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# Appropriate timing of divestitures: An empirical investigation

**Rama Krishna Mishra**

Assistant Professor, Biju Patnaik Institute of Information Technology & Management, Bhubaneswar

Email: ramakrishnamishra@yahoo.com

## Abstract

This paper is an attempt to study how firms recognize the appropriate timing of divesting a segment of its business? What factors influence such decision? What are the motives for divestitures? In these paper divestitures as an overall activity is discussed without taking its various forms such as spin-off, liquidations, equity carve-out in detail. The thrust is put to study "Is there any perfect timing for separating a business unit; irrespective of the mode of disinvestment which unlocks value or simply managers go by their irrational desire to divest one or more business units?". Since the survey of select literature provide a very few and mixed views, the paper relies on several reports published by well-known consultancies in this field to make the study. It is an attempt to test divestitures theories with the real world practices.

**Keywords:** Divestiture, Timing, Spin-off, Liquidation, Value

## Introduction

Domestic reform with globalization of the economy has brought in a paradigm shift in the business environment. In order to keep pace with this reform, companies need to restructure and reorganize themselves. Divestiture, being a part of restructuring initiative, has been adopted as a tool by many companies to fulfill several objectives. One such objective may be to realign the interest of shareholders with that of managers (agency conflict). Another objective may be to transfer assets to those buyers who can use them more efficiently. This helps in enhancing the value of both the selling and buying entities. A third possible objective may be to reverse the formation of conglomerates due to the enactment of various regulations. Especially in India, it happened after the adoption of liberalization policy in 1991. Since 1994, when SEBI (Substantial Acquisition of shares and Takeovers) was passed, and subsequently revised in 1997, a large number of companies have used this regulation to carry out the divestitures and acquisitions successfully. Divestiture is defined as sale of a segment of business for cash or securities or any other consideration such as technology know-how to a third party. Several terms are often used to mean divestitures such as spin-offs, split-offs, equity carve-outs etc. Though these terms are interchangeably used, there lies a substantial difference among each, which needs clarification. In a spin-off, a company distributes its entire holdings it holds, in a subsidiary to its shareholders on proportionate basis. As a result two separate entities with same proportional equity ownership has come to exist. This transaction can be treated as stock dividend since neither the money changes hands nor the subsidiary's assets are revalued. A split-off transaction necessarily involves some of the shareholders of parent company receive the subsidiary's shares in exchange of their holdings in the parent company. Equity carve-out on the other hand, is a tool in the hands of the parent firm to infuse cash without the loss of control, where some of the subsidiary's shares are offered for sale to the general public.

## Why firms undertake divestitures

Linn and Rozeff (1984) argue that there are only two valid reasons for divestitures:

1. The assets are worth more as part of the buyer's organization than as part of the seller's.
2. The assets are actively interfering with other profitable operations of the seller.

Among other reasons, to raise working capital and to pay off debt, which is more of a financing decision, change in market condition, lack of internal talent to grow the business, unsolicited offer by interested buyers compel a firm to go for divestitures activity.

A Divestiture Survey Report 2013 by Deloitte says that corporates have now focused more on strategic rather than financial considerations. A survey by Deloitte of nearly 150 executives who regularly involved in divestitures reveals that, around 81 percent of executives indicated that pruning non-core assets from their business where they have core competencies, is one of the major reasons for divestitures. In contrast to this around 37 percent executives selected financing needs as one of their important goal of divestitures. Among companies that favored divestment of their non-core assets gave reasons of concern over growth and product fit. 37% of executives surveyed selected limited growth potential whereas 30 % of executives selected non-synergistic product as primary reason for divesting non-core assets. Among others, poor operating performance and weak market position are the key drivers for divesting non-core assets. According to the survey, 90% of respondents accept an all-cash deal, 25% accepted seller note and 22% accept continuing equity interest.*

*Source: www.deloitte.com

**Most important reasons for divesting a business**

| Purpose | Rank 1 (in %) | Rank 2 (in %) | Total (in %) |
|---|---|---|---|
| Divesting non-core asset | 62 | 19 | 81 |
| Financing need | Around 17 | 21 | 37 |
| Market change | 8 | 32 | 40 |
| Lack of internal talent to grow the business | 8 | 15 | 23 |
| Unsolicited offer by interested buyers | 1 | 9 | 10 |

Source: www.deloitte.com

Ranks are made on the basis of one of the two most important reasons for divesting non-core assets. For instance 62% respondents indicated the decision that the business unit was a non-core asset was the single most important reason for divesting.

## Literature Review

Copeland, Lemgruber and Mayers (1987) find that taxable spin-offs do not have positive abnormal return, while nontaxable spin-offs do. However when they control for the size of the spin-off, the difference between the two tax categories disappears.

Hite, Owers and Rogers (1987) found that liquidation announcement were often associated with prior news relating to mergers, tender offers or partial sell-offs. At the time of prior announcements, an abnormal return of 9 % was realized.

Kim and Schatzberg (1987, 1988) found that the liquidation announcement was associated with an average 3-day market adjusted return of 14 % to the shareholders of liquidating firms. An additional 3 % abnormal return took place at shareholder confirmation. On the other hand, acquiring shareholders experienced a small positive return at the liquidation announcement and a small negative return at confirmation.

Porter (1987) found that over a period of 1950-1986, most of the sample companies had divested more than the acquisitions made. The findings could also be interpreted as depicting strong and continuing entrepreneurial activities in U.S. corporations. It means the situation could be regarded as a vigorous dynamism rather than an indication of failure.

Schipper and Smith (1983) found a positive 2.84 percent abnormal return to the parent on the spin-off announcement date. The size of the announcement effect is positively related to the size of the spin-off.

Seth 1990; Singh and Montgomery, 1987; Lubatkin, 1987 studies suggest that merging firms capture synergies through asset divestiture and resource deployment.

Skantz and Marchesini (1987) study a sample of 37 firms announcing liquidation between 1970-1982. They found that the announcement-month average excess return is +21.4%.

More or less most of the studies have been carried out to test whether the divestiture in different forms have been successful in terms of producing extra return for the shareholders for both the liquidating as well as acquiring firm. The studies also show that size of spin-off has positive effect on the return for the shareholders, measured through stock market return. No studies have attempted to capture the appropriate timing of divestitures. The unsolved questions like what prompts the firm to take divestment decision? What indicators do the firms use to take such decision? How firms recognize value maximizing opportunities, need to be answered.

## Deciding about timing of divestitures

In the absence of empirical evidences regarding appropriate timing of divestitures, this study tries to first hypothesize the possible factors affecting such timing and then the same can be tested with some actual research reports on divestitures. For doing this, no specific companies' data are used for the reason that even if all divestitures are affected by more or less similar factors, but its impact in terms of effect on share price, future valuation of both the spun-off unit and the seller's entity, etc. may widely differ.

First hypothesis is that firms continuously watch some key statistics of the economy, such as IIP, GDP, the Political stability index, the business environment index, technological innovations and when these indicators give a falling trend, firms may accordingly take divestment decision.

Second, firms also carry out evaluation of its various business segments continuously to find out their NPV and compare them with some benchmarks in each category of the business, which enable them to take divestment decision.

Third, in addition to the above, internal structure of the business like cash reserves, size of the business, employee talent, growth of all the business units vis-a-visa growth of the industry, linkage among all the sub-units of a business entity, core strength in terms of innovation capabilities, leadership etc give a clue to the firm in recognizing the right moment for divestment.

A report by Price water house Coopers (PwC) on "Strategies for Managing a Successful Divestiture" has revealed important insights regarding the timing of divestitures. The report says that divestment decision would generally stem from annual and quarterly strategic reviews, which are typically business unit reviews presented by management. The reviews present a metric based assessment of business unit performance, using metrics like revenue growth, profitability, return on assets etc., which is a continuous process throughout the year. Two early signals: the declining EBITDA and a lack of willingness to invest money into a business unit may give a clue to the management to go for divestment. Moreover risk profile of the unit, unsolicited bidding, and lack of historical capital investment in a specific unit are the typical factors qualifying a business unit for divestiture candidate. The crux of the above study, it is the strategic fit of the underperforming business unit and not the mere financial metrics that decides whether a business unit qualifies for disinvestment. In contrast to this, less than half (43%) of the total respondents of nearly 150 top executives say that they evaluate their business units at least annually to determine whether they should be divested according to a report by Deloitte on “Divestiture Survey Report 2013”. It means companies do not go for a routine exercise which leaves them in a position to miss opportunities, where assets may not fetch desired value. Volume of the business also has an effect on decision about divestitures. Bigger size companies due to their sufficient cash reserves and better bargaining power with banks, attempt more divestitures than small companies (less than 1$ billion revenues) according to the same report.

PwC report says that most of the conglomerates sell a fairly cyclical business, which is driven more by competitive dynamics than by perfection of timing. This means, timing again is a matter of the favorable market condition, number of buyers interested to bid and lot many uncertain economic variables.

A similar report by Ernst & Young on ” Divestitures-a growing trend across the technology M&A landscape”, says an uncertain macroeconomic environment, evolving nature of the technology sector are two key drivers for increased divestitures in the technology sector. Apart, greater focus on strategic priorities, optimization of resources in terms of both financial and human capital, increased transparency for shareholders also drive divestitures across global technology companies.

According to Divestiture Survey Report 2013, sluggish economic outlook is one of the most important factors expediting the divestitures activity. On the basis of response of nearly 150 executives, the following data were obtained in the report.

**Expected influence of economic condition on divestitures in 2013**

| Impact of uncertainty in the economy | Percentage |
|---|---|
| High influence | 30 |
| Moderate influence | 50 |
| No influence | 20 |

Source: www.deloitte.com

According to the same survey, price is the most important factor in choosing a buyer (46%), however there are certain other reasons, such as speed and certainty to close the deal (19%), good fit for management/ employees (13%), ability to have ongoing customer relationship (7%), ease of transition (7%), and a buyer who is not a competitor (8%), which compel the business to go for divestitures.

## Conclusion

Since divestitures are the voluntary decisions by management, big companies take it as a value maximizing tool for their shareholders. Though real world practices confirm to existing principles, over a period of time with changing economic and market condition, many new divestment goals have evolved. In some cases, the goal is clear while in others, the goal is manifold and complex. In particular, the process of sell-off has got more complex. From the study, no clear conclusion can be found regarding perfect timing of divestitures except some signs such as declining EBITDA, decreasing desire for investment and so on.

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