

IMPACT OF DIVESTITURE ANNOUNCEMENTS UPON SHAREHOLDER WEALTH CREATION DURING THE COVID-19 PERIOD: A STUDY OF DIVESTITURES ACROSS ALL INDUSTRIES IN INDIA.

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ABSTRACT

Traditionally, studies on shareholder wealth creation upon divestiture announcement have repeatedly found positive share price reactions to divestiture announcements. This paper tests this premise under the COVID-19 pandemic scenario for companies in India across all industries that undertook divestitures during the COVID-19 period. It finds that unlike traditional studies there are negative statistically insignificant abnormal returns upon divestiture announcement during the COVID-19 period. The authors associate this negative return upon divestiture announcement with a pessimistic opinion of the shareholders towards the event of a reduction in the company's size and its association with bleak chances of survival in these dire circumstances. This sets the COVID period apart from normal circumstances in the case of shareholder wealth creation upon divestiture announcement.

INTRODUCTION

Corporate divestitures such as sell-offs, spin-offs, equity carveouts, and even split-ups have gained importance as a means of restructuring the company. Nevertheless, it has received little attention from researchers ((Feldman & McGrath, 2016)). This could be because divestitures are often seen as a reduction in the size of the company which is interpreted as a setback for the company (Dranikoff et al., 2002) Divestitures also lead to acknowledgment of sunk costs squandered away by management and might be seen as an employee morale-lowering event in the company's life (Huyett & Koller, 2011). Managers also tend to take the action of divestiture only when they feel the external pressure from stakeholders to do the same, leading to delays in divestiture decisions. Divestitures usually happen after credit downgrades and negative analysis comments (Dranikoff et al., 2002).

Earlier studies in the United States of American context have found almost always a statistically significant positive shareholder wealth creation (Brauer & Wiersema, 2012; Hearth & Zaima, 1984). Significant shareholder wealth creation in the United Kingdom's context has also been found(Alexandrou & Sudarsanam, 2001; Gadad & Thomas, 2005; Kaiser & Stouraitis, 2001; Lasfer et al., 1996)

The divestiture includes partial or complete business disposal through exchange, closure, sale, or bankruptcy. Corporate divestiture takes various forms: spin-offs, split-ups, equity carveouts, and sell-offs (Teschner & Paul, 2021). When a company transfers control over its assets to a third party in return for consideration, it is called a sell-off (Slovin et al., 1995). The Company receives cash via this form of divestiture. The company uses this cash to restructure financially. Research has found that such divestitures, mainly when used to settle debt obligations (Kaiser & Stouraitis, 2001) or increase the focus of the Company (John & Ofek, 1995), create value for the shareholders. An obvious question arises as to why the buyer of the asset would buy it from the seller when it is underperforming. Clubb & Stouraitis (2002) state that the buyer of the asset engages in the transaction of purchase of a sold-off entity because the buyer thinks the asset is a better fit for its current operation and as the asset changes hands

from those who hold little value for the asset to those who are more capable of using it shareholder value is created for all parties involved.

On the other hand, when a company voluntarily separates an offshoot of itself as a separate company and lists it as a separate entity on the stock exchange with pro-rata allotment of shares to existing shareholders, it is called a spin-off. Thereby, no cash is generated for the Company. Spin-offs prevent the watering of equity (Slovin et al., 1995). It is also often a tax-free transaction for the parent company (Boreiko & Murgia, 2012). Thus, it becomes a tax-saving avenue for the wealth creation of shareholders. Similar to a spin-off, if a company separates an offshoot of itself and asks the shareholders to choose between the shares of the two separate companies, it is called a split-off. An equity carve-out is a transaction via which the company retains ownership over the separating entity but also issues an initial public offering for the remaining part of it. Equity carveouts lead to both the issuance of shares and the generation of cash flows (Slovin et al., 1995).

Divestitures have several benefits, including an increase in the volume of shares of the Company being traded on the stock exchange (Habib & Johnsen, 1995). In some cases, the value of the two separate entities on the exchange might be more than the consolidated Company on the stock exchange, thus creating value (Kambla, 2016). In this case, the whole is less than the sum of its parts separately. The benefits of spin-offs are better demarcation of resources, better operations management, and a renewed focus on that particular division or branch of business. It also reduces information asymmetry between the shareholders and the management, as the financial results of the separated entity start being reported separately from the parent company's financial results (Bergh & Lim, 2008).

1. LITERATURE REVIEW

Mergers and acquisitions are based on economies of scale and synergies, making the whole greater than the sum of its parts. However, research has found a diversification discount for companies that operate in diverse industries. It has been found that shares of a diversified business trade at a lower price than their peer, which only operate in one industry. This suggests that the sum of the parts can often be greater than the whole. Making a strong case for divestitures. Separating underperforming units that are making a loss can release much-needed cash flows for the company that would otherwise be difficult to raise via the capital market. Also, the agency costs associated with a company reduce when a spin-off occurs as the financial performance of the separating entity starts being reported separately.

A majority of the studies find that there is significant positive shareholder wealth creation upon divestiture announcement in the context of the USA, using different periods of analysis (Bergh & Lim, 2008; Cusatis et al., 1993; Desai & Jain, 1999; Hite & Owers, 1983; Mulherin & Boone, 2000; Rosenfeld, 1984). Only Alexander et al. (1984) find a positive but insignificant relationship between divestiture announcement and shareholder return upon divestiture announcement. The researchers believed it was because the news of the sell-off was preceded by much negative press about the Company, which muted its positive cumulative abnormal return—indicating that these sell-offs were reactive rather than proactive. Another explanation proposed for this slight positive return upon announcement of the sell-off is that the market for sell-off is perfectly competitive, implying no additional net present value is added to the seller via the transaction. Therefore, no change in valuation for the selling company.

Positive synergic effects have been found for both the acquirer as well as the divestor of the assets (Rosenfeld, 1984), with spinoffs offering more returns than other forms of divestiture. Unlike a merger, the positive return is usually only observed for the target company and not for the acquirer. Spin-off creates a CAAR (Cumulative Average Abnormal return) of 6.06%, and sell-off creates a CAAR of 5.25% (Rosenfeld, 1984).

Another interesting way researchers have found to evaluate the returns generated by the divestiture is to study the price reaction of the rival firms. This method found that spin-offs created negative wealth for the shareholders, marked by a rise in the price of rivals. Equity carveouts create positive wealth for the shareholder, marked by a negative return for the rival companies. This indicated that at the time of equity carveouts, the management believed that the investors valued the company more than the managers. Thus leading to a positive stock market reaction (Slovin et al., 1995).

The growth in the company's share price upon the announcement of the divestiture in certain literature has also been associated with organizational learning. Bergh & Lim (2008) found that as the experience of the management increases regarding divestiture, the return upon divestiture announcement also increases. There was a positive 2.2% CAR upon announcement of spin-off or sell-off. Experience with divestiture was also found to be a good predictor of the firm's success with regard to earnings per share and return on investment five years post-divestiture. Some researchers have even found apposite returns, especially for those divestitures undertaken for a merger, and a negative return for divestitures that took place due to legal constraints (Hite & Owers, 1983; Cusatis et al., 1993). Divestiture is an effective and profitable way to merge two companies (Cusatis et al., 1993) No evidence has been found indicating the fact that there is a transfer of wealth from the bondholder to the shareholder upon divestiture. A buy-and-hold method of evaluating the returns of the companies has also been used by several authors to measure the positive effect of divestiture on a company's share price movement. It avoids the transaction cost problem and is more suitable for studying the long-term returns of the shares post-divestiture announcement. Here, the buy-and-hold return of a portfolio of securities that have undergone divestiture is made with a matched control group of the company's buy-and-hold return (Cusatis et al., 1993).

Alexandrou & Sudarsanam (2001) study the effect of a company's characteristics of the seller on shareholder wealth created upon the announcement of a sell-off. The researchers study U.K. companies from 1987 to 1993 and consider seller and environmental characteristics like economic environment, i.e., boom or recession, increase in focus, financial health, company size, whether it is a one-off or a series of sell-offs, and effect of information asymmetry between buyer and seller. The researchers used event study methodology and concluded that company size positively affects the wealth created for shareholders on sell-offs. The researchers also find that sellers benefit more during a recession via a sell-off than during a boom period, this is quite counterintuitive, but the authors explain it via the fact that there are better reinvestment opportunities in case of a recession. The researchers also find that sell-offs made by financially strong sellers, measured via Altman's Z-score, create greater shareholder value. The researchers found no evidence of an increase in focus on the return of the sell-offs, which is contrary to the findings of Desai & Jain (1999), John & Ofek (1995), and Kaiser & Stouraitis (2001). Alexandrou & Sudarsanam (2001) also found no significant difference between returns generated by serial or one-off sell-offs. Where serial sell-offs are defined as more than one sell-off by the parent company in a month, Alexandrou & Sudarsanam (2001) find that information asymmetry has a favorable effect on the return the seller enjoys, measured via the seller's and buyer's location. Alexandrou & Sudarsanam (2001) observe a CAR of 0.39% in the event window of -2 to 0 days and a significant 1% return on the announcement day.

Studies on shareholder wealth creation upon divestiture announcement using event studies have also been made in the context of European countries (Alexandrou & Sudarsanam, 2001; Boreiko & Murgia, 2012; Lasfer et al., 1996; Teschner & Paul, 2021). Almost all of them find positive shareholder wealth creation through divestiture announcements and divestiture events in the long and short term. These studies are mainly concentrated on the financial health of the Company and the use of proceeds to settle debt and its effect on shareholder wealth creation. Thus, based on the above studies reviewed following hypothesis is formulated.

Hypothesis 1 (H1): Divestiture announcement creates significantly positive shareholder wealth

2. SAMPLE

A total of 56 divestitures from an initial sample of 109 divestiture transactions that took place between 25th March 2020, when the lockdown was first announced in India, to 7th May 2023, when the World Health Organization (WHO) declared that COVID-19 was not a public health emergency anymore, are the sample size and period of the study. The remaining 53 divestiture transactions out of 109 divestiture transactions had to be dropped as they took place in companies that were not listed on any stock exchange or for which no media announcement date could be found. All transactions were identified from the Center for Monitoring the Indian Economy's (CMIE) ProwessIQ database.

3. METHODOLOGY

Event study methodology has been used. The market model method of estimating normal returns has been used. In the events study, first, the actual returns are calculated in our study. **Actual returns** are calculated as the natural logarithm of the share price on a given day divided by the share price on the previous day expressed in a formula as: -

$$R_{it} = \ln\left(\frac{P_{it}}{P_{it-1}}\right)$$

where R_{it} is the stock return for the company i on day t , and P_{it} is the share price of the company i on day t .

Post-calculation of the actual return event study requires us to compute the normal returns. This is done using the market model, which takes into account the systematic risk of the company concerned. It is the most commonly used method and thus is used in this study to predict the normal return of the company's share over the event window. Here, normal return refers to the return the share would have provided if market expectations of the Company had stayed the same due to new information. It is calculated via the following formula: -

$$E(M_{it}) = \alpha_i + \beta_i R_{mt} + \varepsilon_{it}$$

Where α_i measures the average return over the calculation period, which is not explained by the market, the β_i measures a company's sensitivity to the market risk component. R_{mt} is the return on a market index. ε_{it} is an error term, and $\sum \varepsilon = 0$.

Abnormal return- is calculated as the difference between the actual return of stock i on day t and the normal return of share i on day t calculated using the normal return formula.

$$AR_{it} = R_{it} - E(M_{it})$$

Where AR_{it} is the abnormal return of stock i on day t , $E(M_{it})$ is the normal return of stock i on day t , and R_{it} is the actual return of stock i on day t .

Cumulative abnormal returns will be calculated as the sum of the abnormal returns over the event window. Since a (-10,+10) event window i is being considered, the formula for it can be written as: -

$$CAR(-t1, +t2) = \sum_{t1}^{t2} AR_{it}$$

As the number of shares under consideration is too many, thus average abnormal returns are calculated by averaging all abnormal returns of various stocks on day t .

$$oneAAR_t = (1/N) \sum_{i=1}^N AR_{it}$$

AAR is the average abnormal return on day t , N is the number of companies, and AR_{it} is the abnormal return of stock i on day t .

Further, CAAR or Cumulative Average Abnormal return is calculated as the sum of average abnormal return over the chosen event window. it can be expressed as:-

$$CAAR_p = \sum_{t=1}^p AAR_t$$

$CAAR_p$ is the cumulative average abnormal return for period p, and AAR_t is the average abnormal return on day t.

Significance level of CAAR is computed via the formula:

$$T - \text{statistic of } CAAR_{it} = \frac{CAAR_{it}}{(\sigma AAR_{it}) * N^{(1/2)}}$$

Where CAAR is cumulative average abnormal return of companies i in event window t, σAAR_{it} is standard deviation of average abnormal return of companies i in estimation window t which. N is the number of days in the event window.

Five event windows have been taken of 21 days, 11 days, 7 days, 5 days, and 1 day. This is done to see the general trend in CAAR over different time period that come progressively closer to the event date. It also allows us to check if in any other time period than just one, there was a significant return and gives a better idea of the direction of the CAAR's movement.

Firstly the entire data set of 69 transactions was analyzed to study the effect of divestiture announcements on shareholder wealth creation during the COVID period, as a whole. Then, the data is categorized based on divestiture type, that is, sell-offs and spin-offs, and again CAAR for all event windows is calculated for both subsets, to check whether there was any significant shareholder wealth creation among these two divestiture types.

4. RESULTS AND DISCUSSIONS

First, all transactions were analyzed together, and their combined CAAR in the 5 event windows, that is (-10,+10), (-5,+5), (-3,+3), (-1,+1), and (0,+1) was calculated and the results are displayed in table 1. As the table shows there was an adverse reaction to the announcement of divestiture during the COVID period this includes companies across all industries. It can be said that the news of a company breaking itself into parts or sell a particular portion of its business was not taken well by the market. Rather it was interpreted as the coming doom of the company as companies were going through a once-in-a-lifetime sort of event. Where future cash flows were uncertain. Whether the business model would survive or not was in question. The operating mechanisms of the company were undergoing drastic changes and the financial future of all companies was uncertain.

We see a decreasing trend of divestiture return as we reduce the number of days to the event and the time before and after it. Only on the announcement date do we see a minor positive reaction by the market to the divestiture announcement. All results are statistically insignificant.

Table No. 1- Cumulative Abnormal Return (CAR), Cumulative Average Abnormal Return and T-stat of different event windows for all transactions in sample data set.

All Transaction			
No. of days in the event window	CAR	CAAR	T-stat
21	-0.0411	-0.00196	-0.04526
11	-0.051	-0.00464	-0.14818
7	-0.02845	-0.00406	-0.16281
3	-0.005	-0.00167	-0.10195
2	0.007842	0.007842	0.831229

Note. Author's own compilation

To further analyze the effect of divestiture announcement of a particular form of divestment on shareholder wealth creation via divestiture announcement, we segregated the data into two forms of divestiture that took place during that period: sell-off and spin-off. Table 2 shows the results of the CAR, CAAR, and T-statistic for sell-offs whereas Table 3 shows the results of spin-offs during the COVID period.

Table No. 2- Cumulative Abnormal Return (CAR) Cumulative Average Abnormal Return and T-stat of different event windows for sell-offs in the sample data set.

Sell-offs			
No. of days in the event window	CAR	CAAR	T-stat
21	-0.05246	-0.0025	-0.05778
11	-0.0683	-0.00621	-0.19845
7	-0.04602	-0.00657	-0.26341
3	-0.01658	-0.00553	-0.33817
2	0.004686	0.004686	0.496751

Note. Author's own compilation

Table 3: Cumulative Abnormal Return (CAR), Cumulative Average Abnormal Return, and T-stat of different event windows for sell-offs in the sample data set.

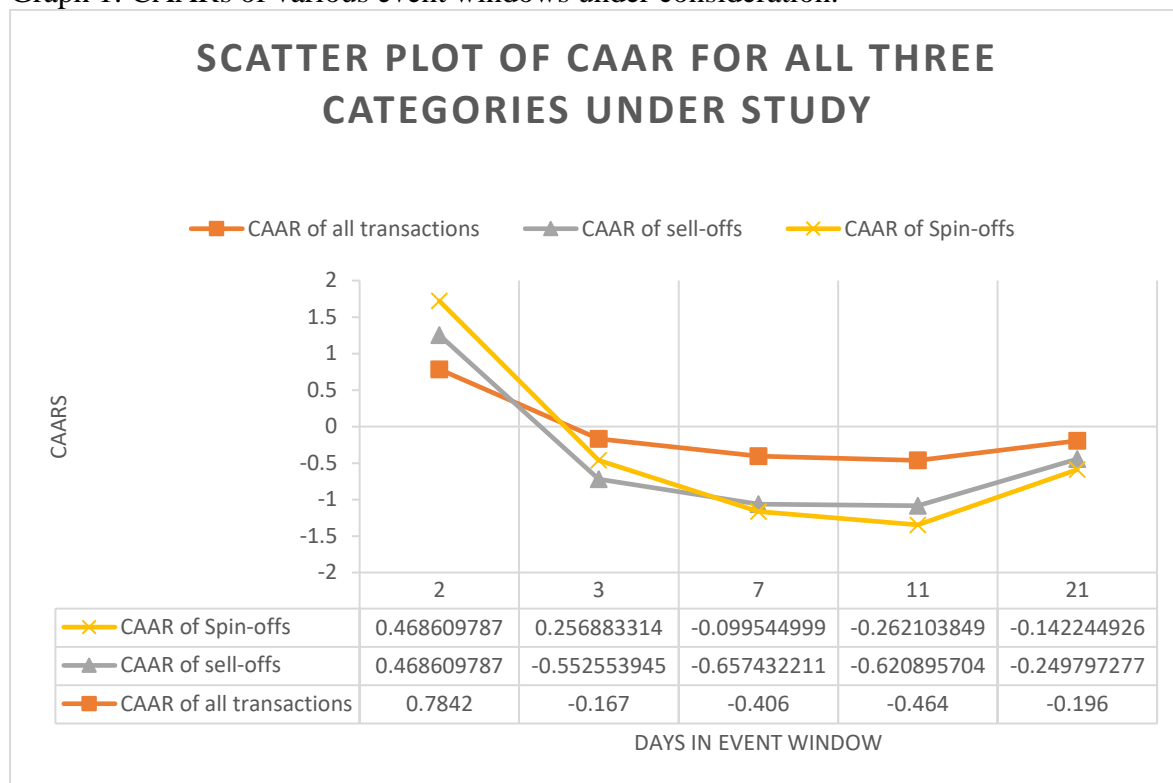
Spin-offs			
No. of days in the event window	CAR	CAAR	T-stat
21	-0.02987	-0.00142	-0.69117
11	-0.02883	-0.00262	-0.92174
7	-0.00697	-0.001	-0.27926
3	0.007706	0.002569	0.471774
2	0.004686	0.004686	0.496877

Note. Author's own compilation

There was a total of 31 sell-offs and 25 spin-offs that took place in the period of the study. Indicating, that sell-off was preferred as a form of divestiture during the COVID period as compared to spin-offs. This further indicates that many of the companies divesting might have been doing so to marshal up the resources to survive the COVID period therefore preferring to sell off part of them to realize cash consideration. This would further indicate to the market that the companies divesting during this period were financially distressed and might not survive the COVID period.

Graph 1 shows the various CAARs of all the five periods under study of both the two subcategories we have made as well as for all the transactions combined. It is clear that as we increase the event window on the either side of the event date the returns start turning negative only to recover slightly towards the highest period of study which is 21 days. The dip in spin-offs is greater as compared to that of sell-offs. Indicating that spin-offs were taken as the worst means of divestiture as compared to sell-offs. This seems to suggest that shareholders feared the loss of control over assets to credit holders due to spin-off, thus a fall in their overall wealth.

Graph 1: CAARs of various event windows under consideration.



Note. Author's own compilation

6. LIMITATIONS OF THE STUDY AND SCOPE OF FUTURE RESEARCH

Almost half the total transactions during the period were lost due to the unavailability of data. This study places greater emphasis on divestitures that had public media announcement dates and corresponding media announcement dates could be found. This means only major private divestitures, which most analysts covered, were analyzed. Thus smaller less media attention-grabbing divestiture events were beyond the scope of this study. Further studies can analyze the impact of the pandemic on various other forms of mergers and acquisition activities like acquisitions, mergers, or even share splits. It is also very difficult to infer anything from this study about the population of divestiture that took place during the COVID period as all findings were statistically insignificant.

5. CONCLUSION

From the research, it can be ventured that there was negative shareholder wealth creation due to divestiture announcement during the COVID period. This is contrary to all findings in the literature in the context of divestiture and shareholder wealth creation. Indicating that during the pandemic unlike normal times, shareholders perceived a divestiture as a wealth reduction event as compared to a wealth creation one. There can be several reasons for the same right for companies doubting the financial security and sustainability of the company undergoing divestiture during these stressful times to fear of shifting of wealth from shareholders to debt holders via spin-offs.

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