Factors Influencing Corporate divestitures in South Africa

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IJMBE International Journal of Management, Business, and Economics

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Abstract

Corporate divestiture decisions are an important aspect of business from both a strategic and operational perspective. Since 1994 South Africa has experienced a significant increase in the number of companies divesting through either sell-offs or spin-offs. The study explores the determinants of corporate divestures for a sample of 103 companies listed on the Johannesburg Stock Exchange over the period between 2000 and 2013. Using a logit analysis the study finds that good corporate governance, high debt levels, stronger financial performance and economic conditions reduce the likelihood of a company undertaking a divestiture.

Keywords: Determinants, Corporate Divestitures, Spin-Offs, Sell-Offs, South Africa

1. Introduction

The purpose of this paper is to identify factors that lead to firm divestiture decisions in South Africa. A divestiture represents a "disposal of a division or controlling interest in a subsidiary company" (Cumming & Mallie, 1999) and it can take on different forms including a spin-off, sell-off or equity carve-out. A spin-off occurs when the shareholders of a parent company receive a distribution of the shares of a in proportion to their shareholding in the parent company (Cumming & Mallie, 1999). A spin-off result in management changes to the divested subsidiary but retains the shareholding of the parent company (Khan & Mehta, 1996). In the case of a sell-off, the parent company sells the subsidiary to a third party in return for some form of consideration (usually cash). In this case both the shareholders and the management of the divested unit change.

The decision to invest or divest are two very important decisions for any firm. It gives a reflection of the direction a firm is going to take in the future. Though both equally important, the analysis of the divestitures decisions have received less attention from researchers compared to investment decision (Haynes, Thomas and Wright, 1999; Holan & Toulan 2006). Investments have typically been considered a more proactive approach to management, whereas divestitures have been considered as a reactive approach and are thus associated with failure on management's part (Nees, 1978)

Previous studies on the antecedents to divestitures have largely focused on developed countries. The main findings that emerge from the literature are that financially weak firms and firms with a high level of debt are more likely to divest (Duhaime and Grant, 1984). On the other hand firms that devote a higher level of expenditure to research and development (R&D) are less likely to divest (Markides, 1992) as they maintain or increase their competitive position. Regarding corporate

governance factors, conflicting evidence has been found surrounding the effect of ownership concentration on divestment activity. In developed markets a positive relationship between ownership concentration and divestiture activity has been found (Bethel and Liebeskind, 1993) whereas a negative relationship has been found to exist in developing markets (Wu, Xu and Phan, 2011). The attractiveness of a firm's core industry has also been shown to have a positive relationship with divestment (Markides, 1992).

Little research has been done on the antecedents to divestitures in the South African context. Our literature review found one study by Chisanga (2013) that investigated this subject in South Africa. Chisanga (2013) investigated factors that lead South African firms to divest, however the analysis conducted was limited to financial factors. This paper contributes to the literature on divestment by focusing on the determinants of divestitures in South Africa. The study extends the study by Chisanga (2013) by investigating corporate governance factors, macroeconomic factors, which were not analysed in that study. The time period under consideration is 2000-2013. The study did not find any of the factors under consideration to significantly impact the divestment decision. The study finds that an increase in return-on-assets is predicted to decrease the likelihood of divestment Effective corporate governance reduces the probability of a firm engaging in divestitures as do stronger economic conditions.

The remainder of the paper is structured as follows: section 2 discusses the literature on the factors that affect the decision to divest, section 3 looks at divestment activity in South Africa, section 4 presents the data sample and discusses the research method, section 5 discusses the results of the investigation and finally section 6 concludes.

2. Literature Review

Several factors have been hypothesised to affect divestiture decisions; these include financial performance, corporate governance and macro-economic factors.

Financial performance is measured by relative fundamental measures such as return-on-equity, return-on-assets and market-to-book (Fluck and Lynch, 1999; Decker & Mellewigt 2007). Duhaime and Grant (1984) investigated the driving factors behind the decision to divest and found firm financial strength (measured by return-on-equity, and dividend yield) to be significantly related to divestment. Their findings indicated that financially weak firms are more likely to divest. This is consistent with the findings of Montgomery and Thomas (1988), Steiner (1997) and Decker & Mellewigt (2007). Montgomery and Thomas (1988) found that compared to industry counterparts, divesting firms exhibit poor performance in the year that precedes divestment. Using hazard function analysis, which incorporates the effect of time on divestitures, Ravenscraft and Sherer (1991) found that the most important factor in divisional sell offs by companies was poor accounting performance with low profitability at division level.

The level of debt also plays a role in the decision to divest, this is because the level of debt undertaken may act as a barrier to firms who want to change their investment portfolio (Markides, 1992). A firm's ability to buy and sell business units is dependent on its access to capital which in turn is affected by its debt burden. Debt has the effect of increasing the financial risk of a company. Funding new operations may thus prove to be a challenge as creditors may not be willing to lend to a company with a large amount of debt. Montgomery and Thomas (1988) found that divesting firms typically had higher debt ratios than non-divesting firms (this was the case both before and after divesture had taken place). Statistical techniques indicated that the differences were significant. This

is consistent with the findings of Steiner (1997) who analysed the decision of firms to undertake sell-offs. Haynes & Wright (1999) found that firms that had completed the process of divestment used the funds obtained to reduce the level of debt. This is similar to what Baker, Benjamin, Kuehl & Verdon (1996) found in their study on management views on voluntary sell-offs. These findings indicate the level of debt as a motivating factor for divestment.

The effectiveness of corporate governance systems has also been shown to influence divestment. Owen, She & Yawson (2010) hypothesise that effective corporate governance would be evidenced by firms divesting business units that are not measuring up to their productive capacity. They found that corporate governance efficacy (measured by board of director characteristics and shareholding structure) increases the chances of a firm undertaking a divestment.

The board of directors is primarily responsible for ensuring effective governance of the company. The board of directors and management determine and implement the strategic direction of the firm and the decision to divest represents a strategic decision in a firm. The composition of the board is often a proxy for measuring corporate governance efficacy (Hoskisson, Johnson & Moesel 1994). Haynes & Wright (1999) found that board composition – measured by the ratio of non-executive directors to executive directors – exhibits a significant positive relationship with a firm's responsiveness to changing market conditions thus increasing the likelihood of divestment where underperforming assets have been identified. Hoskisson, Johnson & Moesel (1994) found that management who has to answer to a board of directors made up of majority independent directors is less likely to take decisions that are not in the best interest of shareholders

Shareholding structure is also an indicator of corporate governance. Shareholding structure is affected by the presence of blockholders as well as the type of the shareholder. Firms that have single shareholders that own at least five per cent of the company (blockholders) tend to reduce the level of diversification and increase divestment activity (Bethel and Liebeskind, 1993; (Hoskisson, Johnson & Moesel 1994). Given their shareholding, blockholders have the ability, through their voting power, to influence strategic decisions. Their large shareholding gives them more of an incentive to ensure that the firm makes decisions that are in their interest as a large amount of their equity is at risk. Consistent with Jensen & Meckling, (1976) and Alchian & Demsetz (1972), Johnson (1996) found that in the case where shares are diffusely held, shareholders do not have a large incentive to check the progress and quality of a firm's strategy. If certain assets are not performing at a level that yields desirable returns then blockholders are likely to exert their influence in prompting the divestment of those assets. This view is consistent with what Owen, She & Yawson (2010) hypothesise about the behavior of well-managed firms.

Wu, Xu & Phan (2011) examined the relationship between ownership concentration (indicated by the presence of blockholders) and divestiture decisions in Chinese firms. Their findings indicate a strong negative relationship exists between divestiture and ownership concentration. The reason for this finding, which is contrary to that of Bethel & Liebeskind (1993), can be attributed to the different objectives of the shareholders. In the Chinese context it is the government that is the majority shareholder in most companies. This structure arose from the inability of Chinese banks to support the shift of the Chinese economy to a market-driven one (Aharony, Lee & Wong 2000). The objectives of the state differ significantly from the objectives of private individuals and institutions. The former is concerned with social welfare while the latter are profit-seeking. The state is inherently averse to engaging in divestment (even if a business is operating below operational capacity) as it would involve people losing their jobs which negatively affects social welfare (Wu, Xu & Phan 2011) Value destroying businesses are thus maintained in the interests of social welfare but at the

expense of minority shareholders. The divergent objectives of the private and public sector thus lead to these findings.

Other corporate governance factors that have been hypothesised to impact the divestment decision are CEO tenure and managerial turnover (Ahn & Walker, 2007; Cumming & Mallie, 1999; Berger & Ofek, 1999). In their study on divisional sell-offs, Ravenscraft & Scherer (1991) found that managerial turnover (as measured by CEO turnover) had a positive, though not significant, relationship with divestment activity. This is similar to the results of Markides' (1992) study. These findings suggest that poor management or management that has been in place for a long period of time avoids undertaking divestitures, whereas new managers tend to be more willing to divest. This view is supported by research done by Lindgren & Spangberg (1981). Haynes & Wright (1999) also found that firms that had undergone a change in management displayed a higher level of divestment activity.

The level of diversification of a firm has also been shown to influence the likelihood of divestment. One of the main reasons that firms invest in new businesses is to increase the level of firm diversification. (Hoskisson, Johnson & Moesel (1994) suggest that one of the reasons that managers invest is to increase firm size in order to increase their remuneration. As a result, managers may invest in assets that do not necessarily increase shareholder value. If managers invest in assets that do not add value to the company, then that will prompt divestment in the future as those investments will perform poorly. This is one of the reasons that divestment may have a negative connotation associated with it as suggested by Nees (1978). Markides (1992) found that firms that have higher levels of diversification relative to their industry competitors are more likely to divest. Lindgren & Spangberg (1981) suggest that this is because as firms become increasingly diversified, the complexity of strategic management also increases and so limits the efficiency of management.

Economic conditions are also said to impact the decision to divest. During times of high economic uncertainty it is more likely that highly diversified firms will reduce their investments in various business units (Johnson, 1996). This may be because companies' resources may come under pressure in periods of economic turmoil. Holan and Toulan (2006) investigated the institutional effects on the timing of divestitures in emerging economies. They used divestment data from Argentina, with a focus on transactions that exceeded US$1 million, for the period 1990 - 2002. They hypothesised that divestitures would cluster around periods of economic turmoil and uncertainty in the macro environment. Their proxy for economic turmoil was the Argentine recession. Examining the frequency of divestitures in the period 1990 – 2002, they found that 95% of divestitures occurred after 1997 which is the period after Argentina went into recession thus indicating the effects of macroeconomic conditions on divestitures. Duhaime and Grant's (1984) findings however differ on the impact of economic conditions as they find that economic conditions do not have a significant impact. Their findings suggest that it is primarily factors internal to rather than external to the business that prompt the decision to divest.

Depending on the attractiveness of the firm's core industry, a firm may choose to divest units unrelated or related to that core. Markides (1992), in his investigation of the economic characteristics of de-diversifying firms, used three variables as proxies for industry attractiveness. These were: advertising intensity of firm's core business, the concentration ratio of the firm's core business and the average profitability of the firm's core business. The estimated model produced significant coefficients on all the variables indicating that the more attractive a firm's core industry is, the more likely a firm is to divest unrelated units and focus on its core industry. This is also supported by research that indicates that refocusing activities have been performed particularly by firms that have

experienced large losses in profitability due to over-diversification and firms that have diversified into unrelated business units (Fluck and Lynch, 1999).

Research and development (R&D) assists firms in remaining competitive and continuing to improve relative to themselves and relative to industry counterparts. Firms that devote a higher level of expenditure to R&D are less likely to divest (Markides, 1992). Hamilton and Chow (1993) found that once firms had divested, they used the excess capital to reinvest in and develop the main activities of the business. This illustrates that the level of R&D is also a factor that is considered to impact the divestment decision.

3. Data Sample & Research Method

3.1 Sample selection

A sample of 483 divestitures that took place between 1990 and 2013 was obtained from the McGregor BFA database. All divestitures that took place before the year 2000 were dropped from the sample leaving 165 observations. Divestitures were then classified as either being spin-offs or sell-offs and observations that could not be classified were removed from the sample. Information on the variables of interest (to be discussed further in the Variables section) was collected for each of the remaining companies for the year that preceded each of the divestitures. This is consistent with Wu, Xu & Phan (2011) who lagged their independent variables by one period. Only companies for which a full variable list could be compiled were retained in the sample, leaving us with a sample of 50 divestitures. 44 of the 50 divestitures were spin-offs and the remaining six were sell-offs. Next a sample of matched companies that did not engage in divestitures in the same period as the divesting companies was obtained. Companies were matched firstly by industry and secondly an attempt was made to match companies closely by total assets. We limited the search to companies that were listed on the JSE in the same period as the divesting companies in order to remain consistent with those companies that had engaged in divestitures as well as to ensure availability of information for our data collection process. This brought our final sample of companies to 103, 50 of which engaged in a divestiture and 53 that did not.

3.2 Variables

The dependent variable is a binary variable, coded as 1 for a company that engaged in divestiture and 0 for a company that did not. The independent variables fall into three categories: financial and debt, corporate governance and economic. The data for all financial variables was sourced from company financial statements as well as from the McGregor BFA database and the information for the economic variables was sourced from the South African Reserve Bank (SARB) website. The financial performance variables are return-on-equity (ROE) and return-on-assets (ROA) and the firms' debt position is measured by the debt-to-equity ratio. The corporate governance factors are CEO tenure, the number of non-executive directors on the board and total blockholding (where total blockholding represents the total percentage of shares held by all blockholders). In this paper blockholders are shareholders who hold in excess of 3% of a company's shares. In most literature blockholders are considered to be shareholders that hold in excess of 5% of a company's shares. In our investigation of the financial statements of various companies, shareholders who hold in excess of 3% were consistently reported and are thus considered important. The economic variables are the level of the JSE all share index and GDP per capita. In Holan & Toulan's (2006) study one event – the Argentine recession – was used as a proxy for economic turmoil. It was thus decided the closest measures of economic conditions would be the level of JSE all share index given that it tends to be a

leading indicator of the economy and the level of GDP per capita as it measures whether the overall economy expanded or contracted in various periods.

3.3 The Model

A logistic regression was deemed the most appropriate model to use in the analysis because it measures the effect that various factors have on the probability of divestiture occurring. The model is as follows:

P(Divestiture=1|Independent Variables) = f(ROE, ROA, Debt-to-equity, CEO Tenure, Non-executive Directors, JSE ALSH, GDP Percapita).

The choice of this model is supported by authors who have previously performed similar investigations and includes Ravenscraft & Scherer (1987; 1991), Markides (1992) and Chisanga (2013).

4. Results

The results of the logistic regression are reported in table 1. The coefficients are reported along with the standard errors which appear in brackets below the coefficients. For a logistic regression either the log of the odds ratios or coefficients can be reported. Coefficients are elected in this paper for ease of interpretation. The coefficients associated with each variable indicate the direction of the effect that a particular factor has on the probability of a firm engaging in a divestiture. A positive coefficient suggests that a particular variable increases the probability of a firm engaging in a divestiture while a negative coefficient suggests a factor has the effect of reducing the probability of a firm engaging in a divestiture.

Table 1 The Results of Logistic Regression Analysis

Factor	Coefficient (Standard Error)
Debt-to-Equity	-0,00678
	(0,04339)
ROA	-0,00637
	(0,02081)
CEO Tenure	-0,01093
	(0,03871)
Number of Non-Executive Directors	-0,01692
	(0,06426)
Total Blockholding	-0,01865
	(0,00947)
GDP Per Capita	-0,00016
	(0,00096)
JSE	-0,00001
	(0,00005)
Constant	2,02018
	(4,44625)

Number of Observations	103
LR chi (8)	6,13
Prob > chi2	0,63290
Pseudo R2	0,04340
Log likelihood	-67,61736

The overall model is not significant. This indicates that the factors examined do not have a strong explanatory power. Despite this result, the coefficients will still be analysed though the limited significance of the model should be kept in mind.

Looking at the financial factors the coefficient attached to ROA indicates that stronger financial performance reduces the likelihood of a company engaging in a divestiture. This finding is consistent with the literature presented (Chisanga 2013; Decker & Mellewigt 2007). Higher debt levels are predicted to reduce divestment activity. The finding on debt is in contrast the findings of Montgomery and Thomas (1988), Steiner (1997) & Baker, Benjamin, Kuehl & Verdon (1996) who reported that positive relationship between the level of debt and divestment activity.

Examining the corporate governance factors, the number of non-executive directors and total blockholding reduce the likelihood of divestiture. The coefficient attached to total blockholding is almost significant at the 5% level. These findings indicate that stronger corporate governance tends to reduce divestiture activity. This is consistent with the findings of Owen, She & Yawson (2010) though presented from a different perspective. Owen, She & Yawson (2010)found that strong corporate governance increases the likelihood of firms engaging in divestiture activity. The reason for this is that firms with effective corporate governance are expected to divest business units that are not yielding the expected returns. The results in this paper indicate that stronger corporate governance reduces the likelihood of a firm engaging in divestiture. The reason behind this may be that effective corporate governance will prevent the existence of non-performing assets in a business thus reducing the need for undertaking a divestiture in the future. An increase in CEO tenure is also expected to reduce divestment activity. This is consistent with the finding that management that has been in place for a longer period of time is less willing to engage in a divestiture. It also supports the finding that divestment activity is more likely to increase with management turnover.

The economic factors suggest that a stronger economic environment reduces the chances of a company divesting its assets as the coefficients attached to both variables are positive. Although economic factors were not found to be statistically significant, an examination of the frequency of divestitures reveals that they are clustered around periods of economic turmoil. This includes the period 1999 - 2001. This time period saw the emerging market crisis due to the Asian financial crisis of 1997, the Russian financial crisis of 1998 as well as the Argentinean great depression that began in 1998. The global economy also experienced a recession in the early 2000s. Table 2 indicates that 38% of the divestures occurred in the period 1999 – 2001 supporting the idea that economic unrest increases divestiture activity. The most recent example of economic turmoil was the global financial crisis of 2008. Looking again at table 2 we see that 26% of divestitures occurred from 2008 – 2010. This finding that divestitures occur around periods of economic uncertainty is consistent with the findings of Holan and Toulan (2006).

Table 2 Frequency of Divestitures in South Africa

Prior Year	Frequency	% of total
1999	9	18%
2000	4	8%
2001	6	12%
2002	2	4%
2003	1	2%
2004	0	0%
2005	2	4%
2006	5	10%
2007	3	6%
2008	3	6%
2009	6	12%
2010	4	8%
2011	4	8%
2012	1	2%
Total	50	100%

5. Conclusion

The aim of this paper was to identify factors that affect corporate divestiture decisions in South Africa. The main factors considered were the financial performance of a company and the level of debt, corporate governance and the macroeconomic conditions. The findings of this investigation reveal conflicting evidence regarding financial performance. Financial performance as measured by ROA is associated with a decline in the probability of a company engaging in a divestiture. Higher debt levels are predicted to reduce divestiture activity. Stronger corporate governance has the effect of reducing the likelihood of divestiture activity as do stronger economic conditions. Though the findings were not statistically significant the expected effects were mostly in line with what has been found in previous studies.

Most of the companies in our sample divested through a spin-off rather than a sell-off and as such our results might be more related to spin-offs rather than divestiture activity as a whole. Future research in the area of corporate divestiture could explore the difference between the characteristics of companies that engage in spin-offs versus sell-offs. Divestiture as a strategic tool in the South African market is also an area that could be further explored.

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