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Performance Effects of Divesting Foreign Production Affiliates: A Network Perspective

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The goal of this study is to examine the short-term performance effects of a firm's decision to divest foreign affiliates that are part of an integrated international production network. Previous literature stresses positive investor reactions toward divestment announcements in the short run. Stockholders seem to expect positive long-term performance effects from refocusing strategies. When evaluating the actual financial consequences of divestments, however, it is unclear whether the benefits of divesting unprofitable production locations will outweigh the costs that arise from withdrawal in the short run. By evaluating outcomes of the remaining network, this study suggests that withdrawing countries from a production network leads to an immediate decline in performance. Efficiency gains that result from more favorable labor cost conditions across the remaining locations, on the other hand, can mitigate the negative performance effects of divestments. A panel analysis of 631 foreign production networks maintained by German manufacturing firms supports the hypotheses.

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Introduction

Corporate consolidation and refocusing by means of disinvestments are important strategy options for firms (e.g., Bowman and Singh, 1993; Harrigan, 1981). In many cases, firms try to strengthen their competitive position by downsizing an overdiversified business portfolio (Hoskisson and Hitt, 1994). In addition to divestment of business lines, firms may also decide to withdraw parts of their international network (Benito, 2005; Boddewyn, 1979). A growing body of research examines the determinants of international divestment decisions (e.g., Dhanaraj and Beamish, 2009; Kronborg and Thomsen, 2009; Mudambi and Zahra, 2007). However, to date, little is known about the performance outcomes of these decisions. This study addresses this question by analyzing the immediate financial consequences of firms' decisions to pull out of host countries in a multinational production network.

Facing uncertain future developments at the moment of investment, firms often evaluate their international activities differently over time and decide to retrace previously made foreign direct investment (FDI) decisions (e.g., Bane and Neubauer, 1981; Berry, 2013). Discrepancies between expected and actual outcomes of foreign investments can stem from diverse characteristics at the subsidiary, host country, and parent firm levels (Berry, 2013; Mata and Portugal, 2000). In regard to the subsidiary's investment mode, joint ventures and acquired affiliates induce more coordination problems and show a higher propensity to be divested than wholly owned subsidiaries and greenfield investments, respectively (Hennart et al., 1998; McCloughan and Stone, 1998; Ogasavara and Hoshino, 2008). At the host-country level, unfavorable market conditions seem to reduce the likelihood that a foreign affiliate will survive (Benito, 1997). Inexperience or inadequate technological resources of parent firms can also lead to higher divestment propensities (Belderbos, 2003; Delios and Beamish, 2001).

From a network perspective, foreign subsidiaries not only enable firms to capture new demand markets or access valuable production resources (e.g., Dunning, 1988), but they also enhance the efficiency of a multinational production network (e.g., Ghoshal and Bartlett, 1990; Jarillo and Martínez, 1990). A firm that maintains incorporated production sites that produce interchangeable outputs in a multiplicity of host countries possesses "operational flexibility" to shift production tasks temporarily across locations in response to short-term cost differentials (de Meza and van der Ploeg, 1987; Kogut, 1985). The divestment propensity of those affiliates depends on their value to the production system as a whole. Foreign affiliates that do not sufficiently contribute to overall production efficiency are more likely to be divested (Belderbos and Zou, 2009; Chung et al., 2008).

Even though international divestment decisions by multinational corporations (MNCs) involve massive shifts in resources, the performance outcomes of these strategic decisions have been largely neglected by researchers. However, numerous studies have analyzed the determinants (e.g., Bowman and Singh, 1993; Moschieri and Mair, 2011) and outcomes (e.g., Lee and Madhavan, 2010) of divestments from a more general strategy perspective. Empirical studies have shown that

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long-run performance can be enhanced through restructuring (Bergh, 1998; Chang, 1996). In the short run, however, restructuring activities that are oriented on long-term strategies might also reveal no (Wu and Delios, 2009), or even negative (Kang and Shivdasani, 1997), performance effects.

This study contributes to the literature in two ways. First, it advances research that points to operational flexibility characteristics as determinants of foreign divestment decisions (Belderbos and Zou, 2009; Chung et al., 2008; Fisch and Zschoche, 2012). The study further develops these approaches by investigating performance consequences of divestment decisions through the lens of operational flexibility. Second, the analysis broadens existing literature on the performance effects of corporate restructuring (Bergh, 1998; Brauer and Wiersema, 2012) by applying network considerations. That is, performance outcomes of restructuring decisions are viewed from the perspective of the remaining members of an interdependent network.

If foreign production locations are completely withdrawn from an integrated manufacturing system, the need to compensate for a location will distort established manufacturing processes in the remaining foreign production sites. This induces costs that lower the performance of the remaining network in the short run. However, each individual production location affects network efficiency very differently. From the perspective of operational flexibility, production units have varying value depending on their absolute cost conditions as well as their redundancy in terms of cost developments relative to the remaining locations. Therefore, the divestment of different locations is expected to have different consequences for overall network performance.

The remainder of this study is structured as follows. The next section offers a brief overview of the existing literature on corporate divestment and performance. In Section 3, we propose several hypotheses about the immediate performance effects of the decision to withdraw host countries from a multinational production system, focusing on the concept of operational flexibility. Section 4 describes our empirical research design, and Section 5 presents the results of an econometric panel analysis of 631 German MNCs. The final section concludes with a discussion of the findings and implications for management practice and future research.

Corporate divestment and performance

Divestment activities are regarded as part of a firm's corporate restructuring strategy. However, firms might restructure their business activities in a variety of ways. Bowman and Singh (1993) distinguish three categories of restructuring activities: organizational, financial, and portfolio restructuring. Organizational restructuring is intended, as the name implies, to increase the efficiency of management teams through changes in the organizational structure (e.g., team sizes, responsibilities, incentive structure, etc.). Financial restructuring affects a firm's capital structure (e.g., leveraged buyouts, asset selloffs, etc.). Portfolio restructuring strategies produce the most sweeping changes through acquisitions or divestment of business lines. These divestments might be realized via different means such as spin-offs (establishment of a legally independent but controlled subsidiary), equity carve-outs (part of the divested unit's stock is sold through an initial public offering), or sell-offs (divested assets are purchased by another firm). In the most extreme case, the divested parts are ultimately shut down.

Despite a growing literature on firms' divestment strategies (Brauer, 2006), consensus has yet to be reached as to whether post-divestiture firm performance is positive or negative (Lee and Madhavan, 2010). One reason for this debate stems from different definitions of what exactly constitutes "divestiture." The term is often bundled with other activities under the broad category of strategic portfolio restructuring. Further, the effects of divestiture have been difficult to isolate because past studies have not provided an accurate definition of restructuring, let alone divestiture (Markides, 1992). Other areas of concern are the use of idiosyncratic definitions of divestiture and the measure of performance used (long-term vs. short-term performance, accounting-based vs. market-based measures).

Depending on the definitions of divestment and performance, previous studies have found positive and negative outcomes of divestment. A first major stream of the divestment literature considers market-based performance measures (e.g., Alexander et al., 1984; Jain, 1985; Mulherin and Boone, 2000). Specifically, such studies assess divestiture performance in terms of stock market reactions (cumulative abnormal returns) and, assuming capital market efficiency, focus on the present value of future income streams (Markides and Berg, 1992). Several of these studies find that divestment announcements have positive effects on performance (e.g., Gertner et al., 2002; Lang et al., 1995; Markides, 1992). These positive effects might be theoretically attributed to wealth transfer (stockholders benefit due to wealth transfer from other stakeholders), agency problem resolutions (divestiture serves to enhance firm performance by addressing agency issues), or better fit (the divestment aligns the unit with a firm that can extract more value than the divesting company; Denning, 1988).

Other studies, however, observe no or negative stock market reactions to divestment announcements (e.g., Schill and Zhou, 2001; Wright and Ferris, 1997). One theoretical explanation for these findings could be that divestiture signals that management perceives the firm as having poor liquidity, a weak outlook, etc. In this view, divestiture is an effort to fend off financial distress such as bankruptcy. Therefore, divestiture could equally plausibly lead to any outcome, depending on a firm's specific situation (Denning, 1988).

Another stream of literature uses accounting-based measures, which — although potentially subject to manipulation — focus on the realized performance of divestiture. Such measures include return on assets (roa), return on sales (ros), and earnings before interest, tax, depreciation, and amortization (ebitda). Here, too, results regarding the outcomes of divestment are ambiguous. Both positive (e.g., Bergh, 1998; Hoskisson and Johnson, 1992; Markides, 1995) and negative (e.g., Bergh,

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