J. of Multi. Fin. Manag. xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

Journal of Multinational Financial Management

journal homepage: www.elsevier.com/locate/econbase

Valuation consequences of the decision to divest in the globalized world

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ARTICLE INFO

Article history:
Received 21 September 2015
Received in revised form 16 April 2016
Accepted 8 July 2016
Available online xxx

JEL classification:
F23
G14
G34

Keywords:
Corporate divestiture
Corporate governance
Abnormal returns
Announcement effects
Multinational corporations

ABSTRACT

This study documents significant difference between the positive announcement returns associated with the divestitures of domestic and foreign assets by U.S. publicly traded firms. On average, the announcements of foreign divestitures lead to 3-day cumulative returns 0.55% lower than the announcements of domestic asset sell-offs. Significant leakage is documented prior to the announcement of domestic asset sell-offs, but not foreign. Accounting for the information leakage during the 30 days prior to the announcement increases the foreign divestiture discount to almost 2%. The difference in the pre- and within- announcement returns is consistent with the information asymmetry faced by the investors. As the relative deal size increases, investors have more incentives to discover the true value of the divestiture, leading to stronger market reaction. Reduction of information frictions through cultural proximity and common language also leads to higher returns for the seller. Asset's and acquirer's country-level characteristics influence the seller's returns.

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1. Introduction

Globalization and integration of the capital markets, especially between the developed countries, has led to a continued debate over the benefits and drawbacks of global diversification. If markets are fully integrated and no cross-border frictions exist, acquisitions and divestitures of domestic versus foreign assets would not generate different returns for the domestic shareholders. However, systematic differences in the valuation of the domestic vs. foreign operations, as well as the differences in the returns for the bidders of domestic vs. foreign acquisitions are well-documented (e.g. Christophe and Pfeiffer, 2002; Denis et al., 2002; Markides and Oyon, 1998). Moeller and Schlingemann (2005) document negative cross-border effect in acquisitions conducted by U.S. firms, explained by the cross-border frictions between U.S. and the target's country. Although the differences in the domestic and cross-border acquisitions are well studied, the comparative analyses of firms divesting domestic and foreign assets are limited. Comparison of the foreign divestitures directly to the domestic asset sell-offs conducted by U.S. firms allows to examine whether the market also reacts differently to these deals.

Borisova et al. (2013) examine domestic asset cross-border sales and find significant difference in seller's returns when selling domestic assets to local versus foreign acquirers. In U.K. study, Cao et al. (2008) explore the effect of information cross-border frictions between the seller and the asset and find significant difference in seller's returns divesting domestic U.K. versus foreign assets. If the markets are segmented and cross-border frictions exist between the seller, the location of

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http://dx.doi.org/10.1016/j.mulfin.2016.07.002
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Please cite this article in press as: Kaprielyan, M., Valuation consequences of the decision to divest in the globalized world. J. Multinatl. Financial Manage. (2016), http://dx.doi.org/10.1016/j.mulfin.2016.07.002

the asset and the acquirer, the divestiture of a foreign asset may not be as value-increasing as a divestiture of domestic asset, due to the same external factors that drive the cross-border acquisition discount documented by Moeller and Schlingemann (2005) or less efficient information flow associated with the foreign asset sales.

Meulbroek (1992) finds that market detects and acts upon the information impounded in the insider trading prior to the merger announcements. Brigida and Madura (2012) find that the well-documented target stock run-up prior to acquisitions is caused by informed trading, with the leakage decreasing in the transparency of the target firms in mergers. However, previous studies on the divestitures by U.S. firms have not given much attention to the behavior of the stock prices during the pre-announcement period (John and Ofek, 1995; Lang et al., 1995; Mathur et al., 2006; Owen et al., 2010). Insignificant difference between pre-announcement returns surrounding domestic and cross-border sales is found by Borisova et al. (2013), while Gleason et al. (2000) find no leakage prior to the foreign asset sell-offs.

The intent of this study is not to provide any opinion on the insider trading debate or recommend policy changes, but only to explore whether the assimilation of information impounded in the asset sell-offs' announcements depends on the location of the asset. If informed traders don't have the incentive to discover the value of deal, the overall market reaction is expected to be weaker, as uninformed traders may use informed trades in price discovery (Meulbroek, 1992; Cornell and Sirri, 1992; Chakravarty and McConnell, 1999). Simply put, the larger are the information frictions, the higher are the costs; thus the likelihood the investors will discover the true value of the deal is lower unless certain incentives or easy access to information exist. Given that divestitures are not as profitable as major corporate restructuring deals for investors, e.g. target stock price run-up in mergers, information leakage is expected to depend largely on the size of the deal. Moreover, reduced information cross-border frictions between asset and the seller, such as cultural proximity, same language and level of development may lead to higher returns for the seller.

I find that over the sample period of 1996 through 2013, the divestitures of foreign assets result in announcement returns of 0.55% lower than the divestitures of the domestic assets by U.S. firms (the foreign divestiture discount). The announcement returns decrease in the cultural distance between the U.S. and the locale of the foreign asset, as cultural diversity increases information frictions for the investors. The information cost theory hypothesis is strengthened by the finding of significant leakage in domestic sample prior to the announcement, but no leakage and some evidence of post-announcement drift in the foreign sample. Cumulating the returns over [−30,+1] event window surrounding the announcement day 0, results in market reaction to domestic divestitures generating almost 2% more in value than the foreign divestitures. Moreover, when cross-border information frictions between the asset's location and U.S. are lowered through cultural proximity, common language or developed status of the country, the market reaction is marginally stronger.

The pre-announcement and announcement returns increase in relative size of the transaction, which incentivizes the investors to discover the true value of the deal. However, relative size of the deal has stronger impact on foreign divestitures announcements and significant difference between domestic and foreign divestitures dissipates for larger transactions. While foreign divestiture pre-announcement returns are largely driven by the relative size of the deal, domestic returns have different determinants. In domestic transactions, leakage is negatively related to financial status of the acquirer, as these firms have more experience in protecting the flow of information. Leakage is positively related to the public status of the acquirer, indicating richer information environment when both parties in the transaction are publicly transparent. Finally, leakage decreases in the profitability of the sellers, as more profitable firms may exhibit less asymmetric information between the investors and managers thus reducing profitable opportunities for the informed traders. Overall, the results suggest that the true value of relatively smaller foreign divestitures may not be fully reflected in the prices upon the announcement, while as the size of the transaction increases, so do the incentives to discover the true value of transaction with informed traders leading the price discovery process.

Analysis of the asset's location reveal that divestitures of assets in countries with lower tax rates than in U.S. and lower level of development are viewed negatively by the investors. Reduction in cross-border frictions between the acquirer and the asset, as well as higher country-level ownership concentration, which is associated with weaker protection for minority shareholders (La Porta et al., 1997), are found to be positively related to the seller's returns. Bargeron et al. (2008) find that public buyers in U.S. M&A's overpay due to agency conflict. Consistent with the agency theory, domestic asset sales yield higher returns when the acquirer is public, while in the foreign divestiture sample, the returns increase in ownership concentration of the public acquirer's country.

This paper contributes to the literature by documenting significant difference in the pre-and within- announcement returns associated with the domestic and foreign asset divestitures by the U.S. public sellers. The foreign divestiture discount and significant difference in the information assimilation process into prices provides support for the information cost theory, which predicts that the value discovery in foreign divestitures is more costly for the shareholders. The study also demonstrates that the characteristics of the seller, the deal, and the country-level institutional and cultural characteristics of both the divested asset and the acquirer location influence the returns of the seller.

The paper is organized as follows. In Section 2, literature review and hypothesis development are presented. Section 3 contains the data and variable description. Section 4 provides summary statistics of the divestitures over the sample period of 1996 through 2013. Section 5 presents univariate and cross-sectional analysis of the abnormal announcement returns and Section 6 concludes this study.

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