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Impact Of Covid-19 Pandemic On Shareholder Wealth Creation Via Divestitures: A Study Of Industries Highly Impacted.

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ABSTRACT

The pandemic was a very stressful time for the financial performance of any firm. The paradigm in which companies operated changed drastically. Services companies in industries of education, tourism, wholesale and retailing, IT, and transport had to change the way they function as their physical customer contact points were lost. They needed new means to connect and deliver services to the customers. One can expect the devastation it had on the financial performance of companies in these particular industries. There were 41 divestitures in IT, wholesale and retail, education, tourism, and transport industries taken together in India. Conventional literature on divestitures states that divestitures lead to positive shareholder wealth creation. All this begs the question - was there positive shareholder wealth creation in these fifty transactions of divestitures of these five industries that were dramatically hit by the pandemic? Did conventional divestiture results also hold in the case of the pandemic for the companies in these five industries? This paper analyses the shareholder wealth created by the divesting companies of these highly influenced industries by the pandemic. This study uses standard market-based event study methodology with an event window of twenty-one days, six days, and three days to investigate the reaction of the stock market to these divestiture announcements and an estimation period of two hundred and forty days to calculate the normal return. The study finds a significant positive 1.26% Cumulative Average Abnormal Return (CAAR) in an event window of ten days before and ten days after the divestiture announcement. Yet the immediate CAAR of the divestiture one day before and one day after the divestiture announcement was statistically significant -0.059%. Whereas the CAAR in the event window of three days before and after the divestiture was 1.43%. This study has great application for investors to devise a strategy around divestiture announcements, which has been shown to have a positive impact on shareholder wealth even in dire conditions of the pandemic.

Keywords: *COVID-19 pandemic, Shareholder wealth, Divestitures*

1. INTRODUCTION

The pandemic saw a sharp fall in the market capitalization of the firms on BSE and NSE, with some estimates placing them at a fall of about 38% in the initial days of the pandemic. A sharp correction followed this in the prices of the companies listed on the stock market, mainly driven by an increase in the value of large-cap companies, with the bourses hitting a record high of 63,588 points on BSE and Nifty at over 18,850 on June 21st,2023. This remarkable journey saw a fall of over 40% in shareholder wealth in the industry of hotels, tourism, and entertainment during the pandemic. The industries that were particularly hit were tourism, travel, wholesale and retail, education, and IT. There was a dramatic change in how these companies operated and derived their revenue. For educational companies, it meant switching to an online mode of taking classes. Many ed-tech companies flourished during the pandemic and provided education and training facilities from the comfort of one's home. IT also saw a revolution in the way it operated. The days when IT employees rushed to the office early in the morning and stayed there till late hours were gone. A work-from-home methodology of operation had to be adopted. Workers worked remotely connected to the internet and provided value-added services to their clients from the comfort of their homes. Transportation also took a great hit. Only transport of essentials was

allowed across borders of the state. Only essential commodities like food, medicine, and various other ingredients that went into it were allowed. That is also after a great deal of vetting and permissions. Commuter traffic was hit dramatically. There was no movement of people from one place to another, considerably hitting the revenue and financial performance of the transport companies. As there was a lockdown, there was no travel for leisure either. Thus, the tourism industries, airlines, and hotels were devastated overnight. All festive functions for which the hotels were used were also canceled, thus further hitting the revenue of these hotel companies. Retail outlets were only allowed to operate only for a limited period, from early morning till just after dawn. This decreased the sales of retailers to a great extent as the interval in which shopping by the customer could take place was greatly decreased. Even the wholesaling industry was not allowed to operate to its full potential due to restrictions on the movement of goods and people.

The divestiture includes partial or complete business disposal through exchange, closure, sale, or bankruptcy. Corporate divestiture takes various forms: spin-offs, split-ups, equity carve-outs, and sell-offs (Teschner & Paul, 2021). When a company transfers control over its assets to a third party in return for consideration, it is called a sell-off. On the other hand, when a company voluntarily separates an offshoot of itself as a separate company and lists it as a separate entity on the stock exchange with pro-rata allotment of shares to existing shareholders, it is called a spin-off. It doesn't lead to any cash generation for the company. Similar to a spin-off, if a company separates an offshoot of itself and asks the shareholders to choose between the shares of the two separate companies, it is called a split up. Whereas a transaction via which the company retains ownership over the separating entity but also issues an initial public offering for the remaining part of it is called an equity carve out. Equity carveouts lead to both the issuance of shares and the generation of cash flows (Slovin et al., 1995).

Divestitures have several benefits, including an increase in the volume of shares of the Company being traded on the stock exchange (Habib & Johnsen, 1995). In some cases, the value of the two separate entities on the exchange might be more than the consolidated Company on the stock exchange, thus creating value (Kambla, 2016). In this case, the whole is less than the sum of its parts separately. Better demarcation of resources, better management of operations, and a renewed focus on that particular division or branch of business are the benefits of spin-offs. It also reduces information asymmetry between the shareholders and the management, as the financial results of the separated entity start being reported separately from the parent company's financial results (Bergh & Lim, 2008).

All the adverse effects of the pandemic on the business environment in which tourism, travel, IT, education, and wholesale and retailing operated led to 41 divestitures by companies in these industries. The conventional findings of divestiture and shareholder wealth creation have also leaned towards positive shareholder wealth creation upon divestiture announcement. Alexandrou & Sudarsanam (2001) found that divestitures create greater wealth during a recession than during a boom. All this begs the question. Did these divestitures in highly COVID-19-affected industries still manage to create value for the shareholders? This research paper tries to answer this question.

The rest of the research paper is divided into four sections, the first among them being the literature review followed by the methodology adopted for the study. Then, the findings of the papers have been disclosed. The paper then presents the limitations and future scope of research in this direction. Followed by a conclusion

2. LITERATURE REVIEW

A majority of the studies find that there is significant positive shareholder wealth creation upon divestiture announcement in the context of the USA, using different periods of analysis (Bergh & Lim, 2008; Cusatis et al., 1993; Desai & Jain, 1999; Hite & Owers, 1983; Mulherin & Boone, 2000; Rosenfeld, 1984). Only Alexander et al. (1984) find a positive but insignificant relationship between divestiture announcement and shareholder return upon divestiture announcement. The researchers believed it was because the news of the sell-off was preceded by much negative press about the

Company, which muted its positive cumulative abnormal return—indicating that these sell-offs were reactive rather than proactive. Another explanation proposed for this slight positive return upon announcement of the sell-off is that the market for sell-off is perfectly competitive, implying no additional net present value is added to the seller via the transaction. Therefore, there is no change in valuation for the selling company.

Rosenfeld (1984) finds that a positive return is better for spin-offs than sell-offs. He also finds that the return for both acquirers and the target in case of a sell-off is positive, indicating a synergic transaction effect for both acquirers as well as the divesting company, unlike a merger where the positive return usually is only observed for the target company's and not for the acquirer. He finds that spin-off creates a CAAR (Cumulative Average Abnormal return) of 6.06%, and sell-off creates a CAAR of 5.25%.

Slovin et al. (1995) study uses the effect of divestiture on a rival company's share price, within the digits SIC code of the divesting entity, as a proxy for value created for shareholders upon divestiture announcement and thus concludes from these findings that spin-offs create a negative return for shareholders of the divested Company, as estimated via a positive return for rival companies' shareholders. Equity carve-outs create positive wealth for shareholders of the Company that is divested. Marked by negative returns for rival companies, managers undertake equity carve-outs when managers believe that an independent divested entity would be more valuable than as a part of the parent company, as indicated by the share price reaction of the rival companies. Indicating that at the time of divestiture, managers believe investors value the company more than the managers themselves. They also state that economic gains from equity carve-outs accrue at the expense of industry rivals.

Bergh & Lim (2008) found that the company's value increases via sell-offs and spin-offs due to organizational learning. Ten years prior experience in sell-off was a good predictor of the success of sell-off, five years post sell-off, as measured via EPS and ROA. They also find that recent experience in spin-offs was a good predictor of the success of spin-offs. There was a positive 2.2% CAR upon announcement of spin-off or sell-off.

Hite & Owers (1983) studied 123 voluntary spin-offs in the U.S. between 1963 and 1981 and found positive returns two days surrounding the announcement of a spin-off for all types of companies. Hite & Owers (1983) also find a positive reaction to spin-offs undertaken to facilitate a merger but a negative return for companies that spun off due to legal constraints. It was found that there was no evidence to indicate that this wealth creation for shareholders was a result of wealth transfer from other security holders to shareholders.

Cusatis et al. (1993) studied 146 spin-offs from 1965 to 1988 in USA-listed companies and studied the spin-off's effect on the company's value. The researchers study the parent, spin-off entity, and the combination of both and measure the buy-and-hold return for three years post-spin-off. This method was used to avoid the complication of transaction costs. The researchers construct market capitalization value-based portfolios and also make a matched comparison based on market capitalization and the SIC code of the companies involved. The researchers measured the difference in returns of the spin-off sample group and matched the control group. The researchers found a significant positive return for spin-offs but only saw abnormal returns for companies that undertake spin-offs for mergers and acquisitions. The researchers, thus, concluded that spin-offs are an effective method of undertaking the transfer of control of assets sought to be disposed of by the Company.

Alexandrou & Sudarsanam (2001) study the effect of a company's characteristics of the seller on shareholder wealth created upon the announcement of a sell-off. The researchers study U.K. companies from 1987 to 1993 and consider seller and environmental characteristics like economic environment, i.e., boom or recession, increase in focus, financial health, company size, whether it is a one-off or a series of sell-offs, and effect of information asymmetry between buyer and seller. The researchers used event study methodology and concluded that company size positively affects the wealth created for shareholders on sell-offs. The researchers also find that sellers benefit more during

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a recession via a sell-off than during a boom period. This is quite counterintuitive, but the authors explain it via the fact that there are better reinvestment opportunities in case of a recession. The researchers also find that sell-offs made by financially strong sellers, measured via Altman's Z-score, create greater shareholder value. The researchers found no evidence of an increase in focus on the return of the sell-offs, which is contrary to the findings of Desai & Jain (1999), John & Ofek (1995), and Kaiser & Stouraitis (2001). Alexandrou and Sudarsanam (2001) also found no significant difference between returns generated by serial or one-off sell-offs. Where serial sell-offs are defined as more than one sell-off by the parent company in a month, Alexandrou and Sudarsanam (2001) find that information asymmetry has a favorable effect on the return the seller enjoys, measured via the seller's and buyer's location. Alexandrou & Sudarsanam (2001) observe a CAR of 0.39% in the event window of -2 to 0 days and a significant 1% return on the announcement day.

Studies on shareholder wealth creation upon divesture announcement using event studies have also been made in the context of European countries (Alexandrou & Sudarsanam, 2001; Boreiko& Murgia, 2012; Lasfer et al., 1996; Teschner & Paul, 2021). Almost all of them find positive shareholder wealth creation through divestiture announcements and divesture events in the long and short term. These studies are mainly concentrated on the financial health of the Company and the use of proceeds to settle debt and its effect on shareholder wealth creation. Thus, based on the above studies reviewed, the following hypothesis is formulated.

Hypothesis 1 (H1): Divestiture announcement creates significantly positive shareholder wealth.

3. METHODOLOGY

A standard market-based event study methodology is used. **Actual returns** are calculated as the natural logarithm of the share price on a given day divided by the share price on the previous day expressed in a formula as: -

$$R_{it} = \ln\left(\frac{P_{it}}{P_{it-1}}\right)$$

where R_{it} is the stock return for the company i on day t, and P_{it} is the share price of the company i on day t. This formula has been used by Gupta et al. (2022), the latest study on shareholder value creation by divestiture announcement in the Indian context. It is thus being used here to keep the results of both studies comparable.

Normal returns can be calculated via the expected return model or modified market model, which takes into account the systematic risk of the company concerned, or market model, which is the most commonly used method and is used in this study to predict the normal return of the company's share over the event window (Sharma & Rana, 2024). Here, normal return refers to the return the share would have provided if market expectations of the Company had stayed the same due to new information. It is calculated via the following formula: -

$$E(M_{it}) = \alpha_i + \beta_i R_{mt} + \varepsilon_{it}$$

Where αi measures the average return over the calculation period, which is not explained by the market, the βi measures a company's sensitivity to the market risk component. R_{mt} is the return on a market index. ε_{it} is an error term, and $\sum\varepsilon=0$.

The Nifty50 index will be selected as the market index for calculating normal market return. As it is, the most traded exchange-traded index fund and the maximum trade volume happen on the National Stock Exchange, whose flag bearer is the Nifty50 index.

Abnormal return- is calculated as the difference between the actual return of stock i on day t and the normal return of share i on day t calculated using the normal return formula.

$$AR_{it} = R_{it} - E(M_{it})$$

Where AR_{it} is the abnormal return of stock i on day t, E (M_{it}) is the normal return of stock i on day t, and R_{it} is the actual return of stock i on day t.

Cumulative abnormal returns will be calculated as the sum of the abnormal returns over the event window. Since the event window is being considered, the formula for it can be written as: -

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$$CAR(-n,+n) = \sum_{i=-n}^{n} AR_{it}$$

As the number of shares under consideration is too many, thus average abnormal returns are calculated by averaging all abnormal returns of various stocks on day t.

$$AAR_t = (1/N)\sum_{i=1}^{N} AR_{it}$$

AAR is the average abnormal return on day t, N is the number of companies, and AR_{it} is the abnormal return of stock i on day t.

For the sake of further, more straightforward comprehension of the result, we calculate cumulative average abnormal return. Which is the sum of the average abnormal return relevant event window. It is measured using the formula: -

$$CAAR_p = \sum_{i=1}^{p} AAR_t$$

$CAAR_p$ is the cumulative average abnormal return for period p, and AAR_t is the average abnormal return on day t.

A cross-sectional t-test is be applied. To determine whether the abnormal return is statistically different from 0. The null hypothesis is that the mean CAR is equal to zero. The following formula will be used: -

$$t_{cross-sectional} = \frac{CAAR(T1,T2)}{\sigma_{CAAR\,(T1,T2)}}$$

And

$$\sigma_{CAAR\,(T1,T2)} = \frac{1}{N(N-1)}\sum_{i=1}^{N}[CAR_i(T1,T2) - CAAR(T1,T2)]^2$$

Where CAAR is the cumulative average abnormal return, CAR_i is the cumulative abnormal return of company i, and N is the total number of companies. T1 is the period from which the cumulative abnormal return is being measured, and T2 is the period at which this measurement of CAR or CAAR ends.

4. SAMPLE

A total of 41 transactions were taken at the beginning of the study, which took place between 1st March 2019 to 1st March 2023. Ten companies had to be dropped as their share price information was not available because they were private companies. Eight companies had to be excluded from the study from these forty-one divestitures as there were days in the estimation plus event window when the stock had not traded. Thus, their closing price was unavailable for the study period due to their illiquidity. The remaining 23 transactions were analyzed using the methodology mentioned above. The companies were from the IT, transport, education, wholesale and retail, and tourism industry.

5. FINDINGS

The study analyses three time periods under one study—first, a period of ten days before and after the divestiture announcement is analyzed. After employing the market-based event study methodology and computation of CAAR, the researchers found an abnormal return of 1.26% in this event window. This finding is statistically significant at a 99% confidence level. This is in keeping with the findings of various authors with respect to shareholder wealth creation as a result of divestiture announcements. Like most other studies, we also find a positive shareholder wealth creation in this event period, which is statistically significant.

In the event period of three days prior to and after the divestiture announcement, we find a CAAR of 1.43%, which is also keeping in line with the findings of the literature. In these two event horizons, we find that there is no deviation from the standard findings of divestiture literature on shareholder wealth creation upon divestiture announcement, but in the immediate event window of one day before and after the event of stock exchange announcement of divestiture by the company, we find a negative 0.59% return. This is not in keeping with the standard findings of the literature on this area of research. This initial negative response can be seen as a negative reaction by the shareholders due to the perception of possible failure and closure of the companies due to

divestitures. But as the results indicate, there is a correction of these estimates over the following days as investors see that the functioning of the company hasn't been much affected by the divestiture, and this initial negative reaction turns into a positive return over six and twenty-one day period of the study with the positive returns being the maximum in six days event window of announcement of divestiture.

Other than the three-day window surrounding the event, the findings of the study are consistent with the standard literature of statistically significant positive shareholder wealth creation for the shareholder of the divesting company. All these findings suggest that the relationship between shareholder wealth and divestiture announcements held true in the circumstances of the pandemic also. Showing the consistency of results in this field of research. All these findings suggest that investors can pursue the standard strategy of buying and holding for three to ten days after the divestiture announcement of the shares of the company to generate positive results for their investments. The divestiture announcement-based investing technique can be a reliable return generator for the investor irrespective of the economic circumstances of the divestiture transaction. Showing an enduring trend between shareholder wealth creation upon divestiture announcement.

6. LIMITATIONS AND FUTURE RESEARCH

There is great scope for research in the direction of divestiture announcements and shareholder wealth creation. Firstly, the time frame can be changed or rather enhanced to include other distressful time periods in the economy to see the endurance of the relation between divestiture announcement and its effect on shareholder wealth creation. Secondly, the scope of the companies that are being studied can be increased by including companies from more sectors and studying the effect of divestiture announcements on shareholders of these diverse sets of companies from different industries.

As a continuation of this research, shareholder wealth creation upon divestiture announcement can be analyzed sector-wise in these five highly affected sectors of the economy via COVID-19. A comparison can be made as to which industries compared better as compared to other companies upon divestiture announcement. The reasons behind these differences in returns for different industries, if any are found, also can be a great topic for further research in this direction. Finally, the reason why this relation between shareholder wealth creation and divestiture announcement held strong can be investigated via qualitative or detailed research on the reasons behind the phenomenon.

7. CONCLUSION

The study uses standard market-based event study methodology to establish and verify the relation between shareholder wealth creation and divestiture announcement. It finds that in a six-day and twenty-one-day event window, the standard positive relation between shareholder wealth creation and divestiture announcement holds true. It is only in the immediate event window of three years around the divestiture announcement that this positive relation is violated, and we observe a slight statistically significant negative return. The research findings lend support to the fact that buying and holding shares of companies undergoing divestiture can be a rewarding and enduring strategy to generate positive returns for the shareholder event in distressful times such as the pandemic.

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