

Volume 33, Issue 3**The role of firm performance in the market reaction to divestiture
announcements**

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Abstract

Divestitures have the potential to create shareholder value. However, the magnitude of the wealth effect depends on the likelihood of finding more valuable uses for the divested assets and the seller's ability to eliminate negative synergies. Strong performers should have less scope to benefit compared to poor performers. Using lagged excess returns as a proxy for such opportunities, we show that the market reaction to divestiture announcements is significantly higher for underperforming firms.

1. Introduction

Existing studies show that divestitures increase shareholder value. A number of arguments explain the positive market reaction to divestiture announcements. First, the divested assets can be reallocated to more valuable uses (Alexander et al., 1984; Jain, 1985; Hite et al., 1987). Second, divestitures allow firms to eliminate negative synergies (John and Ofek, 1995; Daley et al., 1997; Berger and Ofek, 1999). Internal resources can thus be redeployed to higher-value activities. Third, divestitures contribute to ease financial constraints and reduce the firm's cost of capital (Lang et al., 1995).

However, the scope for value creation should depend on the firm's current performance. Well performing firms have fewer opportunities for improvement. Their assets are already invested in high-value uses. They are unlikely to conceal negative synergies or suffer from financial constraints. As a result, it seems difficult for them to extract additional value from their existing assets. In contrast, poorly performing firms are more likely to hold assets that do not cover their opportunity costs, interfere with the firm's other operations, or over-consume internal resources such as management attention. Divesting those assets is expected to generate greater value. The idea is similar to the one that dividend increases are more likely to create value for firms with poor investment opportunities (Lang and Litzenberger, 1989).

The aim of this paper is to test that hypothesis using a sample of divestitures announced by French firms over the period 1990-2010. The results show that shareholders of the divesting firm receive a positive excess return of 1.25% in the 11-day window surrounding the announcement. However, the excess return to well performing firms is less significant while the excess return to poorly performing firms can be up to 4% higher. Overall, the results indicate that the firm's current performance is a critical determinant of the wealth effect associated with divestiture announcements.

2. Methodology and sample description

To measure the gains from divestitures, we use standard event study methodology. The stock returns of divesting firms around the divestiture announcement are adjusted for broader market movements using the market model. We use the CAC 40 index as proxy for the market portfolio because it is the leading indicator for French stocks. The index is also available for the entire period covered by the study. The coefficients of the market model are estimated over the period (-250, -11) days before the announcement. Abnormal returns are given by the difference between realized and expected returns. The value generated by the divestiture is measured by the seller's cumulated abnormal return (CAR) over various windows.

The main explanatory variable is an indicator of whether the firm is a strong or a poor performer. Poorly performing firms are more likely to improve their performance since divestitures reduce overcapacity and correct unproductive investments (Maksimovic and Phillips, 2001; Warusawitharana, 2008). We use the lagged excess return over the market return in the 1-year and 2-year periods ending 10 days before the event. A negative excess return is taken to indicate that the firm is a poor performer. This variable is expected to have a positive effect on announcement returns.

In the regression analysis, we include the relative size of the divestiture, measured by the value of the divested asset over the market value of the firm's equity. Large transactions are more likely to have a material impact on the firm's market value as opposed to smaller transactions. Mulherin and Boon (2000), Alexandrou and Sundarsanam (2001) and Hanson and Song (2006) find significantly higher excess returns for larger divestitures. Similarly, John and Ofek (1995) and Hillier et al. (2009) show that the market reaction is a decreasing function of the firm's market value.

Our data source is SDC Platinum. We consider all divestitures by French firms announced between January 1990 and December 2010. We require the value of the divestiture to be at least €10 million to ensure a nontrivial economic impact on the seller's value. These two requirements returned 812 deals. We then collected stock returns from 2 years and 10 days before the announcement to 10 days after the announcement from Datastream. Due to missing data, the final sample was reduced to 760 divestitures.

3. Empirical results

Table 1 presents summary statistics for the sample. Panel A shows that CARs are positive and tend to increase with the size of the event window. The average CAR (-1,+1) is about 0.5% while the average CAR (-5,+5) is about 1.18%. Overall, divestitures appear to be value-increasing decisions although the market reaction is somewhat weaker than in the US. For instance, John and Ofek (1995) report excess returns of 1.5% in the 3-day window around the announcement. However, the average relative size of their divestitures is 39.4% against less than 15% in our case. It is also useful to note that the dispersion in excess returns increases from about 4.8% for CAR (-1,+1) to over 10.6% for CAR (-10,+10).

Table 1: Summary statistics

Abnormal returns are calculated using the market model. Relative size is divestiture value over the seller's market value of equity. Excess returns are measured by the difference between the seller's stock return and the index return using the CAC 40 index as proxy for the market portfolio. The sample consists of 760 divestitures announced by French firms over the period 1990-2010.

	Mean	Std Dev	Q1	Median	Q3
Panel A: Cumulated abnormal returns using market model (in %)					
CAR (-1,+1)	0.500	4.779	-1.438	0.171	2.250
CAR (-5,+5)	1.177	7.958	-2.489	0.466	3.794
CAR (-10,+10)	0.984	10.632	-4.123	0.200	4.808
Panel B: Divestiture and firm size (in € million or in %)					
Value (M€)	386.8	1133.3	35.0	103.7	323.1
Relative size (in %)	14.92	52.05	0.62	2.15	7.23
Asset (M€)	25,876	32,069	4,472	15,959	35,340
Equity value (M€)	16,024	23,381	1,811	8,176	17,138
Panel C: Excess returns over market index prior to divestiture announcement (in %)					
Excess return 1 year prior	1.398	39.190	-17.388	0.165	16.213
Excess return 2 years prior	1.102	52.884	-28.404	-2.780	22.277

Panel B reveals that the average value of the divestitures is about €386 million. However, the median is much smaller at about €100 million. In half of the cases, the divested assets represent less than 2.15 % of the seller's equity value. This indicates that the seller is generally a large firm. Indeed, divesting firms have on average €25 billion in total assets, while their market value of equity is about €16 billion. Inspection of Panel C shows that divesting firms have on average outperformed the market index in the two years preceding the divestiture. This result does not suggest that sellers are specifically distressed.

Table 2 analyzes the cross sectional difference in CARs over three event windows. In all the regressions, the relative size of the transaction is found to have a positive and significant effect at the 1% level. The coefficients on the two indicators of low performance are also positive and significant. CAR (-1,+1) is about 0.8% higher for low performers, using the 2-year lagged stock return indicator, and about 0.9% higher, using the 1-year lagged stock return indicator.

Table 2: Regressions of CARs on stock-based indicators of seller's underperformance

Relative size is the natural log of divestiture value over the seller's market value of equity. Stock returns are transformed into underperformance indicators equal to 1 if the seller's stock return is lower than the index return over the same period; and equal to 0 otherwise. The t-stats are indicated between brackets. ***, **, * denote statistical significance at 1%, 5% and 10% level.

	CAR (-1,+1)		CAR (-5,+5)		CAR (-10,+10)	
	1	2	3	4	5	6
Relative size	0.0037*** (3.69)	0.0035*** (3.50)	0.0054*** (2.84)	0.0055*** (3.07)	0.0078*** (3.18)	0.0076*** (3.29)
2-year return	0.0083** (2.42)		0.017** (2.98)		0.0339*** (4.50)	
1-year return		0.0091** (2.58)		0.018*** (3.26)		0.0395*** (5.36)
Constant	-0.0023 (-1.15)	-0.0025 (-1.24)	-0.0019 (-0.63)	-0.0019 (-0.69)	-0.0146*** (-3.51)	-0.0159*** (-4.12)
F value	8.53***	11.22***	7.85***	7.97***	13.2***	16.83***
R-squared	0.0327	0.0327	0.0316	0.035	0.0492	0.0601

The difference increases to more than 1.7% when abnormal returns are measured over an 11-day window. Given that the average CAR (-5,+5) is 1.2% the total wealth gains generated by divestitures appear to be economically large in the case of poorly performing sellers, but close to zero in the case of well performing sellers. This result supports the idea that divestitures are more valuable when the firm has underperforming assets with higher opportunity costs (in the hands of other firms). Hence, selling those assets to higher performers and finding other (more valuable) uses for the divested assets can create substantial value for the seller's shareholders (Maksimovic and Phillips, 2001; Warusawitharana, 2008).

Over a longer window, CAR (-10,+10) is between 3.4% and 4% higher for underperforming sellers. Considering the fact that the average CAR (-10,+10) is less than 1%, the result suggests that divestitures are not necessarily value-creating events for all firms. They can even decrease the seller's value if the latter is a strong performer. However the impact on the shareholders of poorly performing firms can be quite significant.

The results can be contrasted with those of Lang and Litzenberger (1989) who show that the market reaction to dividend increases by firms with poor investment opportunities is highly significant while the reaction is insignificant for firms with good investment opportunities. The reasoning is similar to ours. In their case, the lower probability that the firm will make poor future investments is welcomed by investors. However, it only affects the value of firms that are likely to make poor investment decisions. In our case, the decision is related to assets already in place. Divestitures create value essentially when the opportunity cost of the divested assets is higher than their current value under the firm's control.

4. Conclusion

In this paper, we test the hypothesis that the difference in excess returns associated with divestiture announcements is related to the seller's ability to find more valuable uses for the divested assets outside the firm and the scope to enhance its own performance. Lagged stock performance is used as a proxy for the presence of such opportunities. Using a large sample of divestitures by French firms over the period 1990-2010, we find results consistent with our hypothesis. Divestitures create value mainly when opportunities for improving the firm's performance are substantial. In addition, the difference in excess returns is economically large and can be up to 4% higher for poorly performing firms. These results highlight a critical condition for divestitures to generate shareholder value. They also underline the importance of the market for asset sales explored in some recent papers (Maksimovic and Phillips, 2001; Warusawitharana, 2008).

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