The Impact of Divestitures on the Financial Performance of South African Companies

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Abstract

This study examines the effect of divestitures (sell offs and spin offs) on the financial performance of the parent companies that divested over the period 1993-2010. In addition the study makes a comparative performance of sell offs and spin offs. The study examined 68 companies listed on the Johannesburg Stock Exchange. The study reports a consistent decline in profitability, operating efficiency and leverage for periods of up to three years after divestiture. A comparison of sell offs and spin offs revealed that spin offs results in superior profitability performance in relation to sell offs while sell offs showed a higher improvement in operating efficiency.

Keywords: Divestiture, Sell-Off, Spin-Off, Financial Performance

1. Introduction

Divestitures, also referred to as unbundling, are a form of restructuring that allows firms to streamline and refocus their operations to unlock shareholder value. Shareholder value is achieved through improved efficiencies and financial performance which is reflected in share price appreciation. According to (Moschieri & Mair, 2006), divestitures are described as a complete disposal of a subsidiary, business unit or division by a parent company; they come in different forms which include spin-offs, sell-offs, carve outs, split offs, leveraged buyouts and management buyouts. For the purpose of this study, a review of divestitures will be limited to sell-offs and spin-offs. A spin-off occurs when a certain asset, such as a division of the parent company, is divested and then listed as an independent public company with shares in this newly formed company being distributed to existing shareholders of the parent company. On the other hand, sell-offs involve an asset or business unit being sold for cash or securities to another company (Bhana, 2006).

The effects of divestitures on firm performance have been investigated from two perspectives; firstly, based on an analysis of the response of stock prices in the short and long term window periods (event studies) and secondly, an analysis of financial performance based on reported accounting information. The latter perspective is motivated by the inability of the stock market to determine whether corporate restructuring activities create real economic gains and to identify the sources of such gains (Healy, Palepu, & Ruback, 1992). This view was supported by (Gadad & Thomas, 2004a) who highlighted the need for accounting based studies because stock price based event studies do not determine whether divestitures are associated with real economic gains.

Most researchers in the developed markets and in South Africa (SA) have adopted an event study approach using the stock market response to divestiture announcements. Very few studies have analysed the impact of divestitures on financial performance of the parent firms. In SA the literature review found five studies that investigated the performance of firms after divestiture. The studies examined the stock market response in the short and the long term and they reported contrasting results. (Geoffrey & Sinclair, 1996)(Jordan, 2012) analysed the stock market response around the announcement date and reported significant negative results (as reflected by negative cumulative abnormal returns (CAAR)) on shareholder wealth after divestiture events. The results from the aforementioned two studies on SA were not only inconsistent with the majority of prior studies from developed markets that reported significant positive results (positive CAAR) but they contradicted the results of two SA studies by (Bhana, 2004) and (Bhana, 2006) which reported significant positive stock market response after divestiture.

The contrasting and inconclusive results from the five stock market based SA studies clearly indicate the inability of the stock market price event studies to determine whether divestitures create real economic gains or losses and to identify the sources of such gains or losses (Daley, Mehrotra, & Sivakumar, 1997) (Gadad & Thomas, 2004b). Therefore, as pointed out by (Healy et al., 1992), an investigation into the effect of divestitures of financial performance can help to unpack the sources of the negative or positive results that were reported by prior studies. We found one study in SA that investigated the impact on financial performance. The study by (Bhana, 2004) focused on spin offs only and left out sell offs. Using the return on assets (ROA) and sales growth to capture performance, the study reported significant improvements in operating performance as a result of divestitures.

This study investigates the impact of divestitures on the financial performance of SA companies. Similar to (Healy et al., 1992) and (Gadad & Thomas, 2004a) the study is motivated by contradictory results that were reported by five studies that investigated divestitures, in South Africa, from the stock market perspective. This study uses data based on accounting measures of performance to investigate the financial performance of parent companies that divest their operations. As in (Daley et al., 1997), the financial performance is captured by examining the change in efficiency, profitability and solvency ratios over periods of one, two and three year's pre and post divestiture announcement. The study reviews the financial performance of 68 listed firms in South Africa that have embarked on at least one divesture between 1993 and 2010. Given the differences between spin offs and sell offs, this study goes further to make a comparison of how each affects financial performance.

The study reports a consistent decline in profitability and efficiency over the three periods under consideration. The decline in operating efficiency is statistically significant for the three periods, while the profitability decline is statistically significant three years after divestitures and the decline in leverage is statistically significant over the three periods. The results support the findings by Blount and Davidson (1996), (Jordan, 2012) and (Nichols et al., 2013). The results may imply that the negative results reflected by the negative cumulative abnormal results on stock market prices are supported and were driven by the decline in financial performance that ensues after divestiture activities. The study therefore concludes that divestitures do not improve the profitability and operating efficiency of the parent company. A comparison of sell-offs and spin-offs revealed that spin offs results in superior profitability while sell offs record a higher improvement in operating performance and efficiency.

2. Literature review

Poor financial performance due to over diversification has been reported as one of the antecedent factors to divestitures (Markides, 1995). This finding implies that one of the possible motivations for a divestiture is to increase the focus of the seller's operations with the idea of improving financial performance of the parent's remaining assets. The improvement in performance may be driven by various factors, such as elimination of negative synergies with the divested asset or increased efficiency arising from better allocation of management time and other resources in a more focused firm (John & Ofek, 1995). The majority of the prior studies on the effect impact of divestitures on financial performance have focused on developed countries and have they reported improved financial performance a few years after the events. Table 1 below presents the results from prior studies that looked at the impact of divestitures on financial performance.

Table 1: Results from prior studies on the impact of divestitures on the financial performance of parent firms

Authors	Period	Divestiture type	Country/ Region	Performance indicators	Sample size	Results
(John & Ofek, 1995)	1986-1988	Spin & Sell off	Europe	Return on assets (ROA)	164	Significant improvement
(Sun, 2012)	1995-2004	Sell off & Carve out	Taiwan	ROA, Cash flow/Debt Excess Value	266	Significant improvement
(Gadad & Thomas, 2004b)	1985-1991	Sell off	UK	Operating cashflow return, ROA	74	Significant improvement
(Dasilas, Leventis, Sismanidou, & Koulikidou,)	2000-2009	Spin off	USA & Europe	ROA, EBITDA/TA CAPEX/TA	239	Significant decline
(Daley et al., 1997)	1975-1994	Spin off	USA	ROA	85	Significant improvement for the cross industry spin off parent
(Prezas & Simonyan, 2013)	1980-2006	Spin off Sell off	USA	Operating income before depreciation(OIBD)/Assets; Profit margin ROA; OIBD/Sales	322 Spin off 3280 Sell off	Significant improvements Higher improvements for sell offs
(Bhana, 2004)	1988-1999	Spin off	South Africa	ROA, Market to Book ratio	47	Significant improvements
(Haynes, Thompson, & Wright, 2002)	1985-1993	Divestitures type not specified	UK	ROA; Debt ratio; Debt/equity	132	Significant improvements
(Denis & Shome, 2005)	1985-1994	Divestitures type not specified	USA	Operating income/Total assets; Debt ratio; Market to book ratio Operating income/Sales	130	Significant improvements in ROA Leverage ratios insignificant

3.0 Research methodology

3.1 Sample selection

The initial sample of 216 companies was obtained from the JSE information desk. The sample consisted of parent companies that divested through either sell offs or spin offs over the period 1993-2010. Data relating to the type of divestiture (sell off or spin off) was sourced from various company financial statements as well as from South African News Service (SENS) announcements and news articles.

The following criterion was used to select divestiture events to be included in the final:

- The company listed on the JSE at least three years before the divestiture event
- It remained listed on the JSE at least three years after the divestiture event
- The company has financial data available on the McGregor BFA database over the period June 1990 to June 2013
- Only the most recent divestiture is taken into consideration for those companies that have more than one divestiture event occurring within the seven year analysis period (3 year pre-divestiture, event year, and three year post-divestiture).

After taking into consideration the above adjustments, the final sample consists of 68 divestiture events from an initial sample of 216 divestiture events. Of the 68 divestiture events, 17 of them were sell-offs; 31 spin-offs; and the remaining 20 did not specify the mode of divestiture chosen. The table below shows descriptive statistics detailing the number of divestiture events grouped into three year intervals between 1993 and 2010.

Table 2 Companies that divested over the sample period

Period	Number of unbundling events
1993-1995	17
1996-1998	21
1999-2001	9
2002-2004	6
2005-2007	6
2008-2010	9
Total	68

3.2 Empirical analysis

Given that the most recent studies that investigated the impact of divestitures on shareholder wealth using stock market data reported negative results, we expect the divestitures to result in a decline in the financial performance of the parent firms. We therefore formulate the following hypotheses:

3.2.1 Profitability

H_0: Divestitures on average does not result in an increase in profitability for companies over the long term.
H_1: Divestitures on average increases the profitability of companies over the long term.
Rejecting the null hypothesis would signify that divestiture on average improves profitability.

3.2.2 Efficiency

H_0: Divestitures on average does not result in an increase in efficiency for companies over the long term.
H_1: Divestitures on average increases the efficiency of companies over the long term.
Rejecting the null hypothesis would signify that on average divestiture results in the remaining assets being more efficiently utilised.

3.2.3 Leverage

H_0: Divestitures on average does not result in an increase in leverage for companies over the long term.
H_1: Divestitures on average increases the leverage position of companies over the long term.
Rejecting the null hypothesis would signify that on average divestiture results in companies being more leveraged.

3.3 Financial performance indicators

For the purpose of this study, to test the abovementioned hypotheses, the following accounting-based measures, as outlined in table 2, have been chosen.

Table 2 Financial performance indicators

	Financial Performance Indicators	**Definition**	**Hypothesis tested**
Profitability	Return on equity: (ROE) Return on assets: (ROA)	$\frac{\text{net profit after tax}}{\text{Shareholder funds (captial + reserves)}}$ $\frac{\text{net profit before interest and tax}}{\text{Total assets}}$	1
Efficiency	Total asset turnover(TAT) Cash flow to turnover (CF/T)	$\frac{\text{Turnover}}{\text{Total assets}}$ $\frac{\text{Operating cash flow}}{\text{Turnover}}$	2
Leverage	Gearing ratio (D/E) Debt ratio(D/A)	$\frac{\text{Total debt}}{\text{Equity}}$ $\frac{\text{Total debt}}{\text{Total assets}}$	3

The indicators above have been selected as they are a prominent feature in previous restructuring studies and are commonly used to gauge financial performance. The use of cash flows and operating profit for the calculating the cash flow turnover ratio and return on assets respectively is driven by the fact that they represent the actual economic benefits generated by the remaining assets and they are also less susceptible to accounting manipulation (Healy et al., 1992).

For each of the indicators in Table 2, a pre-divestiture average for one, two and three years and a post-divestiture average of one,two and three years will be recorded as follows:

- The year of divestiture is denoted as t=0 and not included in the estimation period
- Pre-divestiture average performance: $\sum \frac{indicator}{3}_t$ [where, t= -3,-2,-1] (1)
- Post -divestiture average performance: $\sum \frac{indicator}{3}_t$ [where, t= +1,+2,+3] (2)

The average pre- and post- divestiture performance for each of the indicators will be compared using a paired t-test to determine if there is a significant difference in financial performance before and after the event. The analysis will be conducted at a 5% significance level. The paired t-test is considered to be the most appropriate as each pair of companies in the sample is not independent; this method is consistent with that used in other studies (Singh, 1993), (Vanitha & Selvam, 2007), (Jordan, 2012). Additional analysis is conducted to compare whether there exists differences in financial performance post-divestiture, across industry sectors. This is achieved by separating companies within the final sample by industry and calculating industry specific averages for each of the indicators of interest.

In addressing the secondary consideration, the final sample is grouped in terms of spin-offs and sell-offs. The average performance indicators are then calculated for each mode of divestiture. Data for each of the indicators, during the sample period, is sourced from McGregor BFA and supplemented by extracting data from company financial statements found online.

Financial crisis of 2008

The sample period for the study spills into the financial crisis period that started in 2008. Given that the financial crisis negatively affected the performance of companies, there is a possibility that the results of this study can be compromised. To account for this, all the tests will be re-run after eliminating the data from 2008 going forward going forward.

4. Results & interpretation

This section presents the results of the effect of divestitures on the financial performance of SA companies. The full sample is analysed for the full sample of 68 companies over three periods; one, two and three years pre and post divestitures. The study also presents the results of a comparative performance analysis between companies that divested through sell off and spin off methods. Overall the study observed a significant decline in the average financial performance after divestiture. The study shows a decline in profitability and efficiency and the tendency for companies to become less leveraged after divestitures. A comparison of the financial performance between spin offs and sell offs shows that spin offs record superior profitability than sell offs. However sell offs show a higher improvement in efficiency compared to sell offs. A re-run of the data after excluding the companies that divested during and after the financial crisis of 2008 does not seem to have an effect on the results. (The results are not presented in this paper but they are available on request)

In Table 3 below, the ROE, ROA, CF/T, TAT, D/A and D/E averages are presented for the pre- and post- divestiture. The table also presents the t-statistics and p-values to indicate whether the results of pre divestiture announcement period are significantly different to the post divestiture announcement period.

Table 3 Mean Pre- and Post-divestiture Performance Indicators

Year	**1**		**2**		**3**	
Variables	**Pre (-1)**	**Post (+1)**	**Pre (-2)**	**Post (+2)**	**Pre (-3)**	**Post (+3)**
Profitability						
ROE						
Mean (%)	20.0978	18.9284	18.6701	17.2814	18.1388	15.2534
T-stat paired	-0.2193		-0.3886		-0.2706	
P-value (1 tail)	0.4135		0.3605		0.3934	
ROA						
Mean	9.1586	11.5756	10.8070	10.1798	11.0659	6.4371
T-stat paired	1.104		-0.3186		-1.6079	
P-value (1 tail)	0.1368		0.3755		0.0563*	
Operating efficiency						
CF/TA						
Mean (%)	27.9432	-21.5162	23.9040	0.5012	22.2813	0.3726
T-stat paired	-1.3904		-1.3029		-1.8077	
P-value (1 tail)	0.0853*		0.0993*		0.0383**	
TAT						
Mean	0.9265	0.8213	0.9110	0.8229	0.9127	0.8081
T-stat paired	-1.4508		-1.4594		-1.7460	
P-value (1 tail)	0.0758*		0.0746*		0.0427**	
Leverage						
D/A						
Mean (%)	0.4123	0.3672	0.4057	0.3639	0.4068	0.3652
T-stat paired	-1.8149		-1.8402		-1.8864	
P-value (1 tail)	0.0371**		0.0352**		0.0319**	
D/E						
Mean (%)	1.4085	1.3461	1.1387	1.3299	1.1875	1.3139
T-stat paired	-0.1777		0.7293		0.4975	
P-value (1 tail)	0.4298		0.2342		0.3102	

3.2.3.1 **DF: 67 with the exception of CF/T (DF: 50)**

3.2.3.2 **Significant at the 5% level; * Significant at the 10 % level

4.1 Profitability

After divestiture, profitability is expected to increase as companies hone in on their more profitable ventures and move to enhance operational efficiency as suggested by the focus hypothesis (John & Ofek, 1995). However, this does not hold true in the South African context. The average profitability ratios show a decline after divestiture announcements. The ROE declined from 20.098% to 18.93% over one year period, from 18.67% to 17.28% over the two year period and from 18.14% to 15.25% over the 3 year period and the difference between the pre and post-divesture results for the ROE are insignificant for the three periods and for the two ratios. The ROA shows an improvement from 9.16% to 11.58% over the one year period but it starts to decline over the two and three year periods. The ROA decline over the two year period is statistically significant at 10% level. As a result of these findings the null hypothesis is not rejected. Therefore, divestiture, on average, does not result in an increase in profitability over the long term.

4.2 Efficiency

As a result of divestiture, the company's asset base declines and the remaining assets are expected to be utilised in a more efficient manner by channelling resources to the areas of the business that may need it. The efficiency ratios, the CF/T and TAT, all show a statistically significant decline over the one, two and three years under consideration. This suggests that the average efficiency of the sample companies decreased three years after divestiture. Thus, H_0 of the efficiency hypothesis cannot be rejected; hence, divestiture does not result in an increase in efficiency, on average, over the long term.

4.3 Leverage

If the motive to unbundle is to decrease debt levels of the company, it is expected that divestiture will reduce the leverage position of the company post-divestiture. The D/A declined from 0.41 to 0.37 in year one, in year it declined from 0.41 to 0.36 and in year three it fell from 0.41 to 0.37 and the declines are statistically significant at a level of 5%. These findings are consistent with that of Denis & Shome (2005) who found lower debt ratios in the years after divestiture. The D/E, however, increased from 1.187 to 1.314 times but this result was statistically significant. As a result of these findings the null hypothesis cannot be rejected. Hence divestitures on average do not result in an increase in the leverage position of companies.

4.4 Sell-off versus Spin-off

A comparison is drawn between the financial performance of companies that pursued sell-offs and those that chose to unbundle via spin-offs. The comparison is based on the data for three years pre and post divestiture.

Despite declining financial performance observed overall for the entire sample, certain financial performance indicators were found to increase for sell-offs and/or spin-offs group. This suggests that the mode of divestiture chosen may signal expectations of the companies' future performance in terms of profitability, efficiency and leverage. Table 5 presents the results of the grouped sample of sell off and spin offs.

Table 5 The mean results for sell-offs versus spin-offs companies over the 3 year period, pre and post divestiture.

Financial ratios	Sell-off (n=17)		% Change	Spin-off (n=31)		% Change
	Pre	Post		Pre	Post	
Profitability:						
ROE	15.048	11.509	-24%	19.911	35.719	79%
ROA	10.002	6.147	-39%	9.041	5.829	-36%
Efficiency:						
CF/T	7.354	10.164	38%	19.298	-12.466	-165%
TAT	0.83	0.834	0%	0.994	0.776	-22%
Leverage:						
D/A	0.444	0.453	2%	0.392	0.348	-11%
D/E	2.297	2.839	24%	0.957	0.744	-22%

From the final sample (n=68) 20 companies did not specify the method of divestiture.

4.4.1 Profitability

Companies in both groups showed a declining ROA result which is consistent with the result found for the entire sample but spin offs fared better as they had a lower decline. As far as the ROE concerned a significant improvement is observed compared to a decline for the sell-off group. Overall spin offs experience as superior performance in profitability compared to sell offs.

4.4.2 Efficiency

A comparison of the efficiency ratio show sell offs experience a superior levels of efficiency compared to spin offs. Spin offs experienced significant declines in CF/T and TA/T while sell off experienced significant improvements for CF/T and a marginal increase in the TA/T. This indicates that sell offs experience a general increase in operating cash flow compared to spin offs.

4.4.3 Leverage

Overall, it is found that both leverage levels increased post-divestiture for the sell-off group whilst the converse is true for the spin-off group, which experienced lower efficiency and leverage levels, consistent with the results of the entire sample. The increase in leverage for sell offs can be an indication that companies are taking on more debt after the selloff events, this coupled with the decline in leverage from the spin offs group is consistent with hypothesis that spin offs are considered to have the effect of reducing bonding and agency costs compared to sell offs (Woo, Willard, & Daellenbach, 1992).

5. Conclusion

The study investigates the impact of divestitures on financial performance of SA firms listed on the JSE. In addition the paper makes a comparative performance of spin offs and sell offs. A sample of 68 divestiture events that occurred between 1993 and 2010 was studied. The financial performance was analysed by comparing the average pre and post divestiture performance over one, two and three years for parent companies. The financial performance was measured by profitability, efficiency and leverage ratios.

The empirical results refute the hypotheses, from prior research, that divestitures enhance financial performance. The study reports a consistent decline in operating efficiency and profitability after divestitures. Hence the study concludes that divestitures result in a decline in financial performance and leverage. The decline in financial performance can be viewed as the source of the negative results that were reported by prior studies (Geoffrey & Sinclair, 1996), (Jordan, 2012), (Nichols et al., 2013) that examined the impact of divestitures on stock market performance.

A comparison of sell offs and spin offs revealed that spin offs results in superior profitability performance in relation to sell offs while sell offs record a higher improvement in operating performance and efficiency. Leverage also increases with sell offs compared to spin offs.

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