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Title: A Study of Impact of De Merger on Equity Prices and Financial Performance of Indian Companies

ABSTRACT

Demerger wave is increasing with rapid pace across the world and also in India. In India, however there is not much empirical evidence available on demerger and its underlying impact on business firms in Indian corporate sector. The present study is an attempt to analyze and find out the impact of demerger on corporate performance.

OBJECTIVES OF THE STUDY

- To find out and evaluate the motives for demerger.
- To evaluate the pre-and post-demerger financial performance of demerged companies.
- To study the effect of demerger on equity prices thereby shareholders' wealth.

RESEARCH METHODOLOGY

The present study is designed into three parts to evaluate the impact of demerger on corporate performance. The first part of the study evaluates the motives of demerger. For this, the secondary data have been collected on motives of demerger of Indian companies. In the second part of the study, the financial performance of companies that have gone for demerger in financial year 2006-07 and 2007-08 have been examined. The data have been collected on seventeen parameters indicating financial performance of the sample companies. In the third part of the study, the impact of demerger on equity prices has been analyzed. For this purpose, equity share price data of sample companies indicating shareholders' wealth of companies have been collected.

MAIN FINDINGS OF THE STUDY

(a) Motives of Demerger

The causes and motives of demerger have been extensively scrutinized by relating them with real life demergers. The summarized findings are as follows:

1) An in-depth scrutiny of demerger schemes revealed that the prime motives of demerger are to afford core competence, better administration, expanded capital base, better leverage, operational improvement and consequent cost savings, improve market share and achieve market dominance, achieve diversification, thus enhance growth prospects by product extension and market extension.
2) The most commonly reason for adopting demerger as restructuring option is unlocking or enhancing shareholders' wealth.
3) It is also found that some firms were demerging because of regulatory restrictions that apply to particular business within the group.
4) Settling family agreements is also one of the reasons for demerger. The most popular case is Reliance demerger.

(b) Impact of Demerger on Financial Performance

Profitability, Turnover and Solvency

Nine performance variables, relating to profitability, turnover and solvency have been examined. For all nine variables, null hypothesis, is accepted stating that there is no difference in financial performance after demerger.

- **Cash Flow**

The study has investigated operating cash flows before working capital changes and operating cash flows from business operation. It is found that there is significant increase in operating cash flow before working capital changes. Mean value of net cash flow from business operations also has increased in post-demerger period, but insignificant t-value accepted the null-hypothesis that there is no change in cash flow from operation in post-demerger period.

- **Productive Growth Rate and Accumulated Earnings**

Two ratios namely – pre tax return on net assets and retention ratio have been examined under this heading. No difference is found in pre-and post-demerger productive growth rate and accumulated earnings.

- **Value and Wealth Maximization of Shareholder**

The performance of both proprietary ratio and capital gearing ratio in post-demerger period is not supported by paired sample t-test leading to acceptance of null hypothesis that there is no change in post-demerger period. Insignificant t-value and p-value for dividend payout ratio and earnings per share reveal that there is no change in dividend policy of the firm as well as earnings per share.

(c) Impact of Demerger on Equity Share Prices

The analysis of pre-and post-demerger equity share prices has shown that some companies have succeeded in enhancing shareholders' wealth while others have not. The paired sample means is negative showing increase in equity share prices after demerger. But, lesser t-value and higher p-value accepts null hypothesis that there is no change in equity share prices after demerger and reject alternate hypothesis.

SUGGESTIONS AND IMPLICATIONS

1. The company should find out whether spin-off undertaking can justify its existence as a separate entity. While selecting a particular strategy, some of the key issues should be considered by company such as operative activities of the undertaking, type of products/services produced by it, nature and quality of assets of the company, use of technologies, market positioning, market value of share and so on.
2. Before pursuing demerger strategy, company should ensure achieving the purpose of the demerger. According to the purpose, company should plan its strategy.
3. The companies in post-demerger period should focus on reducing cost, higher sales growth and effective utilization of assets.
4. The company should ensure the intrinsic value of the share which will decide market price of the share accordingly.