Print ISSN: 1738-3110 / Online ISSN 2093-7717
JDS website: http://www.jds.or.kr/
http://dx.doi.org/10.15722/jds.21.12.202312.83

Spin-off and Treasure Shares Magic: Focusing on the Korean Distribution Industry

Ilhang SHIN[1], Taegon MOON[2]

Received: June 30, 2023. Revised: August 13, 2023. Accepted: December 05, 2023.

Abstract

Purpose: Research on spin-off and treasury stock is necessary because the market has realized that this can be utilized for major shareholder private interest. Considering the unique characteristic of a spin-off and treasury stock in the Korean stock market, this study contributes to the literature by examining the effects on shareholder value in the Korean distribution industry. **Research design, data, and methodology:** The present study investigates literature, analyst reports, and news articles to examine the spin-off process and analyze how treasury stock magic happens. **Results:** Setting the exchange ratio favoring Spin-Co in the spin-off is the leading cause for reducing the minor shareholders' value. Moreover, treating treasury stock as an asset is also problematic, allowing the allocation of Spin-Co shares. This leads to an increase in the major shareholder controls of Spin-Co without any contribution from the major shareholders. Therefore, the exchange ratio should be calculated reasonably, and treasury stock from the stock repurchase should be treated as stock retirement. **Conclusion:** By analyzing the spin-off and how treasury stock magic occurs, this study provides recommendations to improve shareholder value. Moreover, it contributes to the maturation of the Korean capital market by promoting a discussion on the revision of spin-off and treasury stock.

Keywords: Spin-off, Treasury Stock Magic, In-kind Transfer, Holding Company, Shareholder Value

JEL Classification code: M48, M40, M10

1. Introduction

A spin-off is a divestiture procedure in which a company allocates its assets to establish a new company. Shareholders are allocated new company shares according to a pro-rata rate. For example, if shareholders had a 7% stake before the spin-off, they would have a 7% stake in the new company. The problem which arises from spin-off is that if the existing company holds treasury shares, new company shares can be allocated as the existing company is treated as a shareholder, allowing the existing company's major shareholder to have more control over the new company. The enhancement of the major shareholder's control over the new company can be achieved without additional contributions from the major shareholder, called treasury stock magic, which has been continuously pointed out to reduce the interests of minor shareholders. However, despite the controversial issues of the treasury stock magic, progress in improving the system and legislation is limited.

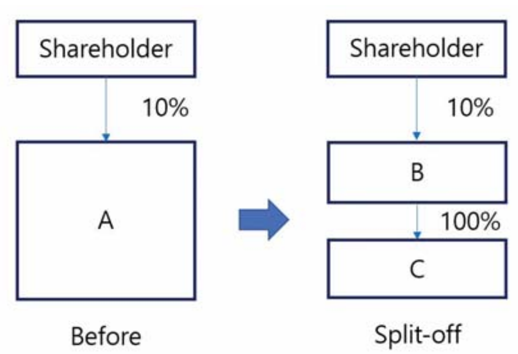
Therefore, this study examines the use of treasury stock magic in spin-offs in the Korean distribution industry. By discussing the nature of treasury stock and examining its use in spin-offs, this study aims to improve the system to protect the value of minor shareholders.

1 First Author. Associate Professor, College of Business & Economics, Gachon University. Email: jayshih00@gachon.ac.kr
2 Corresponding Author. Ph. D. Candidate, School of business, Yonsei University. Email: taegon.moon@yonsei.ac.kr

2. Spin-off and Holding Company in Korea

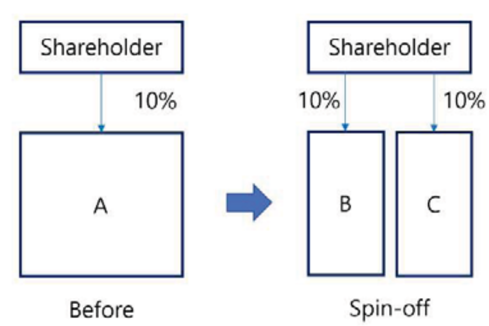
2.1. Spin-off: Definition

A spin-off is a divestiture procedure in which a specific business unit is established as a separate legal entity. Instead of a vertical relationship, the parent company divides itself horizontally. The parent company's shareholders also have control over the newly established company (hereafter Spin-Co), and Spin-Co shares are distributed to existing shareholders on a pro-rata basis (Lee, 2020). If a shareholder had a 10% share before the spin-off, he would have 10% of the parent and Spin-Co shares (Kim, 2022). The main difference between split-offs and spin-offs is how existing shareholders of the parent company control the Spin-Co. In a split-off, the parent company receives 100% of the shares of the Spin-Co, and the existing shareholders have indirect control through the parent company, representing a vertical relationship. However, the spin-offs is the horizontal relationship in which shareholders can exercise direct control over Spin-Co shares.



Source: '[NW Report] LG Chem-Big Hits Also 'Split'-The Economics of Spin-Offs'

Figure 1: Split-off



Source: [NW Report] LG Chem-Big Hits Also 'Split'---The Economics of Spin-Offs'

Figure 2: Spin-off

2.2. Holding Company in Korea

A holding company is one whose main business is to control another company's business through stock ownership. A holding company can be established by converting an existing company or newly established company. Legislation regarding holding companies has changed along with government policies. The Fair Trade Act prohibited the establishment of holding companies during its introduction. The holding company was allowed in February 1999 and gradually encouraged holding companies in the mid-2000s. The reason for revising holding company legislation was that it was difficult to restructure companies in a situation where controlling shareholders had already controlled a group of companies through a more complicated corporate governance system than that of the holding company. Therefore, the government wanted to promote corporate restructuring by encouraging its conversion to holding companies. Holding companies can also improve management transparency through explicit authority and responsibility.

2.3. Advantages and Disadvantages of Holding Company in Korea

Understanding why holding companies have been banned in Korea is necessary before identifying their advantages and disadvantages. Circular ownership is a significant issue in Korean corporate governance. One problem with circular ownership is that many companies with small shareholdings can be controlled through a complex investment process. If the problem arises from the ownership link between companies, the corporate governance structure is disrupted, weakening controlling shareholders' control. Therefore, they are exposed to the risk of hostile M&A to acquire control. This risk was realized in 2003, when SOVEREIGN, an overseas fund, attempted a hostile takeover by purchasing shares of SK in a short investment horizon. At that time, SOVEREIGN could control the entire SK Group by acquiring control of SK only.

Considering the circular ownership problem, switching to a holding company governance structure eliminates complex circular investments and restructures corporate governance into pyramid ownership, increasing management transparency. In addition, when converting to a holding company system, the holding company must acquire a certain percentage of subsidiary shares according to regulations, strengthening controlling shareholder control over the entire corporate group. Transparent corporate governance prevents the risk of hostile M&A and solves the problem of controlling an entire affiliate with a small number of shares. Moreover, complex corporate governance in the circular ownership structure makes it difficult to dispose of an affiliate with an insolvent company. However, the holding company system provides a simple governance structure in which the parent company owns the shares of the subsidiaries, making it easier to organize the insolvent affiliate and improve management efficiency. From a management perspective, the holding company management can concentrate on strategic decisions, whereas subsidiary management can focus on business operations. This independent management system increases the responsibility for the management of business operations, which benefits shareholders.

However, the holding company's structure does not solve all these problems. There is still potential for large amounts of control to be exerted by a small amount of capital in the holding company structure. This is because controlling shareholders do not need enough subsidiary shares in the holding company to exercise management control over all subsidiaries. Additionally, the holding company system cannot prevent financial difficulties in restructuring affiliates. The holding company can still exercise control and force certain affiliates to help other affiliates, increasing the subsidiaries' financial difficulty. Therefore, introducing a holding company does not guarantee a solution to all the problems arising from circular ownership.

3. Spin-off Issues in Korea

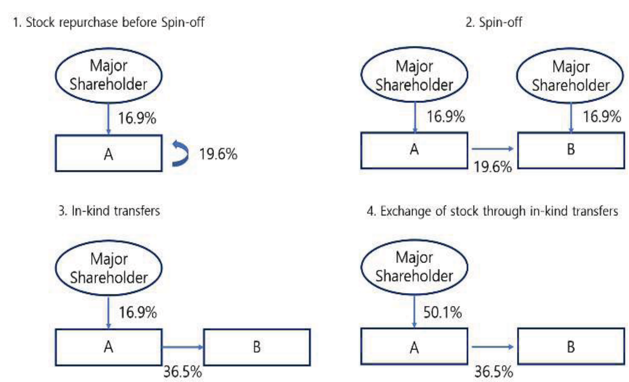
3.1. Spin-off and Shareholder's Value

As price discounts from equity carve-outs have been issued in the Korean stock market, companies are choosing spin-offs as a divestiture process, which is considered to have more shareholder value. However, a price discount also arises from the spin-off, which increases shareholder dissatisfaction. The spin-off decision is based on the criticism that equity carve-outs reduce shareholder value. Equity carve-out is a divestiture process in which a parent company's core business unit forms a new subsidiary and takes it public; it has been a popular way for many companies to raise capital while retaining control. This has been considered bad news for minor shareholders because existing parent company shareholders do not receive shares in the new subsidiary, and the parent company's stock price decreases owing to the loss of the core business unit. Therefore, the regulator recently introduced legislation to protect the value of minor shareholders from price discounts, such as strengthening disclosure in the IPO process and appraisal rights. Conversely, the spin-off is considered a divestiture process that preserves the control of existing parent company's shareholders, owing to the distribution of new subsidiary shares to existing shareholders. In addition, increasing corporate governance transparency through the specialization of business operations is an advantage for spin-offs.

However, the problem is whether a spin-off and equity carve-out are recognized as bad news for minor shareholders. Shareholders react negatively to a spin-off that involves receiving shares in a new subsidiary because a spin-off could be misused to increase controlling shareholders' control. In a spin-off, new subsidiary shares are allocated to the parent company if it holds treasury stock. In this case, a spin-off increases the equity proportion of controlling shareholders for the parent company without additional costs, and this phenomenon is called treasury stock magic. According to the Kim (2022), 92 of the 193 spin-offs of listed companies from 2000 to 2021 were related to holding company conversions. The equity proportion of controlling shareholders for the parent company and Spin-Co increased by 15% and 11%, respectively, after the spin-off and treasury stock magic. Conversely, minor shareholders decreased by 6% compared with before the spin-off, resulting in distortions in control and wealth allocation.

3.2. Treasury Stock Magic

Figure 3 explains how to increase the equity proportion of major shareholders by establishing a holding company and treasury stock magic.



Source: 'Analysis of Holding Companies under the Fair-Trade Act of 2018'

Figure 3: Treasury Stock Magic

Control was increased in four steps. First, Company A acquires 19.6% of treasury shares in the market. Second, Company A is split into two companies, A and B, through spin-offs. The total number of shares held by the major shareholders remained the same at 16.9% for each company after the spin-off. Third, major shareholders make in-kind transfers of 16.9% of Company B's shares to Company A and receive Company A's shares from Company A in exchange. After completing all transactions, the equity proportion of major shareholders in companies A and B skyrocketed from 16.9% to 50.1% and 36.5%, respectively. This mechanism can be explained by the spin-off and in-kind transfer phases.

The first phase is the spin-off phase. Company A was split into Company A and Company B through a spin-off. For example, Company A, with a value of 100, was divided into two companies in a 60:40 ratio. The shareholder was split into two 60:40 shares when the total outstanding shares were 100. The new shares to be issued to the Spin-Co are allocated to existing shareholders according to the proportion of their shareholdings. This is called the pro-rata basis. When the spin-off is completed, Company A becomes Company A and Company B, and the shareholder composition of Company A and Company B after the spin-off is the same as that of Company A before the spin-off. From the shareholder account perspective, the value of 100 shares of Company A in the shareholder account was reduced to 60, and the value of 40 shares of Company B was added to the shareholder account. Thus, the total value of the shareholder accounts remained unchanged.

Treasury stock magic occurred after the spin-off. As mentioned, Spin-Co shares are allocated to existing shareholders on a pro-rata basis. The critical issue of the treasury stock magic is whether to allocate Spin-Co shares to the 19.6% treasury stock acquired by Company A in the first place. As Company A's property is divided by the spin-off, the treasury stock acquired by Company A before the spin-off should also be divided. If the company decides not to divide treasury stock, where it should be placed after the spin-off is also controversial. Company A is recognized as a shareholder if the treasury stock remains in Company A after the spin-off. Therefore, the logic of the treasury stock magic is that Company B's shares will be allocated to Company A's corporate account for 19.6%.

Consequently, Company A has a 19.6% stake in Company B. The major shareholders have a direct interest in Company B (16.9%), but Company A has a direct interest in Company B of 19.6%; therefore, major shareholders have 36.5% (= 16.9% + 19.6%) control over Company B. Through their control over Company A, major shareholders can also control Company B through voting rights. Company B's control power increases after stock repurchase and spin-off, even though the major shareholder has not purchased any shares with its private funds. This phenomenon is known as the treasury share magic effect. The acquisition of treasury stock and the allocation of Spin-Co shares amplify treasury stock magic, and the increase in control without cash outflows is the purpose of treasury stock magic for major shareholders. In this case, the minor shareholder value of common stocks will decrease compared with before the spin-off. Share value is discounted when there is a high degree of ownership dispersion of shares and when control is concentrated in the hands of a specific major shareholder (Kim & Park 2019; Lee 2020). The value of voting rights that can monitor major shareholders' manipulation and conflicts of interest inherent in common shareholders' shares is reduced. This decreases the minor shareholder value but increases the value of the major shareholders' shares or control premium. As shown in Figure 3, a major shareholder equity proportion of 36.5% is sufficient to dominate the control of a large, highly diversified company. Therefore, the major shareholders' share value, which constitutes major shareholders' control over Company B, increases and decreases the value of minor shareholders' shares. The essence of a spin-off with a treasury-share magic problem is a conflict of interest and wealth transfer between major and minor shareholders.

The second phase is the in-kind transfer phase, illustrated in Steps 3 and 4 of Figure 3. The spin-off allocates 16.9% of Company B's shares to major shareholders. Company A issues new shares to the public, and major shareholders participate and obtain Company A shares by making an in-kind transfer of their stakes in Company B to Company A. The total equity proportion of major shareholders increased by up to 50.1%. The main purpose of the spin-off is to exchange shares between Company A and Company B, and the exchange ratio is a significant factor in how major shareholders' equity proportions can spike. For example, if the value of both companies is split 1:1 and the value of the shares is also split 1:1, one share of Company A will be exchanged for one share of Company B. However, if the value of B is split 80%, which is four times the value of 20% of A, and the value per share of B is four times the value per share of A, then one share of B will be four shares of A. If all other shareholders participate in the exchange, they remain unchanged; however, this is unrealistic for a public company. Therefore, this 1:4 exchange ratio generates a significant increase in Company A's major shareholders' equity proportion.

Collectively, the major shareholders can increase their equity proportion rapidly by 1) setting the exchange ratio in favor of Company B in the spin-off and in-kind transfers and 2) the spin-off and in-kind transfer process itself, which automatically generates shareholders who do not participate in the exchange to amplify the effect of exchange. These relate to conflicts of interest between major and minor shareholders.

3.3. Treasury Stock in Korea

We need to understand the concept of treasury stock in Korea because treasury stock magic distorts the distribution of controls and wealth transfer. Allocating new shares to treasury stock indicates that the treasury stock has shareholder rights treated as shareholders. Recognizing shareholder rights also implies that treasury stock has a value that is treated as an asset (Kim, 2021). However, this is inconsistent with the nature of listed companies established based on public investor contributions. Assuming that the company acquires all shares for itself, it follows the liquidating process by distributing the residual property to shareholders. The company cannot be a voting entity and is economically indifferent to paying dividends. If a treasury share is treated as an asset, the company's value correlates with the value of the treasury shares held. However, this is contradictory.

Additionally, the limitation of the source of funds for acquiring treasury stock to distributable earnings indicates that the acquisition of treasury stock is viewed as a capital outflow rather than an investment in assets. Therefore, stock repurchases should be recognized as a return on capital and stock retirement.

4. A Case of Lotte Spin-off

4.1. Increased in Equity Proportion of Major Shareholders through the Spin-off

On September 29, 2017, The Lotte Group approved the spin-off and merger of four affiliates: Lotte Confectionery (currently Lotte Wellfood), Lotte Shopping, Lotte Food, and Lotte Chilsung Beverage. The spin-off is part of the Lotte Group's transition to a holding company system, dividing the four affiliates into investment and business companies and then merging the four investment companies back into the Lotte Confectionery Investment Company. The holding company was officially launched in early October. Split ratio is 1 for Lotte Confectionery, 1.14 for Lotte Shopping, 8.23 for Lotte Chilsung Beverage, and 1.78 for Lotte Food.

Table 1: Lotte Spin-off Ratio

Name	Spin-off Ratio
Lotte Confectionery	1
Lotte Shopping	1.14
Lotte Chilsung Beverage	8.23
Lotte Food	1.78

Note: Published by Yonhap News

The holding company evaluates subsidiary management, provides business support, and manages brand licenses. Lotte has been criticized for its corporate governance structure due to its complicated circular ownership structure. The market expects holding companies to provide an opportunity to increase management transparency and shareholder value. Lotte gradually reduced its 416 circular ownership structures to 67 by the end of July, and the number of circular ownership structures will be reduced to 18 (Kim, 2019). In addition, Lotte expected that spin-offs generate the opportunity for Chairman Shin Dong-bin to further strengthen the control over the entire group, and Lotte's image as a Japanese company would be significantly diluted. However, there were concerns about the opposition of minority shareholders because spin-offs represented only major shareholders' benefits. The conditions for passing the spin-off were demanding: more than half of all shareholders had to be present, more than two-thirds had to agree, and one-third of all outstanding shares had to vote in favor of the proposal.

However, Chairman Shin's favorable stakes in the four affiliates were strongly bonded in that the spin-off passed with the approval of nearly 90% of the shareholders. The approval percentages by affiliates were 86.5% for Lotte Confectionery, 82.2% for Lotte Shopping, 88.6% for Lotte Chilsung Beverage, and 91% for Lotte Food. The National Pension Fund, one of the most significant variables in shareholder meetings, had previously decided to support the spin-off, which also played a part in the outcome. The National Pension Fund holds a 4.03% stake in Lotte Confectionery, 6.07% in Lotte Shopping, 10.54% in Lotte Chilsung, and 12.3% in Lotte Food. [Table 2] shows the changes in the equity proportion of major shareholders after the spin-off. Chairman Shin's control of the Lotte Holding Company increased from 9.07% to 10.51%. Lotte explains that, although there was opposition from some minority shareholders, it would be unreasonable to assume that they represent the will of all minority shareholders. The consensus is that a holding company conversion enhances management transparency and increases shareholder value.

Table 2: Changes in the Equity Proportion of Major Shareholders after the Spin-off

Before the Spin-off	After the Spin-off
9.07%	10.51%

Note: Lotte Holdings Financial Statement (2017)

4.2. Increased Equity Proportion of Major Shareholders through In-kind Transfers after the Spin-off

On April 27, 2018, Lotte Holding offered rights issues through in-kind transfers to the shareholders of Lotte Confectionery and Lotte Chilsung Beverage. The rights issue aimed to transform the holding company's core affiliates, such as Lotte Confectionery and Chilsung Beverage, into wholly owned subsidiaries that meet the holding company's requirements. Along with fulfilling holding company requirements, the most interesting feature of this rights issue is how much the equity proportion of Chairman Shin Dong-bin's control will increase.

The Market expected Chairman Shin to become the holding company's controlling shareholder through in-kind transfers in which he would contribute shares of his business to the holding company in exchange for new shares to be issued by the holding company. The Market estimates Chairman Shin's stake in the holding company at an exchange rate of 10–20%. Mr. Shin holds 9.07% (381,608 shares) and 5.71% (45,626 shares) of Lotte Confectionery and Lotte Chilsung Beverage, respectively. As he has the right to participate in Lotte Holdings' rights issue, the market views his participation as definite. If Chairman Shin fully contributed his Lotte Confectionery and Chilsung Beverage shares in kind, he would receive 1,212,321 and 1,268,195 new shares from Lotte Holdings, respectively. At the end of 2017 Chairman Shin's stake in Lotte Holdings (based on common shares) stood at 10.5%, but in April 2018, his stake dropped to 8.63%. This was due to the dilution of his stake, as Lotte Holding issued 3,995,294 new shares as part of a merger with their affiliates. Lotte Holding planned to receive up to 630,000 shares of the Lotte Confectionery and 120,000 shares of the Lotte Chilsung Beverage on rights issues. Among the largest shareholders and related parties, Chairman Shin Dong-bin's participation alone was sufficient to fulfill the holding company requirements for Lotte Confectionery and Lotte Chilsung Beverage (holding a 20% or more stake in listed subsidiaries). The dilutive impact of Chairman Shin's participation in rights issues was minimal.

[Table 3] shows the changes in the equity proportion of major shareholders. The equity proportion has increased by 1.95% through in-kind transfer from 10.47% to 11.62%. Other than the Chairman, related parties are the only shareholders interested in this rights issue. This is because holding company shares are focused on controlling rather than generating profits through stock trading. For this reason, it is expected that most minority shareholders primarily interested in realizing profits will have little to gain from rights issues and, therefore, will not participate in capital increases. Consequently, Chairman Shin's proportion of equity in the holding company increased by 11.62% after the rights issuance.

Table 3: Changes in the Equity Proportion of Major Shareholder after the Rights issue

Before the Rights issue	After the Rights issue
10.47%	11.62%

Note: Lotte Holdings Financial Statement (2019)

5. Conclusions

This paper examines the effect of the spin-off on changes in the equity proportion of major shareholders by analyzing the Lotte Group case. Treasury stock can be used for the personal benefit of major shareholders, such as treasury stock magic in spin-offs, and defend control from hostile takeovers. The acquisition of treasury stock is based on dividend-able earnings (Im, 2022), representing the contributions of major shareholders cannot be justified in increasing the control of major shareholders. This indicates that acquiring treasury stock may also be associated with major shareholder benefits.

In addition, only 2.3% of publicly traded companies retire their treasury shares. It represents that firms can utilize the acquired treasury stocks to maximize major shareholders' value by disposing of the treasury stock to the market. Several legislations have been proposed to solve the issue of treasury stock, including prohibitions on the allotment of new shares to treasury stock and the mandatory retirement of treasury stock. However, these still need to be implemented appropriately. The contradictory situation of recognizing treasury stock as an asset should be replaced; otherwise, treasury stock issues will continue to be problematic. If a stock repurchase represents stock retirement, it reduces the possibility of treasury stock abuse by major shareholders.

References

Heo, J., E. (2021). [NW Report] LG Chem-Big Hits Also 'Split' - The Economics of Spin-Offs. *Newsway.* https://www.newsway.co.kr/news/view?ud=2021041415495570405. Date of last accessed: 2023.12.11.

Im, J., H. (2022). Necessity of Unified Regulations on the Acquisition and Disposal of Treasury Stocks - Focusing on the Comparison of Regulatory System between the Tax Law and the Company Law -. *Seoul Tax Law Review*, *28*(2), 7-65.

Jung, Y. (2017). Lotte approves the spin-off. First step toward becoming a holding company. *Yonhap News*. https://www.yna.co.kr/view/AKR20170829104751030. Date of last accessed: 2023.06.29.

Kim, D., H. (2019). The Holding Company System in Lotte Group. *The Review of Business History (KABH)*, *34*(1), 27-46.

Kim, J., S. (2022). The Magic of Treasury Stock and the Nature of Treasury Stock. *Korean Capital Market Institute*, *16*, 1-5.

Kim, B., U., & Park, H. (2019). A study on the Taxation System for the Conversion of Holding Company through the Combination of Spin-off and Stock exchange. *Seoul Law Review*, *27*(2), 1-40.

Kim, H., K. (2021). Study on the Nature and Operation Plan of Treasury Stock System in S.Korea While evaluating the operational performance of improving the treasury stock system under the 2011 revised Korean Commercial Act. *Korean Commercial Law Association*, *39*(4), 65-121.

Lee, S., H. (2020). Company Split and 'Treasury Shares Magic' in Korea. *Commercial Law Review*, *39*(2), 367-411.

Lee, S., H. (2020). LG Chem's Company Split: Holding Company Discount and the Remedy under Korean Law. *Kyungpook Natl. Univ. Law Journal*, *71*, 301-334.

Park, G., H (2018). Analysis of Holding Companies under the Fair-Trade Act of 2018. *Fair Trade Commission.* https://www.ftc.go.kr/www/selectReportUserView.do?key=10&rpttype=1&report_data_no=7974. Date of last accessed: 2023.12.11.

Appendixes

Appendix 1: Summary of the Main Contents of Previous Research

Previous research	Theoretical Background
Im (2022)	The acquisition of treasury stock is based on dividend-able earnings
Kim (2019)	Analyze the process of establishing Lotte Group's holding company system and changes in its shareholding structure.
Kim (2022)	Definition and explanation regarding treasury stock magic
Kim (2021)	Explanation regarding the treasury stock in Korea
Kim and Park (2019) Lee (2020)	Explanation regarding the establishment of a holding company through a spin-off
Lee (2020)	Definition and explanation regarding split off and spin-off