as a caution. It is possible that the announcement response is close to zero and insignificant. Given our doubts about the "true" announcement response, and given the small magnitude of the days (-1,1) response (about 1%-2% only), we conclude that the parent stocks' "true" announcement response is (economically) negligible.

The Long-Term Response of Parent Stocks

Table 2 summarizes the long-term performance of parent stocks. In the two years before the announcement, parent stocks performed poorly. The average market model excess return in the two years before the announcement is about -27%, with a t-statistic of -3.5. However, net of market and net of matched firm pre-announcement excess returns are about -9% and statistically insignificant.

[Table 2 about here]

After the announcement, parent stock performance continues to be dismal, on average. In the overall sample, the average two-year post-announcement excess return is about -29% (t-statistic = -2.3) according to the market model, -16% (t-statistic =-1.7) according to the net of market methodology, and -8% (t-statistic =-0.6) according to the net of matched firm technique. The difference between the pre- and post-announcement periods, reported on the lower third of Table 2, is statistically insignificant in the "all announcements" sample. Thus, the tracking stock announcement appears like an insignificant event in the long run because, on average, parent stocks continue to underperform at the same rate before and after the tracking stock announcement.

If tracking stock announcements do not help the parent firms, then, tracking stock issuance may be redundant. That is, if parent firm shareholders do not gain in the short or long run, why issue tracking stocks? The situation is even more complex because Billett and Vijh (2002) show that the issued tracking stocks severely underperform in the years after their issuance. It appears that equity restructuring via tracking stock is a value-decreasing endeavor.

It is possible though to offer some defense for tracking stock issuance. Table 2 also compares the 32 firms that went on to issue tracking stocks with the 22 firms that cancelled (indefinitely postponed) the planned issue. In the pre-announcement period there is no statistically significant difference between "cancelled" and "issued" parent stocks, as all stocks perform poorly. However, in the post-announcement period these two groups differ substantially. The two-year post-announcement stock performance of firms that issued tracking stocks is neutral (slightly positive, yet statistically insignificant), while the two-year post-announcement stock performance of firms that cancelled the tracking stock issue is significantly negative.

To complement the picture, Table 2 also presents "return improvement" statistics. Stocks of firms that cancelled the planned issue worsened their performance, in fact accelerated their downhill slide, in the two years after the announcement. In contrast, stocks of firms that issued tracking stocks improved their performance relative to the two-year pre-announcement period. It appears that firms that issued tracking stocks managed to recover (regain normal performance), whereas firms that cancelled the planned issue continued to deteriorate.

The evidence in Table 2 suggests that parent firms that issued tracking stocks might have benefited from it. Without issuing the tracking stocks their fortune might

have been similar to that of the firms that cancelled the planned issue. We cannot reject the hypothesis that somehow issuing tracking stocks helped parent firms to stop their decay. To sum, despite of the evidence that tracking stock issuance does not offer any significantly positive excess returns, it is possible that the tracking stock issuance stabilizes the parent company.

Summary and Conclusions

Equity restructuring via tracking stock issuance does not generate any significant excess returns opportunities for the parent firm stocks in the short or long run. This contrasts with the evidence on spin-offs and carve-outs. In spin-off and carve-out restructuring, parent stocks gain in the short run and have neutral performances in the long run – see Desai and Jain (1999), and Vijh (1999)

The picture can be made ever grimmer, once we add the Billett and Vijh (2002) evidence that tracking stocks severely underperform in the years following their issuance. It appears that equity restructuring via tracking stocks dissipates value. The value destruction could emanate from agency problems, namely from the frequent disputes between parent and tracking stock shareholders.

On the other hand, it could be argued that despite of the insignificant excess returns, parent firms benefited from the tracking stock issuance. Before the issuance, parent stocks manifested poor performance, and after the issuance their performance turned into "average" or "normal". This recovery or stabilization may be attributed to the tracking stock issuance, also because of our finding that firms that announced but did not eventually issue tracking stocks, demonstrate poor stock performance *before and after* the tracking stock announcement.

For the sake of clarity, we do not claim that tracking stock issuance is necessarily a bad equity restructuring idea. Nevertheless, given the agency problems it generates, and given its dubious revaluation consequences, the complete cessation of tracking stock issuance since year 2000 appears to us far from surprising.

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Table 1. Stock Response to Tracking Stock Announcements, 1984-2000

	All Announcements (N = 54)	Announcements Without Confounding News (N = 31)	Announcements of Firms that Eventually Issued Tracking Stocks (N = 32)
Days –1 through 1 around the Announcement			
Average Raw Return	1.6% (1.4)	2.0% (1.5)	1.6% (1.1)
Average Net of Market Return	1.2% [3.0]	1.6% [3.2]	1.0% [2.5]
Average Market-Model Excess Return	1.3% [3.2]	1.7% [3.6]	1.2% [2.9]
Average Net of Matched-Firm Return	2.8% (1.7)	5.1% (3.1)	4.2% (1.9)
Days –5 through 5 around the Announcement			
Average Raw Return	0.5% (0.4)	-0.6% (-0.3)	0.4% (0.2)
Average Net of Market Return	-0.7% [-0.2]	-1.3% [-0.2]	-0.9% [-0.2]
Average Market-Model Excess Return	-0.2% [0.6]	-0.6% [0.5]	-0.1% [0.7]
Average Net of Matched-Firm Return	1.6% (0.9)	2.4% (1.3)	3.0% (1.1)

Notes: t-statistics in parentheses, and Z-statistics in brackets. The net of market return is computed by subtracting from the return on the stock, the return on the value-weighted index of NYSE-AMEX-NASDAQ stocks. The market model excess return methodology uses the value-weighted index and a parameter estimation period from day –315 to day –61 relative to the announcement. Net of matched-firm return is calculated as the announcing firm stock return minus the return on the stock of the firm in the same industry (4-digit SIC code) that is closest in size (total capitalization of equity) to the announcing firm.

Table 2. Long-Term Stock Performance around Tracking Stock Announcements, 1984-2000

	All Announcements (N = 54)	Announcements by Firms that Cancelled the Planned Issue (N = 22)	Announcements of Firms that Issued Tracking Stocks (N = 32)	t-of Difference Between Issued and Cancelled
Months –24 through –1 before the Announcement				
Average Net of Market Return	-8.3% (-1.5)	-5.9% (-0.7)	-9.9% (-1.4)	-0.4
Average Market-Model Excess Return	-26.9% (-3.5)	-37.5% (-2.8)	-19.9% (-2.2)	1.1
Average Net of Matched-Firm Returns	-9.1% (-1.0)	3.4% (0.2)	-17.9% (-2.0)	-1.1
Months 1 through 24 after the Announcement				
Average Net of Market Return	-15.7% (-1.7)	-41.6% (-2.5)	1.6% (0.2)	2.4
Average Market-Model Excess Return	-28.7% (-2.3)	-71.5% (-2.8)	-0.1% (-0.0)	2.6
Average Net of Matched-Firm Returns	-7.5% (-0.6)	-27.0% (-2.3)	6.1% (0.3)	1.5
Return Improvement between Pre- and Post-Announcement Periods				
Average Difference in Net of Market Return	-7.4% (-0.7)	-35.7% (-1.8)	11.5% (0.9)	2.1
Average Difference in Market-Model Excess Return	-1.8% (-0.2)	-34.0% (-1.8)	19.8% (1.5)	2.3
Average Difference in Net of Matched-Firm Returns	1.6% (0.1)	-30.4% (-1.3)	24.0% (1.0)	1.6

Notes: t-statistics in parentheses. The net of market return is computed by subtracting from the return on the stock, the return on the value-weighted index of NYSE-AMEX-NASDAQ stocks. The market model excess return methodology uses the value-weighted index and a parameter estimation period from month –84 to month –25 relative to the announcement. Net of matched-firm return is calculated as the announcing firm stock return minus the return on the stock of the firm in the same industry (4-digit SIC code) that is closest in size (total capitalization of equity) to the announcing firm.