Effect of Corporate Restructuring on Shareholder’s Value in the Information Technology Sector

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Abstract

Corporate restructuring is the process of revamping one or more aspects of a company which can happen due to various factors either external or internal. The need for restructuring a corporate entity is often a necessity when the company has grown to the point that the original structure can no longer efficiently manage the output and general interests of the company. For example, a corporate restructuring may call for spinning off some departments into subsidiaries as a means of creating a more effective management model as well as taking advantage of tax breaks that would allow the corporation to divert more revenue to the production process. In this scenario, the restructuring is seen as a positive sign of growth of the company and is often welcome by those who wish to see the corporation gain a larger market share. There are a number of motives behind a company opting for a corporate restructuring few of them being inefficient management, to gain market leadership, to increase market share etc. but maximising shareholders value is never a motive for restructuring the business. It becomes an implied motive and hence it is not necessary that all acquisitions or mergers should be able to create value to the shareholders. The research is to find out the impact of a corporate restructuring on value creation for the shareholder. The data collected to measure shareholders value is collected from the annual reports of the company’s websites with no specific restrictions on the time horizon. The financial tools that will be used to measure value is Economic value added (EVA), Market value added (MVA) and Enterprise value. The statistical tools that will be used in the study are descriptive statistics, correlation and regression. Econometric analysis and GARCH model will also be used and tested.

Key words: corporate restructuring, sell-off, split-off, Economic value added (EVA), Market value added (MVA), shareholders value.
1. Introduction

1.1 Prelude

Corporate restructuring is an act of reorganising the business by changing the capital investment, using state of the art technology, and displacement of capital base etc in order to improve the performance. Crum and Goldberg define corporate restructuring as “a set of discrete decisive measures taken in order to increase the competitiveness of the enterprise and thereby increase its value”. Business combinations, which may take various forms like mergers, acquisitions, amalgamations and takeovers, are important features of corporate changes which have indeed played a major role in the external growth of a number of leading companies in the world. Corporate restructuring has become a universal practice in the corporate world for the purpose of achieving growth, expansion, and globalisation of the business enterprise. The main idea behind opting for a merger or an acquisition is to achieve synergy, this being the special alchemy of any merger or acquisition. The key principle behind buying a company is to create value to the shareholders over and above the worth of the two companies. Two companies together should be worth more than as two separate companies- atleast that is the main reason behind M&A.

(Hoskisson, Johnson, Tihanyi and White 2005) in their study argue that corporate restructuring was a very useful tool during the past 25 years and its impact was felt in almost every sector of the US and European economies. They categorise the entire corporate restructuring activity into three fragments namely: asset restructuring, financial restructuring and organizational restructuring. Asset restructuring involves the sale or spin-off of businesses within the corporate portfolio, leading to a refocused (predominantly lower) level of diversification. Financial restructuring encompasses leveraged buyouts, stock repurchases, and leveraged recapitalisations, whereas organizational restructuring entails reorganisations within the firm that do not involve the sale or disposal of assets.

The information technology sector in India is divided into two major parts IT services and IT enabled services. Nasscom expects the IT services sector in India to grow by 13-14 per cent in 2013-14 and to touch US$ 225 billion by 2020. “Indian IT companies have thoroughly realized the value of making strategic cross-border acquisitions as demonstrated by Infosys Ltd’s acquisition of Lodestone, M.Phasis ltd’s acquisition of Digital Risk Llc and Wipro’s acquisitions of Promax, and we believe the cross- border activity is expected to increase in 2013,” said Arunkumar Krishnamurthy, partner (transaction advisory services) at Grant Thornton India.
1.2 Historical background

The financial crisis in the early 1990’s gave way for the announcement of the new economic policy in July 1991 through which India witnessed several changes in the economy. Restructuring the corporate sector was a major challenge for the government. During the presentation of the budget for the year 1999-2000 the then finance minister emphasised on the need for corporate restructuring and stressed on the point of divestiture and concentrate on the core business activities. Thus started the demerger wave in India from the year 2000-01 in order to avail tax benefits, increase corporate control and thereby increasing or enhancing shareholders value. Today corporates have understood the importance of restructuring and revamping their business in order to sustain in the market. So corporate restructuring is one of the means employed to meet the challenges that a business can confront and thus create value to its shareholders.

2. Literature Review

Restructuring can mainly take three forms being asset restructuring, financial restructuring and organisational restructuring. There are numerous studies conducted to find out the impact or effect of asset sales or asset restructuring on value creation but not many
studies are conducted to find out the impact of an entire business sell off on value creation. Since the study not only concentrates on sell offs, literature in reviewed in the areas of spin-offs, split-offs mergers and acquisitions. (Boudreax 1975) conducted one of the first studies on divestiture and its impact on shareholders’ value. The researcher collected data from 1965 to 1970, for 169 US corporate divestiture, of which 138 were voluntary and 31 involuntary. He argued that if a company divests, then it gives up the cash flows associated with the divested assets and takes on the cash flows of the acquiring divisions. A positive net present value to the divesting firm should be related with an increase in shareholders’ value. To divest, conglomerate firms proceed to sell-offs, which are defined by (Alexander, Benson & Kampmeyer 1984), as the action of selling some assets of a parent firm, like a division or a product line, to another firm. (Jain 1985) conducted a similar study to investigate the effect of voluntary sell-offs on stock returns. The researcher studied a sample of a thousand sell-off events and found strong evidence that both sellers and buyers receive significant abnormal positive returns. The study also found evidence that for a period before the sell-off announcements, the sellers experienced significant negative returns and thus supports the view that the sellers performed poorly before the sell-off had taken place.

A study by (Berger & Ofek 1995) on “Diversification’s Effect on Firm Value” showed that diversification destroys value. They estimated the value of diversified firms’ segments as if they were conducting business as separate firms and found that the loss incurred varied from 13% to 15%. (Jones & Miskell 2007) in the study indicate that many mergers and acquisitions had unsatisfactory outcomes and that financial economists concluded that, on average, acquisitions benefited the shareholders of acquired firms rather than acquiring firms. In a similar study conducted by (Deo & Shah 2011) on “shareholders wealth effects to merger announcement in the Indian IT industry “ conducted a study from the June 2000 to June 2010 on 28 merger firms and found out that the target shareholders by and large enjoy higher returns to merger related deals. While as, it has breakeven point inference for bidder shareholders. The study concludes that the target companies shareholders gain more than the bidder companies’ shareholders in the short run just after the merger announcement is made which is contradicting the hubris theory.

2.1 Evidence from recent acquisitions

On 13th May 2011, IT firm iGate completed its acquisition procedure of its competitor patni computers for an estimated value of 1.2 billion dollars which was funded by $770 million debt, $330 million by issuing convertible preferred stock to Apax Partners, the PE firm with which it formed a consortium to make this acquisition, and the balance by cash. Now iGate holds more than 82.5% stake in Patni computers, now called a iGate Patni. Announcing the acquisition, Phaneesh Murthy said, “Our integration focus is to bring revenue
and earnings growth in both companies and hence enhance shareholder value in both organizations”. The deal was accepted whole heartedly by the shareholders of both the companies with the share price of Patni computers. Patni’s share price was around Rs 450 in January 2011. Murthy had indicated then that he would be comfortable with delisting Patni at a share price of Rs 400-450. A week after the merger announcement, Patni’s shares on BSE closed at Rs 477.95, up 0.88%, after hitting a 52-week high of Rs 502.15 earlier in the day. The Sensex rose 0.48% to 17,077.18 points. Since Patni’s stock price is moving close to the acquisition price of Rs 503.50 a share, Murthy said he is also open to selling some of the stock to dilute iGate’s holding in Patni from 83% to 75% to comply with a regulatory norm.

September 3rd 2013, saw the most magnificent deal of the decade being Microsoft acquiring Nokia’s mobile phone business for a whopping $7.2 billion, a full cash transaction. The deal makes Nokia license its patents and mapping services to Microsoft. The purchase is set to be completed in early 2014, when about 32,000 Nokia employees will transfer to Microsoft. The three main reasons why Microsoft purchased Nokia are the immense employee base of the latter that have access to the consumers throughout the world, the best-in-class hardware manufacturing and a great relief for Nokia from its debt crunch.

2.2 Need for the study/ research questions

There are a number of motives behind a company opting for a corporate restructuring few of them being inefficient management, to gain market leadership, to increase market share etc. but maximising shareholders value is never a motive for restructuring the business. It becomes an implied motive and hence it is not necessary that all acquisitions or mergers should be able to create value to the shareholders. The research is to find out the impact of a corporate restructuring on value creation for the shareholder.

2.3 Scope of the study

Proponents like Alexander, Benson and Kampmeyer (1984) and Berger and Ofek (1995) who favoured diversification argue that diversified firms gain benefits such as enhanced operating efficiency, larger internal capital markets from where companies could increase their debt capacity, lower taxes and the capability of taking up more positive net present value projects. On the other hand, critics of diversification argue for divestiture and re-focusing instead.

The study is conducted on selected companies in the information technologies sector with no dissection between IT and ITES companies. Two cases in each of the form of restructuring is selected and the time horizon considered for the study is 2000-2013. The forms of restructuring taken for the study are mergers, acquisitions, split-off, spin-offs, sell-offs and joint ventures.
2.4 Sampling Techniques

The sample IT firms that are involved in the merger deals from the period 2000 to 2013 are collected from Centre for Monitoring Indian Economy (CMIE) Prowess and BSE website. Announcement dates had been verified by comparing them with data available on Money Control (A Financial Information Source). The data collected to measure shareholders value is collected from the annual reports of the company’s websites from 2000-2013. Since many studies have already been conducted to find the impact of corporate restructuring on shareholders’ value among large size firms an attempt has been made to include mid size and small size firms in the study.

2.5 Data and Methodology

The financial tools that will be used to measure value is Economic value added (EVA), Market value added (MVA) and Enterprise value. The statistical tools that will be used in the study are descriptive statistics, correlation and regression.

The other important tools used in the study are Econometric analysis and GARCH model. Econometric analysis is applied on time series data or cross sectional data. The main purpose of econometric analysis is to give both a quantitative answer to relationships among variables through statistical tools, using available data, and an interpretation of the results obtained. GARCH model will be used to test the volatility of the data.

This study concentrates on the information technology sector, and uses the theory in an attempt to understand and explain the specific. An exploratory case study approach will be employed to explain the reason behind an observed practice.

Case studies are viewed as a way to use a theory to explain observations. If the theory provides convincing explanations, it is retained and used further. If not, it is rejected and modified. If a sufficient number of similar case studies can be collected, researchers would be able to generate a theory. However, researchers should be careful not to fall into “the trap of trying to select a representative case or set of cases” (Yin, 1984:39), in order to produce statistical generalizations.

3. Limitations

- The study completely relies on available data which are secondary in nature.
- The time period considered for the study is from 2000-2013 and hence years before are not considered.
- The aim is not to produce generalizations but to provide explanations for observed practices.
References

Articles

Books