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Divestiture and performance: A study of the relationship between divestiture and company performance

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DIVESTITURE AND PERFORMANCE: A STUDY OF THE RELATIONSHIP BETWEEN DIVESTITURE AND COMPANY PERFORMANCE

by

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BY

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GRADUATE COLLEGE
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Neil D. Gilchrist, Ph.D.

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This research examined the relationships existing between the divestiture of a portion of a company and the subsequent performance of the divesting company. Of additional interest was whether significant performance differences were exhibited by companies divesting for different reasons, changing diversification levels, and size of divestiture.

This study measured the effects of divestiture on the overall performance of the divesting company and the impact of the divestiture on the shareholders of the firm.

Overall company performance was measured by the profitability ratio, Return On Equity. Shareholder welfare was measured by the cumulative abnormal return to shareholders.

The research results support the contention that divestiture is an often used, unique, and important strategic option in the management of companies.

This research presents findings of interest with respect to the overall effectiveness of divestiture, the reasons for divestiture, and returns to shareholders. Little evidence was found that suggested the overall performance of companies improved after divestiture. The reasons given by companies for the divestiture had little effect on the subsequent performance of the firm. Change in diversification level demonstrated little impact on firm performance. The size of the divestiture (as a percentage of parent firm's total assets) had little effect on overall firm performance. The findings pertaining to shareholder wealth suggest that the stated reason for divestiture and the size of the divestiture do have significant effects on shareholder returns, but the diversification level does not.

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Statement of the Problem

Strategic management is the continuous process that attempts to fit the organization with its environment in the most advantageous way possible (Digman, 1990). A key element in this process is the selection of strategy, i.e., the pre-selected approach the organization will use to cope with its ever-changing environment. One corporate-level strategy available to the organization is asset redeployment through divestiture.

While other corporate-level strategic options such as diversification and acquisition often emphasize organizational growth, divestiture can be a means of down sizing the firm. Perhaps the growth orientation of most organizations in the private sector (and many in the public sector) explains why relatively little empirical research has been conducted concerning the effectiveness of the divestiture strategy.

An important aspect of the divestiture strategy involves the reason the parent firm is divesting a

division or subunit. This strategy of down-sizing the organization may be selected for various reasons: poor performance of the unit to be divested; a poor strategic fit with the parent organization; as part of changing the business unit mix of the organization; a need for cash by the parent for debt reduction; competitive pressure; threat of hostile action against the parent by another firm; or perhaps just an "irresistable purchase offer" from another company. Divestiture strategies are being used regularly in today's business environment under the assumption that the overall performance of the divesting parent can benefit from the transaction.

Voluntary divestitures (i.e., not a result of antitrust or similar legal actions) in 1981 alone exceeded $12 billion (Hearth and Zaima, 1984). According to Mergers and Acquisitions (January 1986) divestitures increased to $40 billion in 1985. Divestiture is big business and has a major impact on the divesting firm.

The purpose of this research was to examine the effect of a divestiture on the subsequent performance of the divesting firm. Of additional interest were the reasons for the divestiture: Are there any significant differences in performance between firms stating different reasons for the divestiture? This research is unique in

its efforts to compare the underlying reasons for divestiture and performance of divesting firms.

Importance of the Research

An important area of interest to researchers in the strategic management field is the relationship between organization performance and organization characteristics such as size, stage of organization's life cycle, and stated strategy. Hambrick (1980) has suggested that the relationship between strategy and overall organization performance may be the most important aspect of research in this area. Considering how often divestiture is used, relatively little empirical attention has been given to this strategy.

Therefore, this study contributes to the field of strategic management by examining relationships between one particular strategic option of corporate management--i.e., divestiture--and overall firm performance. Of additional interest are any performance differences demonstrated by firms giving different reasons for the divestiture. This area of research has not been explored previously.

This research is relevant not only to academicians,

but also to top corporate management and other stakeholders of the divesting firm (e.g., investors and creditors).

Background

History of Strategy

> The pattern or plan that integrates an organization's major goals, policies, and action sequences into a cohesive whole. A well-formulated strategy helps to marshal and allocate an organization's resources into a unique and viable posture based on its relative internal competencies and shortcomings, anticipated changes in the environment, and contingent moves by intelligent opponents. (Quinn, 1980, p. 7)

Although the above definition of strategy was written in 1980, the concept of strategy is much older. On an individual basis, strategy (in a crude form) was probably used by early man in his attempts to survive in a hostile environment. Man's survival was dependent upon his ability to exercise dominance over existing competitors and his ability to deal with environmental changes (Makridakis and Heau, 1987).

Strategy is often associated in history with war and military action. As early as 500 B.C., Sun Tzu, a venerated Chinese general, recognized the importance of

strategy. In his essays, "The Art of War," he addressed all of the elements that comprise the modern definitions of strategy. For example, in his essay on weaknesses and strengths, he states:

> Now an army may be likened to water, for just as flowing water avoids the heights and hastens to the lowlands, so an army avoids strength and strikes weakness. And as water shapes its flow in accordance with the ground, so an army manages its victory in accordance with the situation of the enemy. And as water has no constant form, there are in war no constant conditions. Thus, one able to gain the victory by modifying his tactics in accordance with the enemy situation may be said to be divine. (Griffith, 1963, p. 101)

Sun Tzu addressed other elements of strategy such as making an estimation of the situation, gaining advantage over the enemy, method of attack, the use of secret agents, and the use of authority (Griffith, 1963).

The concept of strategy in business is not as ancient as it is in war. Little specific emphasis was placed on strategy in business until the decades of the 1950s and 1960s brought forth large firms, expanding opportunities, and changing environments. It was then realized that the entrepreneurial, administrative, and operational abilities of the business owners and managers might not be sufficient to ensure the success of the firm. What was

needed was an overall plan that would guide the firm in the use of its resources, including how it would compete effectively and deal with an ever-changing environment. What was needed was strategy and comprehensive strategic management.

Early Strategy Research

Although the concept of strategy in business was addressed in early management literature (Drucker, 1954), Chandler (1962) was perhaps the first to research the concept in business. His main interest was the relationship between a firm's strategy and its structure. He suggested that as a firm developed new strategies, the structure of the firm would have to change to match the new strategies. These early authors did not differentiate between the process of strategy and the content of the strategy itself. This important conceptual difference would be developed by other authors at a later time.

Organizational Performance Literature

Existing research has examined the link between performance and other organizational phenomena such as structure, content and planning. A brief overview of this research follows.

Performance and Structure. The performance-structure linkage has been extensively researched. The underlying assumption is that an organization with the proper structure performs better. Research has focused on various aspects of structure such as authority relationships, bureaucratic procedures, planning systems, and information systems (Mintzberg, 1977). Woodward (1965) linked technology and structure to performance and Lawrence and Lorsch (1967) linked structure and environment to performance. A review by Fowler (1985) suggested other studies linking performance to formalization (Child, 1974; Hage and Dewar, 1973) specialization (Blau, Heydebrand and Stauffer, 1966) centralization (Hage and Dewar, 1973; Pennings, 1976) and subunit and organization size (Bidwell and Kasarda, 1975).

Performance and Strategic Planning. Much of the research concerning the linkage between performance and strategic planning has concentrated on formal strategic planning (Thune and House, 1970; Herold, 1972; Ansoff, Avner, Brandenburg, Portner, and Radosevich, 1971; Karger and Malik, 1975; Rue and Fulmer, 1973; Robinson and Pearce, 1983; Pearce, Robbins, and Robinson, 1987). A review of such studies found a positive relationship between performance and strategic planning in 20 of 31

studies (Shrader, Taylor & Dalton, 1984).

Performance and Strategy Content. An underlying assumption of the strategic management paradigm is that the selected strategy does have an impact on organization performance. In their review, Dalton, Todor, Spendolini, Fielding, and Porter (1980) found that 12 of 13 studies reviewed demonstrated a positive relationship between organizational performance and content of the strategy. In another review Shrader, Taylor, and Dalton (1984) discovered a positive relationship between implemented strategy and organizational performance in the 22 studies reviewed.

The Research Question

Current interest in the relationships existing between selected strategies and subsequent firm performance was the basis for formulating the following research question:

Do divesting firms exhibit significant changes in selected performance measures following divestiture?

Subsidiary Questions

1. Are there significant differences in the selected

performance measures among firms that divest for different reasons--i.e., does the firm that divests because the business unit is a poor strategic fit perform better following the divestiture than the firm that divests because of the poor performance of the business unit?

2. Do the shareholders of divesting firms realize any significant change in returns (positive or negative) following the divestiture?

3. Is there a significant difference in returns to investors with respect to the stated reason for the divestiture?

4. Are there significant differences in the selected performance measures among divesting firms whose level of diversification changes due to the divestiture?

5. Are there significant differences in the selected performance measures of divesting firms depending on the size of the divestment (as a percentage of the parent firm's total assets)?

Terms

Divestiture: "the selling of a company, subsidiary, division, or a product line as a going business." (Guth, 1985)

Corporate-level Strategy: the strategy that defines