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THESIS

DIVESTITURES AS RETRENCHMENT STRATEGIES:

A CORPORATE GOVERNANCE PERSPECTIVE

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Extended Abstract

Generally, strategic management literature has always been considering growth strategies as main means to organizational change and development (Lubatkin and O'Neill, 1988; Bowman and Singh, 1993; Capron et al., 1998; Capron and Mitchell, 1999; Karim et al., 2000), being mainly committed to portray restructuring ones as a reaction to strategic mistakes or a change to earlier decisions.
The increased foreign competition and the effects of the financial and economic crisis have raised pressure on managers to improve the performance of their organizations. As the deal firms are expected to restructure their business portfolios to cope in the challenging markets. In this context, divestiture emerges as valuable strategy for building shareholder wealth (Moschieri and Mair, 2008). This is a tool to propel firms change process through the redeployment and disposal of resources as well by the uprooting of underperforming ones (Capron et al., 2001). Despite a relatively sound understanding of the antecedents and outcomes of divestiture activity is gradually arising (Brauer, 2006; Lee and Madhavan, 2010), some very basic questions remain unanswered concerning whether and how parent ties with divested unit are related to value creation. Once selected what to divest, casting it for a value-enhancing disposition poses a variety of strategic challenges. Specifically, the newly established governance structure might create both risks and opportunities, especially having concern the divestiture mode chosen.
Therefore, this thesis offers a valuable contribution to literature on divestiture, deepening the understanding of the relation between divestiture mode choice and value creation. Moreover, it sheds light on a neglected issue of corporate governance enhancing its potential value as signal.
Specifically, the sweeping research question is: *How do corporate governance mechanisms affect divestiture performance?* To answer this question three essays are presented, each addressing a specific aspect of the compelling issue.

The first essay examines the theoretical perspectives and research findings on divestiture mode choice to draw the current state of knowledge and outline a set of issue for further research on the topic. A significant amount of academic works has been written about divestiture. Previous empirical studies have been mostly focused on performance implications whether divestitures are reflections of the economic cycle (Garvin, 1983; Duhaime and Grant, 1984; Aron, 1991; Ito, 1995), a means to reverse previous strategic decisions (Markides, 1992; Hoskisson et al., 1994), or proactive strategic options (McGahan and Villalonga, 2003). However, despite the increasing interest devoted to divestitures in both academic and managerial journals, little is still known about the way firms ought to take their divestiture decisions to further the performance.
The main challenge is to review existing research on divestiture mode alternatives to identify common threads and gaps, and to propose some ideas and avenues for future studies. Departing from this kind of insights, the essay takes under proper concern that divestiture modes differ over firm value creation. Thus far, scholars have mainly considered that divestiture performance problems arise from underestimated implementation difficulties, rather than from selection mistakes (Jacobides and Billinger, 2006). Yet, selection capability differs from implementation capability. Divestiture entails a wide range of corporate restructuring activities: spin offs, sell offs and equity carve outs. Even if these strategies serve similar objectives, they differ in their ability to cope with the characteristics of the firms involved and in their strategic implications (Rosenkopf and Nerkar, 2001; Menon and Pfeffer, 2003). Making the right choice of divestiture mode has an important impact on the subsequent ability of the firm to deploy effectively its skills to meet rent-achieving goals, especially for the tie opportunities acknowledged. To deepen the understanding on this topic, the following research question will be address: *What is acquired and what should be acquired in literature on the relationship between divestiture mode choice and value creation?*
Assuming that firms recognize opportunities and risks shaping their foresights, the aim is to contribute to the understanding of how divestiture mode choice adds value through its staggering effect on strategic performance outcomes. To achieve this aim is demonstrated that "one-fits-all" approach of firm divestitures turns out inappropriate and counter-productive.
An analytical review is developed to systematically evaluate the current state of knowledge on this topic and draft a meaningful agenda for future research. The findings of the major published studies are summarised to reveal the patterns of theoretical arguments.

The second essay explores the relationship between board characteristics of a divested unit and wealth creation. It offers support to demonstrate that the subjectivity of board characteristics might affect firm market valuation. Specifically, the analysis have been focused on equity carve outs. The attractiveness of equity carve outs as research objects is largely due to their dualistic nature as both means of parent company

financing and corporate restructuring. An equity carve out is an operation through which a new independent firm is created hiving off a parent's subsidiary and selling the shares of the new company in a public offering. Previous research states that a lower underpricing of the offering is observed for equity carve outs compared to conventional IPOs (Nanda, 1991). The underpricing is the difference between the initial offer price and the first-day closing price of an IPO's shares (Michaely and Shaw, 1994). This represents the unretained wealth for the initial shareholders who sell their equity due to information asymmetry (Certo et al., 2001; Daily et al., 2003) and agency concerns (Beatty and Zajac, 1994; Brennan and Franks, 1997) arising with the new investors.
Literature on IPOs has demonstrated that a number of governance related signals can enhance the firm value reducing the magnitude of the wealth transfer (McBain and Krause, 1989; Mikkelson et al., 1997). However, for equity carve outs the new corporate governance system required might determine equivocal signals due to its endogeneity in the parent divestiture strategy. With the occurrence of an equity carve out, evidence state that the parent company generally holds a majority of shares, and that the connection between the two entities is even stronger due to the frequent presence of overlapping directors. These are meant as those ones employed also by the parent firm at the time the equity carve out is undergone (Baysinger and Butler, 1985). A general agreement exists among scholars on the board ability to affect a firm operating performance through its actions and activities (Pfeffer and Salancik, 1978). Recent studies have stated that the characteristics of board of directors affecting the organizational legitimacy influence the market performance too (Certo, 2003). However, in the debate about the aforementioned relationships no study have still questioned whether and to what extent the presence of overlapping directors can affect the foreseen effects. The present research has the aim to question the signalling effect of overlapping directors on the IPO underpricing of equity carve outs. To achieve this aim the following research question will be address: *How do overlapping directors affect equity carve out underpricing?* The study examines the relationship between ECO underpricing and wealth and states that the wealth assessment during the first day of trading is a function of the board of directors composition. The observed effect might be explained through several finance literature's theoretical arguments on underpricing (Baron, 1982; Rock, 1986). Actually, it is inferred that information asymmetry concern of market investors represents a root cause of the tested relationship between board composition and underpricing in that the market will attach different value to overlapping directors. The rationale of such effect is supported by the argument that market investors suffer from a bias against risk and don't appreciate initial offerings of firms with an opaque value (Prasad et al., 1995). To support the discussion it is necessary to consider the possible effect of directors' overlap to the firm capacity to create wealth. It seems plausible that positive legitimization effects will accrue to overlapped ECOs. Actually, such effects portend the possibility of future wealth creation by the firm. Ironically, while capital markets show an initial favour for overlapping directors, above a certain level of overlap they become skeptical about the directors capacity to add value to the firm. This is because a high probability of expropriation detrimental for minority shareholders is foreseen due to a multi agency concern that arises on the directors. Zooming out this study, we propose that board structure is not uniform in its effects on the underpricing of divested firms, but rather varies across the percentage of overlapping directors as well as the capital stake divested by parent firm on the stock market. Together, these two dimensions form the grounding of our exploration into the subjectivity of directors' characteristics and market valuation. Recalling Samademi and Cannella's (2011) arguments we employ the percentage of capita stake divested as moderator of overlapping directors' effects. To deepen these considerations the following research question will be addressed: How does the percentage of capital divested by the parent firm moderate the foreseen relationship between overlapping directors and divestiture underpricing?
The observations mentioned above collectively suggest that board characteristics in an ECO represent a neglected area of research. The analysis gives support to the belief that the market investors' valuation is partially a function of the perceived legitimization of the governance arrangements. It suggests that the first day investors' perceive the firm quality employing nonfinancial information.

The third essay employs a corporate governance perspective to examine interlinks between board of directors composition and parent stock market reaction to equity carve out announcement. Scholars, regarding at ECOs as corporate restructuring strategies, shows that carve outs bring a positive stock market reaction to the parent firm (Schipper and Smith, 1986). However compared to other divestiture modes (i.e. sell offs and spin offs) lower abnormal returns are observed (Vijh, 2002) and surprisingly, little is known as to what drives these differences. Strictly speaking, ECOs may not be considered as "conventional" divestiture operations due to two main reasons. First, the parent firm usually retains the majority ownership in the subsidiary and establishes long-term financial and product-market relations with it (Boone, 2003). These

links might affect the performance of the parent firm given the strong interrelation between the cash flows of the two entities. Second, evidence demonstrates that ECOs are transitory arrangements (Klein et al., 1991; Schipper and Smith, 1986): most parent evaluate in a later time the choice of whether to further divest, stop mid-way, or regain control over the business unit (Perotti and Rossetto, 2007). Underlying effect of these factors is that at the ECO announcement investors receive noisy information flows concerning the potential divestiture gains due to the perceived uncertainty associated to subsequent events (Desai and Savickas, 2010). Investors are less aware of the effective future gains for the parent associated to the announcement; therefore an information asymmetry concern rises (Otsubo, 2009).

Since scholars argue firms consider their governance arrangements as part of their corporate strategy (Moschieri, 2008), our study aims to question whether these might represent valuable signals to provide investors with a stronger and clearer outlook about parent strategic future. Specifically, market investors critically view and value clarity of strategic direction (Filatotchev and Bishop, 2002). Overlapping board directors may represent a superior signal providing a venue where strategic ambiguity may be reduced. To investigate this aspect, the present work will address the following research question: *How do overlapping directors affect to divesting firm value creation?*

The aim of this study is to extend the role of board of directors as a catalyst for parent wealth creation. We expect board composition to influence investors' perception of the firm divestiture gains acting as a valid signal of its guidance about the future, since investors when unable to discern economic disclosure of value, turn to more social indicators of it (Podonly, 1994).

Uncertainty regarding subsequent parent strategies, lack of codified interrelation data between parent and subsidiary present market investors with equivocal guidance about parent gains. Since market investors have to handle a greater information uncertainty when a carve out occurs, compared to the informational flows generally associated to alternative divestiture modes, board characteristics serve as a secondary indicator of subsequent strategic actions and thereby help market forecasts. The findings demonstrate that within one highly uncertain context market reaction is positively associated with a particular directors' characteristic: overlapping. This governance aspect, visible to market investors', suggests that parent firm has provided endorsement as knowledgeable party. This seems to clarify the parent strategic directions as signal of bundling strategic outline between the two entities. Markets appear to reward those firms that grant such endorsements and clarifications as secondary subjective information indicators. Actually, previous studies generally suggest that endorsement effects from subjective indicators reduce the uncertainty associated with new firms and allow market investors to have more information from which to judge the venture (Chaterji, 2009; Higgins and Gulati, 2003). However, our results imply that these arguments might be referred not only to new and young firms. Even if the signalling firm already has a market track record, investors' valuation might be affected by directors' affiliation in the carved out subsidiary. This is used as objective information to anticipate the expected parent gains from the equity carve out.

This thesis aims to contribute to the literature that explores divestiture and its effects on performance. Scholars have under investigated the divesting process and how the structuring of divestiture itself concurs in explaining the divestiture performance (Bergh et al., 2008). To fill this gap, this project provides a groundbraking model that associate the overall value creation of divestiture operations with their casting, disaggregating the current knowledge on antecedents and outcomes. In doing so, it expands current explanations of divestiture performance, strengthening an emergent grounding that future studies may further to build a more complete understanding of divestiture activity. What specifically is emphasized it's the relevance of the potential link between the divested unit and the parent firm and the effects associated to the tightness of this relationship on performance (Moschieri and Mair, 2008). This depends on the post deal involvement of parent managers, on the effective creation of a newly independent firm with an own identity and strategy, and on the development of a common sense of opportunity (Moschieri, 2011). From a corporate strategy perspective, firms are called to face a variety of challenges choosing between integration and independence (Karim and Mitchell, 2000; Capron and Mitchell, 2009). Specifically, our evidence confirms that risks and opportunities arise from the newly established governance structure. This represents a signal used by market investors to evaluate the foreseen value creation associated to the operation.

This thesis should be esteemed in light of some noteworthy limitations. Most of them are accurately highlighted in each essay. However, one requires some specific consideration and refers to the generalizability of our findings. A sample of 141 US equity carve outs referred to the period of 1996-2009 has been used for our empirical analyses. This practise has been mandatory given the necessity to collect detailed information concerning the characteristics of the operations and the subsequent governance arrangements employed. Since accurate data are provided only for listed companies, this equity carve outs

have represented an ideal room for testing our conjunctures. Examining the possibilities for the application of our analyses on a sample of alternative divestiture modes opens new avenues for future research. Another limitation of the presented empirical analysis resides on the lack of individual level data on board of directors composition. This has forced our inferences to a limited understanding of the factors that affect market perception of potential divestiture value creation. Future research should explore which other characteristics enable divestiture value creation signalling to market investors the wealth-related implications of this hybrid organization spawning. It is expected that such attributes will be valuable signals, especially if employed when underlying economic indicators cannot be easily observed and understood.

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