11

Divestiture and Restructuring Theories: Problems and Prospects

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Abstract

This study examined the divestiture and restructuring theories, problems and prospects. While various scholars argue in favour of divestiture and restructuring, some were against it, because many of the divestitures and restructurings that were carried out over time failed as a result of wrong timing and other unnecessary parameters. It was also observed in the course of this study, that majority of the scholars who argued in favour of divestiture and restructuring however cautioned that for divestiture to be carried out successfully, it must be done with care, and also at the appropriate time by managers in order to avoid unquantifiable mistakes.

Keywords: Divestiture and Restructuring.

The term "Divestiture" which in other words means "Divestment", is the reduction of an asset or business through sale, liquidation, exchange, closure, or any other means for financial or ethical reasons. It is the opposite of "Investment".

A company undertakes a divestiture when it disposes-off or sells a business unit. Divestiture, which is also called Divestment, refers to a company selling (Divesting) parts of its business or specific assets because it believes that by following such an action the value of the business will be improved. For an example, a company may sell part of its operations which is not a core business so that it can focus its full attention on the core business and invest money obtained from the sales, on expansion of the core business.

Sometimes, selected operating units or departments are sold to its current management. Such transactions are usually financed via Leveraged Buyouts (LBO's). Spin-off is another way to undertake divestment. This occurs when a certain operating unit becomes an independent business. If a buyer cannot be found for part of the business or specific assets and the business no longer necessary, then liquidation of the business or assets is another option in which divestiture can be accomplished. Liquidation for obvious reasons is the least attractive option to accomplish divestiture. It is often the case that an organization's breakup value is greater than its current value.

Breakup Value refers to sum of value of each part of the business that could have been sold independently. A company with a high breakup value is more an attractive acquisition target for acquiring company. This is because, the acquirer can keep the valuable parts, and sell the parts it does not need at a price and use the money to pay down the price of the original acquisition. Divestitures have become increasingly common operations and one of the major options for companies in enhancing their strategic, organizational and financial performance. Kaul (2012) depicted innovations as a dynamic process of scope expansion into new domains via resource-making acquisition combined with scope reduction out of existing non-core business via divestitures.

Research on divestitures in the field of strategic management rests on two key assumptions. First, Managers are Value-maximizing: the foregoing discussion reveals that while the finance literature views divestitures as a solution to the internal and external problems created by self-interested managers running diversified firms, the strategy literature treats divestitures as a proactive tool that value-maximizing managers can use to improve the internal functioning and external perception of the firms (Feldman and McGrath, 2016). Divestiture emerges as valuable strategy for building shareholder's wealth (Moschieri and Mair, 2008).

Moschieri & Mair (2008), argued that the increasing nature of the foreign competition and the effects of the financial and economic crisis have raised pressure on managers to improve the performance of their organizations. In this regard, firms are expected to restructure their business portfolio in order to cope with the challenging markets and so divestiture emerges as a valuable strategy for building shareholder's wealth.

Kuppuswamy and Vilalonga (2010), detected that the independence from external capital markets increased the value of diversified firms during the 2007-2009 financial crises by reducing funding constraints through an efficient resource allocation.

Bergh, Johnson, and Deweit (2008), opined that managers choose divestiture models (selloff versus spinoff) based on how easily they can convey information about the divested assets to external constituents, and Litov, Moreton and Zenger (2012), showed that firms must strike a balance between the rent-generating potential and the informational discounts that are associated with unique corporate strategies (like divestitures). Although the success of corporate strategies typically depends on the effectiveness of their implementation and scholars have so far devoted scant attention to the study of the divesting process (Bergh, Johnson and Dewitt, 2008).

Accordingly, divestitures create value because they solve or mitigate managers' lack of bandwidth to run multiple businesses (especially multiple unrelated businesses) to extract value from their firms for their own personal gain (Feldman and McGrath, 2016). Divestiture entails a wide range of corporate restructuring activities such as Spinoffs, sell offs and equity carve outs. The finance literature typically treats divestitures as a means of resolving the challenges that often plague diversified firms, such as information asymmetry, managerial entrenchment, and inefficient internal capital markets. By comparison, the strategy literature (especially recent work) views divestitures as a proactive strategic tool that managers can leverage to create value for their firms, oftentimes as part of a dynamic and iterative process of scope expansion and reduction. Regardless of which of these perspectives one espouses, the theoretical and practical importance of divestitures as a topic for research is undeniable, especially now, as more and more companies are using these transactions as a means of altering their corporate scopes (Feldman and McGrath, 2016).

In another contribution to the literature, we study the differences in the post-divestiture stock return performance of firms divesting assets through spinoffs and sell-offs. The existing literature studies the post-divestiture performance of firms which either spin off or sell off assets, but not both (Prezas and Simonyan, 2015). Corporate restructuring in a broad term, is to denote significant reorientation and realignment of the investment (assets) and/or financing (liability) structure of a company through conscious management actions with a view of drastically altering the quality and quantum of its future cash flow streams.

Objectives

The purpose of this study is to examine the causes of divestiture and also, as it affects the performance of a divested unit. It will in addition take a look at whether corporate restructuring can be best by typified as an efficient response to economic shocks or instead, is better described as an imperfect reaction to management entrenchment and hubris. Finally, to investigate the relationship between firm characteristics governance, strategy and performance are the high levels of divestment among down scoping firms.

On the menu of corporate strategy actions, divestiture is an important complement to acquisitions, compared to other forms of corporate strategic action, such as Mergers and Acquisitions (M&A) and strategic alliances. However, divestiture has received relatively little systematic attention from strategy scholars.

Ebrahim and Effatdoost (2013) opined that if top managers have the tendency to use the diversity strategy, first they should measure their current status, strengths and weakness, and opportunity-threat points, and then if they considered the diversity suitable for the organizations' purposes, they should expand their business area with a clear visibility. Results of each diversification and centralism options may emerge soon; so it is suggested that managers should consider the time gap and not judge too soon in order to decide the efficacy and effectiveness of the chosen strategy.

A subset of studies has examined the relationship between divestitures and subsequent firm performance. Divestitures, by freeing resources that can be used to repay debt and improve a firm's financial position or that can be reinvested in new opportunities for growth, have potential consequences on the subsequent performance of firms. This set of studies, however, provides mixed results regarding the impact of divestiture activity on subsequent performance, (Vidal and Mitchell, 2014). A more recent study by Feldman (2014) focused on the comparison of subsequent performance of firms that divested legacy to those that did not, and her findings indicated that the subsequent performance of firms that divest legacy businesses is lower than firms that retain them, particularly when the divested unit is related to the core business. While considerable research has explored how the governance exercised by equity owners shapes the performance consequences of diversification, the influence of lenders on diversification remains unexplored, (Cornnelly, Hoskisson, Tihanyi and Certo 2010).

The first rationale suggests that governance structures, including boards of directors, ownership and managerial incentives, were inadequate to prevent high product diversification. Outside owners, with the exception of the holders of large blocks of equity, do not have sufficient incentives to bear the cost of monitoring managers. The second rationale for down scoping activity is that top executives have made significant strategic errors by pursuing unrelated diversification or by pursuing too many avenues of related diversification simultaneously.

Riddix (2011) explained that diversification leads firms to reduce their numbers of business units or to emphasize financial control over strategic control because, information-processing constraints on corporate executives increased with diversification. Strategic control loss and poor strategy can lead to performance difficulties and so restructuring and increased divestiture activity occur to correct the performance problem.

The Nigerian Experience

Divestiture is not peculiar to the developed countries alone, as similar incidence started in the early 90's in Nigeria. In Nigeria, after a brief lull in the early 1990s, the market for corporate control became increasingly active towards the end of the decade. Both 2005 and 2006 set new records for the number of Nigerian merger fillings, and 2008, 2009 and 2010 brought high profile "mega-mergers" especially in the financial sector. In banking sector alone, a wave of mergers activities which was caused by the CBN recapitalization policy during Prof. Charles Soludo's era, led to widespread industry restructuring and consolidation.

Like other business practices that do not conform to textbook models of competition, mergers, acquisitions and financial restructurings have long been viewed with suspicion by some commentators and regulatory authorities. However, the academic literature clearly suggests that corporate restructurings do, on average, create value.

Existing Literature Review

Divestiture is defined as "a firm's adjustments of its ownership and business portfolio structure via Spin-off, equity carve-out, split-up or unit sell- off" (Brauer, 2006). Divestiture is also classified namely; Spin Offs, Splits, Equity Carve-outs, Disinvestment. In Spin Offs, a company creates a subsidiary company in which the shares of the new entity are distributed to the shareholder of the parent company on a pro-rata basis. However, the parent company also retains ownership in the spin-off entity. Splits Divestiture involves dividing the company into two or more part. This is done with an aim to maximize profitability by removing stagnant units from the mainstream business. Equity Carve-out on the other hand referred to a percentage of shares of the subsidiary company being issued to the public. This method leads to a separation of the assets of the parent company and the subsidiary entity. Equity carve outs result in publicly trading the shares of the subsidiary entity. Divestment as a type of divestiture occurs when a company boycotts or liquidates stocks. The aim of disinvestment is to pressurize a government for a change in rules. Another aim is to pressurize a company or industry for a change in policy.

Pham (2012) in his research on Divestiture and Corporate Restructuring found out that even after controlling the motives of the divestiture, a firm may divest a segment for different reasons. For example, a parent firm may divest one of its segments simply because of financial constraints. It may need cash to invest in a profitable project or to expand the current business, or to pay back debt. It was also discovered that when firms divest, firms that are both financially constrained and have high growth/investment opportunities (most likely divest to invest or expand production, less likely to make itself an attractive acquisition target) consistently experienced lower increase in acquisition likelihood compared to firms that neither are financially constrained nor have high growth/investment opportunities (least likely divest to invest or expand production, more likely to make itself an attractive acquisition target). The result suggests that a firm will have chance of receiving a takeover bid when it strategically divests to make itself an attractive takeover target.

Aggrawal and Zhao (2009) found that in some cases, the diversification discount does not hold in high restructuring and divesting firm. They argued that diversified firms should outperform single segment firms in industries with higher external transaction cost, (for example, industries where there is a severe problem of information asymmetry, industries where the exercise of control rights in resource shifting is difficult, and emergent high-tech industries). They contend that the finding of diversification discount depends on the firm's relative balance between external transaction costs and internal transaction costs.

Eckbo and Thorburn (2012) opined that corporate restructuring may be initiated by top- level management, by divisional manager, or by outside sponsors like buyout funds. Occasionally, the restructuring is defensive, arising in response to a control threat from the market for corporate control. Regardless of who initiates the transaction, the parties are likely seeking to improve operating efficiency, increase cash flow, and ultimately, enhance firm profitability. Despite the number of studies on the topic, there is little consensus in the literature as to whether post divestiture firm performance is positive or negative. There are several reasons for such mixed results, some practical and some theoretical.

Jain, Kinin and Shenoy (2011), investigated firm's decision to vertically disintegrate through a spinoff or equity carve-out. They found that the likelihood of vertical disintegration increases with positive subsidiary industry demand shocks and financing conditions, and decreases with parent firm productivity. They found significantly positive announcement returns for parent firms, their rivals, and subsidiary supplier firms, suggesting that vertical divestitures result in efficiency gains to parent firm due to enhanced focus. The announcement return reflects a combination of the market's estimate of the target gains from a deal and the likelihood that the deal succeeds. Hege, Lovo, Slovin and Sushka (2011), showed that sellers have higher announcement returns when the buyer is a private equity fund rather than a strategic buyer. Overall, the target shareholders tend to make substantial gains in leveraged buyouts.

Tykvova and Borell (2011) examine the extent to which buyout companies become financially distressed and go bankrupt. Their sample was 1,842 European buyouts in 2000-2008 and matched control firms. Importantly, private equity-backed companies have no higher bankruptcy filing rates than the non-buyout companies. In fact, when the private equity sponsor is "experienced" – i.e., has carried out a buyout transaction before – the probability of bankruptcy filing is even lower. Wilson and Wrigth (2011) confirmed the result that private equity-backed firms have no different failure rates in a large sample of U.K. firms over the period 1995-2010.

Thomas (2018), identified several reasons for corporate divestitures. Among these reasons, three are prominent.

1. To increase investment as a means of giving the Unit of the Corporate firms an opportunity to turn its performance around.
2. Availability of Better Alternatives: Firms may also decide to divest because they see better investment opportunities. Organizations have limited resources. They are often able to divert resources from a marginally profitable line of business to one where the same resources can be used to achieve a greater rate of return.
3. Lack of Strategic Fit: A common reason for divesting is that the acquired business is not consistent with the image and strategies of the firm. This can be the

result of acquiring a diversified business. It may also result from decisions to restructure and refocus the existing business.

Ngige (2012) studied the implication of restricting on the performance and long-term competitiveness within the Kenyan banking sector and further, the significance of different modes of restructuring adopted by the banks in influencing performance. Findings revealed that generally, restructuring resulted to improvement in performance in terms of market growth in quality of product, geographical spread and customer retention. Further findings revealed that banks used different strategies of restricting which had different motives in influencing performance.

Semadeni and Cannella (2011) opined that divestitures necessitate the separation of shared financial, managerial and reputational resources processes which by the organizations are quite costly and difficult to implement. Further to this point, certain divestitures may disrupt tacit and taken-for-granted, yet organizationally valuable, competences and interdependencies that have developed over time with diversified firms, suggesting that the costs of divestitures for divesting firm can, at times, outweigh their benefits (Feldman, 2014).

Precautionary Measures - Divest with Care

The ability to divest strategically is as important as the ability to acquire strategically. Acquisitions always get a lot of senior management attention and, for those who want it; there is no shortage of outside advice, including a lot in the management literature. By contrast, you did be hard-pressed to find much on the science of divestiture — few people have thought through its theoretical aspects.

"Dump it, dump it all", Gordon Gekko says as the tape moves against him and a lot of corporate divestitures have this feel to it — reactive. There are times, of course, when companies systematically look at their portfolios and decide what to keep and what to act. But this is usually when they have a major restructuring, which is to say when they are in trouble of some kind and because they tend to do this in haste and under duress, these divestitures are often driven too much by financial exigencies and emergencies, leading to a force sale that can end up weakening the company over the long term.

Consequential Effects

Divestiture is a discipline that should be ongoing, helping you keep the corporate house free of clutter, so to speak, and eliminating the need for a massive employing — out of the attic. A sophisticated approach to divestiture will give you:

(1) A better-fitting portfolio when you are done; and

(2) A means of getting a higher price for what you are selling.

Since you will have identified buyers to whom your asset is worth far more than it is to you. So how should you go about getting your strategy for divesting successfully?

To start with, divestment strategy should be a mirror image of acquisition strategy, and that they both should be done primarily to strengthen a company's differentiating capabilities. By this, we mean the handful of things a company does to offer products or services to its customer love, so that its competitors cannot come close to matching. When these things work together, they create what we call a capabilities system. Examples include Frcho-Lay's direct-to store delivery, Disney's genius for developing and commercializing family friendly characters, and SM's incremental innovation machine.

A pinpoint understanding of their differentiating capabilities is equally important for companies trying to decide what to divest. A company should divest any business that does not contribute to or take advantage of what it does uniquely well, regardless of whether and perhaps especially if the business is thriving. A company that looks at its portfolio in this way will shed assets that pull it in unnatural directions, and will preserve its capital and energy for the activities closest to its core.

A capabilities lens is also useful in identifying divestitures that do not make sense. For instance, it makes no sense to divest a business that accounts for a core part of the company's capabilities system, even if it is performing poorly. At the very least, the seller should separate out, and hold onto, the pieces of the business that are integral to its capabilities. Nor should a company divest an underperforming product or service that, by any reasonable assessment, should be thriving in its capabilities system. In that case, the problem is execution and the appropriate action is to find and correct what isn't working.

Here, let us take on a few high profile divestitures or would-be divestitures.

The IBM-Lenovo divestiture happened in 2005 and was questionably the right move. IBM's capabilities began moving away from manufacturing commodity, sourcing and selling in the mid-1990s, when it shifted into software and services and started building its capabilities in the areas of data centre management and enterprise systems integration. One question that seems reasonable in light of the law is ($1.75 billion) price tag. Did IBM wait too long to sell this PC-making unit?

Another firm is GE-NBC/Universal. Another divestiture (partial: GE retains a 49% stake) that is hard to argue with. GE's expertise at building and marketing engineered products is legendary, but media and entertainment call for different skills. Jeff Immelt was happy to free up some of the capital. GE had in NBC/Universal two years ago how long before he decides to free up the rest? Pfizer Inc. to Pfizer Consumer Healthcare. Pfizer invested its consumer healthcare business in 2006, selling it to J&J for more than 20x EBITDA. It was a spectacular move. Since then, end-user consumers have become more important everywhere in the healthcare industry. Did Pfizer let go of capabilities it should have kept? Some of those capabilities, incidentally, came back to Pfizer in 2009, as part of its acquisition of Wyeth, which had a consumer health business of its own? Gillette's rationale for this acquisition sounded good. Gillette would benefit from Duracell's expertise in front-of-the shore merchandising and marketing and Duracell would gain by leveraging Gillette's matchless ability to get customers to "trade-up" to higher-price products via innovation but the mode of capabilities never really worked the way Gillette hoped. Now, that Procte & Gamble owns Gillette, should it divest the Duracell unit?

Conclusion

This study has probed into existing literature of various scholars. While various scholars argued in favour of divestiture and restructuring, some were against it, because many of the divestiture and restructuring that were carried out over time failed as a result of wrong timing and other unnecessary parameters.

It was also observed in the course of this study, that majority of the scholars who argued in favour of divestiture and restructuring however cautioned that for divestiture to be carried out successfully, it must be done with care, and also at the appropriate time by managers in order to avoid unquantifiable mistakes.

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