



Ownership structure and divestiture decisions: Evidence from Australian firms

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ABSTRACT

Divestitures create shareholder value by helping firms to optimize their portfolio of assets. However, firms may forego value enhancing divestitures because of agency problems. More specifically, large controlling shareholders may prefer to retain the assets in order to extract private benefits of control at the expense of minority shareholders. In this paper, we explore the role that other blockholders play in constraining the largest shareholder's influence. The results indicate that divestiture activity decreases with the ownership of the largest shareholder. The presence of another significant blockholder appears to curb this negative bias towards divestitures. Our findings provide an economic rationale for the higher performance of firms characterized by more balanced ownership structures. Involvement of family owners also appears to provide similar benefits.

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1. Introduction

Divestitures play an important role in fostering economic efficiency (Maksimovic, Phillips, & Prabhala, 2011; Ravenscraft & Scherer, 1987). Firms can use divestitures to rectify past investment mistakes, such as unsuccessful acquisitions, and put resources back to their best use (Hearth & Zaima, 1984; Hite, Owers, & Rogers, 1987). In particular, firms can use divestitures to reduce the scale of their investments when demand fails to meet expectations (Warusawitharana, 2008). Divestitures can also help firms to free up capital or management time which can then be redeployed to higher value operations. John and Ofek (1995) show that negative synergies due to excessive diversification can be reversed using divestitures. In addition, firms can rely on divestitures as an alternative way to raise fund for paying back their debts (Lang, Poulsen, & Stulz, 1995; Shleifer & Vishny, 1992).

Event studies indicate that the market reaction to divestiture announcements is positive (Alexander, Benson, & Kampmeyer, 1984; Gleason, Mathur, & Singh, 2000; Hearth & Zaima, 1984; Hite et al., 1987; Jain, 1985; Owen, Shi, & Yawson, 2010). This is hardly surprising given the significant improvement in operating performance that firms typically experience in the years surrounding a divestiture (Gleason et al., 2000; Hillier, McColgan, & Werema, 2009; John & Ofek, 1995; Montgomery &

Thomas, 1988). Nonetheless, various obstacles can prevent firms from completing a divestiture despite the potential benefits. Entrenched managers usually prefer to accumulate assets, especially when cash flows are strong (Jensen, 1986). One reason is that firm size is usually associated with higher compensation. In fact, studies show that executive compensation tends to increase by one third each time the firm doubles in size. For instance, Merhebi, Pattenden, Swan, and Zhou (2006) report a size elasticity coefficient of 27.4% for the 500 largest Australian firms. In addition, asset growth provides more opportunities for managers to build up their careers and divert corporate resources to their own benefits. Bad investments can be concealed in the firm's balance sheet whereas their disposals would reveal losses and poor management decisions. As a result, managers will prefer to absorb the losses over time through gradual depreciation. Monitoring is thus critical to ensure that under-performing assets are quickly divested to preserve their economic value (Hanson & Song, 2006; Haynes, Thompson, & Wright, 2003).

In this paper, we explore the influence of ownership structures on divestiture decisions. Ownership concentration is considered to be beneficial because it contributes to resolving the free rider problem that dispersed shareholders are unlikely to overcome (Admati, Pfleiderer, & Zechner, 1994; Shleifer & Vishny, 1986). A number of studies show that the presence of a large shareholder is associated with better monitoring of management decisions. Given that managers are reluctant to undertake divestitures, the presence of a large shareholder should be associated with a higher rate of divestiture. On the flip side, unrestricted power gives the controlling shareholder an incentive to extract private benefits at the

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expense of minority shareholders (Bennedsen & Wolfenzon, 2000; Nicodano & Sembenelli, 2004; Shleifer & Vishny, 1997). In fact, there is growing evidence that the presence of a single large shareholder is associated with a lower firm value (Attig, El Ghouli, & Guedhami, 2009; Maury & Pajuste, 2005) and a higher cost of capital (Attig, Guedhami, & Mishra, 2008). These results suggest that the controlling shareholder may be more concerned about diverting corporate resources than engaged in making decisions that would create shareholder value. This argument also suggests that we might observe a lower level of divestiture activity in firms with a controlling shareholder.

In contrast, greater balance of power between the blockholders is considered to result in better governance. Recent research indicates that the presence of other large shareholders leads to higher firm value because it prevents the extraction of private benefits and restricts the distortion of corporate decisions in favor of the largest shareholder. For instance, the latter has been associated with a lower propensity to take risk (Mishra, 2011). The governance structure resulting from the presence and relative power of other blockholders besides the largest shareholder may have important implications for divestiture decisions.

Our main hypothesis is that the presence of multiple blockholders contributes to reducing the distortions induced by the largest shareholder. More precisely, other blockholders help firms to focus on value creation by constraining the extraction of private benefits by the largest shareholder (Pagano & Roell, 1998). As a result, firms become more likely to use divestitures despite the largest shareholder's reluctance. This outcome is consistent with evidence that multiple shareholding structures increase firm value and operating performance (Attig et al., 2009; Lehmann & Weigand, 2000; Maury & Pajuste, 2005). We also investigate whether blockholder identity plays a role. Most studies indicate that family owners are associated with higher firm values because of their longer investment horizon and greater alignment of interests (Anderson & Reeb, 2003; Harvey, 1999). Accordingly, we hypothesize that the presence of family blockholders helps increase the use of divestitures by preventing the firm from pursuing inefficient policies to the benefit of the largest shareholder.

Our analysis is based on a sample of divestitures carried out over the period 2001–2010 by Australian firms with at least one blockholder. To isolate the effect of ownership structure, we use a propensity score matching (PSM) approach. Following Haynes et al. (2003) the firm's need to divest is first identified using a set of financial characteristics including firm size, leverage and performance. For instance, highly-levered and poorly-performing firms are considered more likely to divest. Each divesting firm is then matched with a non-divesting firm in the same industry with the closest propensity score. Divesting and non-divesting firms thus become virtually indistinguishable apart from differences in their ownership structures. We then test whether these differences have the power to predict a divestiture. The PSM method has appeal over the more traditional characteristic by characteristic matching procedure (Li & Prabhala, 2006). This is especially true in a smaller market like Australia where the largest 200 companies account for more than 90% of total market capitalization. In particular, the characteristics of each pair of firms are allowed to vary as long as their propensity to divest is similar.

Our empirical analysis supports the hypothesis that the largest shareholder does not generally contribute to improve firm performance. In fact, the evidence points to a strong distortion towards lower restructuring activity. This finding provides evidence consistent with the extraction of private benefits. On the other hand, greater balance of power among blockholders is found to have a positive influence on firm decisions. More precisely, the significant presence and power of other blockholders contribute to curb the influence of the largest shareholder and lead to more divestitures. However, these effects are only observed when family ownership is involved as the main or second largest blockholder. This outcome is consistent with the lower agency conflicts and greater incentives associated with family ownership.

This paper adds to the growing literature exploring the implications of various ownership structures. It shows that some ownership

structures can severely affect corporate decisions. It follows that they may hurt firm performance and, on a broader scale, could hamper a country's competitiveness. More specifically, our results suggest that one of the reasons for the lower (higher) value assigned to firms with a single blockholder (multiple blockholders) is not just related to a higher risk of expropriation that investors might be concerned with, but due to distortions in the management of the firm's portfolio of assets. As is often the case, delegation without proper checks and balances can prove costly. With its decisions insufficiently questioned, management may more easily collude with the largest shareholder resulting in lower firm performance. Indeed, we show that without the presence of a second significant blockholder, divestitures are less likely. Our study also adds to the literature on family firms. While family ownership can be associated with both costs and benefits, we show that in the case of Australian firms, one of the clear benefits of family blockholders is the greater readiness to restructure assets and lower inclination to hold on to existing assets.

The rest of the paper is structured as follows. Section 2 provides a background on corporate divestitures and multiple shareholding structures. It also outlines two testable hypotheses linking ownership and divestitures. Section 3 details the propensity score matching methodology used to construct the sample. Section 4 provides a brief description of the data. Section 5 contains the empirical results. The last section concludes.

2. Background and hypotheses

2.1. Divestitures and value creation

Divestitures can create value in several ways. The most obvious one is by disposing of assets with a negative net present value. In that sense, a divestiture can be seen as the opposite of an investment. Firms undertake a project because the present value of the expected cash flows exceeds the opportunity cost of the assets involved in generating the cash flows at the time of the investment decision. The passage of time reveals the true value of the project. For instance, the cash flows may be higher than expected, which should prompt the firm to increase the scale of its investment. But they can also be lower because demand for the output is less than anticipated. Assuming that the assets retain their market value because they can still be employed in alternative uses, their opportunity cost may now potentially exceed the value of the (remaining) cash flows. In that case, the firm would be better off selling the assets in order to capture the difference between the opportunity cost of the assets and the value of the cash flows they are expected to generate. In short, divestitures allow firms to eliminate the negative NPV associated with the inefficient use of the assets.

Another way divestitures can similarly create value is by allowing firms to adjust the scale of their investments. Contrary to the previous case, firms do not need to entirely dispose of the asset. For instance, the firm may have over-invested in anticipation of higher demand that has failed to materialize. The problem may not come from the quality of the project itself, but from the scale of the investment. By reducing the amount of invested capital, the firm may still be able to meet its current demand. But it would also be able to recover the value of the excess assets that are undermining the profitability of the project. For example, suppose that the firm has acquired \$500 million of assets whose projected cash flows have been reevaluated to \$400 million. Provided the assets can be salvaged for the same value, the NPV associated with the decision of retaining all the assets is $-\$100$ million. Suppose now that the firm can generate the same cash flows with \$300 million of assets. A divestiture would mean that the firm might generate \$200 million in value from the sale of the surplus assets. This amount can be decomposed as the sum of the positive NPV of \$100 million from the rescaled project and the elimination of \$100 million of negative NPV from the original oversized project.

Another related situation that would require a divestiture is when the value of the assets has changed. This happens when assets have

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