CORPORATE REFOCUSING: STRATEGIC APPROACH

Kherchi Ishak

The Faculty of Economic,
Commerce and Management Science
University of Hassiba Benbouali, Chlef,
Algeria

Meddah araibi Elhadj,

The Faculty of Economic,
Commerce and Management Science
University of Hassiba Benbouali Chlef,
Algeria

ABSTRACT

Most researches on corporate refocusing has concentrated only on two broad issues; the effect of strategic refocusing on the firm performance and the choice between diversification or refocusing, while The literature is almost silent on the strategic approach of corporate refocusing. This study investigates the corporate refocusing from a strategic approach. We provide the concept of corporate refocusing, History and causes of corporate refocusing, and the corporate refocusing options.

Keywords: Corporate refocusing, Strategic refocusing, corporate refocusing options.

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Introduction:

Corporate refocusing is one of the most important decisions that could be taken by managers as part of growth for the firm. researchers have paid attention to corporate refocusing and well investigated the relation between corporate refocusing and performance based on agency theory, finance theory, the transaction costs theory.
Fewer researchers have investigated on corporate refocusing from a strategic approach There is a lack of clarify about this concept in the firm strategic management. Researchers in the field of strategic management need more information and clarification, managers need more strategic options to refocus firm's activities and make it more competitive.
Previous researches on corporate refocusing has concentrated only on two broad issues; the effect of strategic refocusing on the firm performance, and the choice between diversification or refocusing.
The literature is almost silent on the strategic approach of refocusing; we have an incomplete picture of corporate refocusing from a strategic approach, which is this research provide the strategic approach of corporate refocusing; corporate refocusing definitions, History and Antecedents of corporate refocusing, and different options for corporate refocusing. It does not consist in providing neither the relationship between refocusing and performance, nor the choice between refocusing and diversification; those two topics are well investigated by other contributors.
Against this background the purpose of this research is to answer the research questions: Why it is important to addressing corporate refocusing from a strategic approach? Why firms engaged in corporate refocusing? What are the corporate refocusing options?
More specifically, this research has the following objectives: -To contribute the theoretical understanding of corporate refocusing -To identify the corporate refocusing from a strategic approach. -To describe corporate refocusing options.
The rest of the article is strutted as follows: First the introduction, next literature review, later theoretical framework; definitions, History and Causes of corporate refocusing, corporate refocusing options, The Benefits and Costs of Corporate Refocusing, and finally conclusion.

Literature Review:

Hofer (1980), Hambrick and Schecter (1983) define a refocusing strategy as a focus on the businesses that were most profitable, or in which the firm holds a distinctive strength. According to (Bhagat *et al.,* 1990; Hoskisson and Turk 1990; Shleifer and Vishny 1990 and Markides, 1995) corporate refocusing may be referred to as an attempt by firms to reverse their excessive levels of diversification, most of which occurred in the 1960s and 1970s.
Markides (1990) estimates at least 20 percent (and perhaps as many as 50 percent) of Fortune 500 firms refocused between 1981 and 1987. Markides (1990) further estimates that this type of restructuring occurred in only about 1 percent of the firms during the 1960s and 1970s. Hoskisson and Johnson (1992) provide evidence that the majority of firms refocusing are not unrelated diversifiers; rather, they are firms that combine related and unrelated units in their portfolios. Furthermore, Markides (1992b) presents evidence to suggest that refocusing is equally likely among the *Fortune 400-500* as it is with the ***Fortune*** 100 .Kaplan and Weisbach (1992) and Williams et al. (1988) provide evidence that the majority of divestitures in the early 1980s were units unrelated to the parent's core business.
Markides (1992a, 1992b, 1995) has argued that firms may have diversified beyond optimal levels, causing performance to suffer. Hoskisson et al. (1994) present evidence that suggests that the majority of firms that refocused exhibited higher levels of diversification than their industry counterparts.
Duhaime & Grant(1984), Ravenscraft & Scherer(1991) found that managers cite poor performance as a major motivation for sell-offs. Seth and Easterwood (1993) provide evidence that many firms engaging in LBOs (financial restructuring) end up divesting units that no longer fit firm strategy.
Similarly, Smart and Hitt (1996) found that high levels of diversified scope were more likely to lead to refocusing as opposed to financial restructuring (LBOs). Hoskisson et al. (1994) found that refocusing firms on average exhibited higher levels of diversified scope than the industry average and that these high levels were positively related to divestment intensity (number of units sold, percentage of assets divested, and the time spent refocusing).

Theoretical Background:
Definitions:

Corporate refocusing is defined as the voluntary reduction in the scope of activities by a firm in an attempt to concentrate on the core business, primarily, though not necessarily, achieved through major divestments. This

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reduction in diversification has also been referred to in the business press as 'dediversification', 'de-conglomeration' or more colorfully, as 'sticking to the knitting' (peters and Waterman, 1982).
In the same meaning, corporate refocusing is the process of contraction through reducing levels of diversification and/or segment divestitures (Hoskisson & Hitt, 1994; Markides, 1992). This corporate strategy is an important one for bankrupt firms as it can improve their strategic choice by increasing their cash flow and slack resources (Bibeault, 1982; Hall, 1980; Pearce &Robbins, 1993) and strengthening a firm’s stance relative to its competitors (Hoskisson& Hitt, 1994; Lubatkin&Chatterjee, 1994).
Furthermore corporate refocusing means that a firm aims to eliminate peripheral activities. Especially businesses that are unrelated to a firm’s core are abandoned. Hence, a firm’s current core is to be strengthened. The basic idea behind a refocusing strategy is to reduce a firm’s complexity through the reduction of simultaneous operations and the concentration on core competencies. Hofer (1980) and Hambrick and Schecter (1983) therefore define a refocusing strategy as a focus on the businesses that were most profitable, or in which the firm holds a distinctive strength.
According to Woo,Willard & Daellenbach (1992),corporate refocusing is conceptualized as a collective term for asset disposal mechanisms such as sell-offs, spin-offs and leveraged buyouts. It is defined as the disposal of one or more of the corporation’s strategic business units to existing share-holders, a third party, existing management or a combination of existing management and third parties, either by means of proportional share redistribution, on outright sale, or the sub-stitution of a debt for equity.

History of corporate refocusing:

The prevalent explanation for refocusing (for example, Bhagat *et al., 1990;* Shleifer and Vishny, 1991; Markides 1995a), is that firms are attempting to reverse their excessive levels of diversification, most of which occurred in the late 1960s and early 1970s. This explanation implies two things: first, that there exists some optimal limit to the extent to which a firm may diversify without adversely affecting its performance; and second, that if refocusing became a widespread phenomenon from the 1980s, as Bhagat *et al.* (1990), Markides (1995a, b) etc. suggest for the US and is argued here for the UK, then a large number of firms must have found themselves to have been in breach of this optimum, during the period in question. As a result, the profitability and market value of over diversified firms will suffer and the issue of externalizing transactions by divestment to form an independent entity (e.g. a management buy-out) or to another organization becomes worthwhile (Wright & Thompson, 1987).
Williams *et al., (*1988) report that during the 1980s many large diversified firms have been reducing their complexity primarily through unrelated divestitures and related acquisitions. Davis et al (1994) found not only a one-third drop in the level of total diversification among *Fortune 500* firms between 1980 and 1990, but also a more than 40 per cent show that this conglomerate was brought about by two processes: firms with high diversity were taken over at an increased rate and subsequently unbundled, while less diversified firms started to reject conglomerate growth strategies. Similarly, Markids (1993) reports that between 20 and 50 per cent of fortune 500 firms refocused in the period 1981 to 1987 as opposed to negligible proportions in the 1960s.
Empirical evidence seems to lend support to the claim of increased corporate refocusing since the 1980s. Data presented by Singh (1993) show that while 1960s could be characterized as a period diversification mainly through acquisitions, the 1980s have been marked by high level of divestitures and leveraged buyouts in addition to acquisitions.

Causes of corporate refocusing:

Firms engage in a strategic refocusing for several reasons. Refocusing during the 1980s may have reversed prior acquisition. Diversification and expansion decisions carried out by non-value-maximizing managers. (To reduce agency costs). Jensen (1986, 1990)
According to Bhide (1990) firms engage in a strategic refocusing to reduce internal capital market efficiency. Refocusing may have reduced the scope of firms' internal capital markets as continuing innovation in financial markets and the reinvigorated market for corporate control during the 1980s reduced their advantage in allocating capital among lines of business relative to external capital markets.
Shleifer and Vishny (1991) show that corporate refocusing occurred for response to antitrust relaxation. Relaxed antitrust enforcement in the 1980s may have increased the comparative value of horizontal market expansion relative to diversification, leading firms to expand core businesses and shed peripheral businesses with small

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market shares.
While Stein (1994) shows that corporate refocusing occurs to reduce misevaluation. Refocusing may have been intended to reduce information asymmetries between shareholders and managers by simplifying the valuation problems of complex diversified firms and allowing hidden asset values to be realized
Firms also engage in a strategic refocusing to shed unwanted or under-valued assets. In fact, Kaplan and Weisbach (1992) and Williams et al. (1988) provide evidence that the majority of divestitures in the early 1980s were units unrelated to the parent's core business.
Other rationales for corporate refocusing involve firm governance, strategy and performance. Johnson (1996) argues that inadequate or weak governance allowed managers to utilize free cash flows without adequate controls. When shares are diffusely held shareholders have insufficient incentive to monitor firm strategy For example; boards of directors with little equity ownership appear to have little incentive to monitor strategy significantly unless performance suffers. This rationale suggests that the board of directors, ownership, and managerial incentives were inadequate to prevent high levels of diversification and poor strategy formulation.
Furthermore Markides (1993) provide three economic reasons why firms diversified in the 1960s.Equally, there are economic reasons why they are trying to reduce their diversification in the 1980s:
3.3.1. Every firm has a limit to how much it can diversify. This limit is a function of the firm's characteristics (more specifically its non-transferable specific assets) and its external environment.
3.3.2. Some firms (but not all) have (for **a** variety of reasons) diversified beyond this limit over the period 1950-80. **As** a result, their profitability and market value have suffered
3.3.3. Primarily because of a stronger market for corporate control (but also because of organizational learning) the over-diversified firms will be reducing their diversification to return to equilibrium. **As** a result, their profitability and market value will improve.

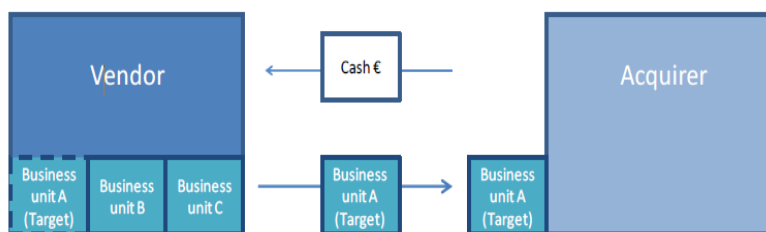
Strategic options for corporate refocusing:

Corporate refocusing is a type of asset restructuring, in which a firm cuts unprofitable or unimportant business segments to focus on an original or new core business. Consistent with this definition, a firm can refocus in three ways. First, it can downsize, by divesting peripheral, unprofitable, or unimportant business segments to focus on its remaining core business. Second, in addition to divesting, it may increase investment in its original core business by acquiring related business segments. Third, a firm may exit its original core business through a series of divestments and acquire new businesses, in order to shift to a new core area. (Mak.C.Y, et al.2011).

Asset sale/Sell-off:

An asset sale is defined as the sale of a division, subsidiary, product line or other assets directly from one firm to another firm. An asset sale involves three parties the acquirer, the divesting company (vendor) and the subsidiary or division being sold off (target). From the view of the acquirer and the target the transaction is an acquisition, while it is a divestiture from the view of the divesting company. The acquiring firm is taking over the corporate control of the target and absorbs the transferred subsidiary or division into the organizational structure of the firm. The payment of asset sales is normally in cash, but the payment can also be done in the stock of the buying firm (Weston, et al., 2004).

Figure1: Asset sale/Sell-off



Source: Fogh.L.K (2009)

Spin-off:

A spin-off of a business division can be seen as a stock dividend to the shareholders of the vendor company. A spin-off is defined as a pro-rata distribution of shares in a subsidiary to the existing shareholders of the parent.

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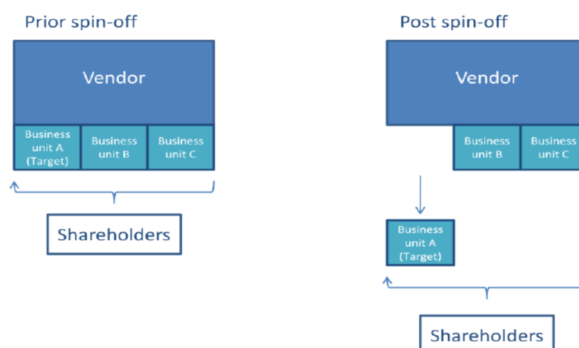
This type of refocusing creates a new publicly traded company that is completely separated from the parent company. The parent company is not generating any cash in this type of refocusing (Weston, et al., 2004). In a spin-off there is no acquiring company as in the case of asset sales.
The figure below shows the vendor company before and after the spin-off of business unit A to the existing shareholders of the company.

Figure 2: Spin-off

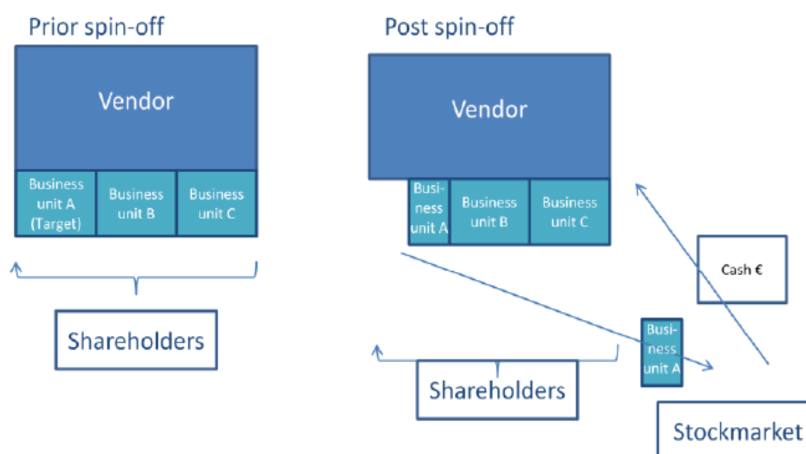


Source: Fogh.L.K (2009)

Equity carve-out:

An equity carve-out is defined as the offering of a full or partial interest in a subsidiary to the investment public. An equity carve-out is an IPO of a corporate subsidiary, or a split-off IPO. This mode of refocusing creates a new, publicly traded company with partial or complete autonomy from the parent firm (Weston, et al., 2004). This form of refocusing is often used in situations where the parent company does not want to give up full control over a business unit or subsidiary in those cases the refocusing is referred to as a minority carve-out (Koller, et al., 2005).
If the parent company and carved-out business unit still have operating or strategic synergies it is likely that an equity carve-out is not the optimal refocusing mode. Legal protection of the minority shareholders of the carved-out business often demand that all transactions with the parent company is done on fair market terms, why most synergies between the parent and the business unit is lost in an equity carve-out (Annema, et al., 2001). Klein et al. (1991) observe that most equity carve outs are followed by a second event, where either the parent company sells its remaining shares in the subsidiary or reacquire the remaining shares in the subsidiary. This suggests that equity carve-out often is not a permanent organizational structure (Allen et al., 1998).
The figure below shows how the vendor company carve-out a part of business unit A in an IPO of the unit and receives cash in return

Figure 3: Equity carve-out



Source: Fogh.L.K (2009)

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Split-off:

This is the same as the spin-off, except that the shareholders of the parent corporation give up some of their stock in the parent corporation in exchange for stock of the subsidiary much like a stock redemption or partial liquidation of the parent. (Brown.R.L 2007).

Split-up:

Here the parent corporation distributes the stock of two or more of its subsidiaries whether newly formed or preexisting, in complete liquidation of the parent corporation. (Brown.R.L 2007).

Management Buyouts:

Management Buyouts take place when the former management (management buyout) or a group of private investors, typically including the former management (leveraged buyout) replace public Stockholding of the parent company, normally using debt financing. Typically, a management buyout is chosen if the parent wants to maximize cash flows from the sale, is interested in its post-divestiture performance, and the buying managers are ready to pay a higher price for the unit than the value perceived by the parent (Sewing.J.H, 2010).

Choosing among corporate refocusing options:

The choice of refocusing mode has been researched linked to antecedents and/or outcomes of refocusing. In principle, the decision to choose a specific mode of refocusing (whether a sell-off, carve-out, spin-off, split-off, split-up, or Management Buyout) is based on three groups of factors: the characteristics of the parent (such as performance, degree of financial distress, diversification), characteristics of the business unit (e.g., performance, relatedness to the parent or other businesses), and characteristics of the environment (profitability and growth, for example). (Sewing.J.H, 2010).
According to (Prezas.A.p, Simonyan.K 2012) The choice among forms of corporate refocusing ; sell-off, carve-out, spin-off, split-off, split-up, or Management Buyout are based on the characteristics of refocusing firms (such as their valuation in the market relative to their intrinsic value and their marginal tax rate), by the characteristics of the assets being divested (their current performance under parent firm's management relative to their full potential), and by the prevailing market conditions at the time of divestiture (such as the degree of investor optimism or pessimism).

The Benefits and Costs of Corporate Refocusing:
Benefits of Refocusing:

Corporate Refocusing should be especially beneficial for firms in differentiated and incremental choice situations. For example, in differentiated choice situations, where firms have strategic choice and face strong external constraints, it would seem useful to refocus a diversified firm around a new or traditional core business with greater promise and less constraints.
Such efforts would move the firm closer to a maximum choice situation. Refocusing would also generate additional slack from nonessential activities, thereby further increasing the strategic latitude of firms in differentiated choice situations. Such latitude would permit the redeployment of assets to improve competitive prospects in the newly defined core businesses.(David .D ,James.J, Bruce .T 2002)
Liebeskind & Opler (1992) provide four explanations have been provided for the corporate refocusing phenomenon which point to the value created by reducing the costs of diversification. These explanations are:
3.6.1.1.Reduction of agency costs. Poor incentive structures may cause managers in public corporations to over-invest in diversifying expansion, reducing the value of the firm. Managerially-motivated diversification may reduce firm value by permitting managers to cross-subsidize unprofitable lines of business. Managers may also over pay for takeover targets. Refocusing may have increased during the 1980s, and not before, as the extent of the extent of agency costs associated with diversification was revealed. Pressure to refocus may also have intensified during the 1980s because the rise in real interest rates increased the costs of cross-subsidization, and because financial innovations reduced the costs of launching a hostile takeover? The agency theory explanation for refocusing suggests that private corporations where managers typically own more equity should be less likely to have undertaken wasteful diversification in the 1960s and 1970s than managers in public firms.

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Consequently, privately held firms should have had less need to refocus during the 1980s than public firms. The agency explanation of refocusing also predicts that firms which have a low Tobin's *q* should refocus since low Tobin's *q* signifies low expected cash flows relative to invested assets, an indicator of poor expected firm performance and agency conflict.

3.6.1.2. Reduction of internal capital market inefficiency. A second explanation for refocusing is that external governance of capital allocation among lines of business became more efficient relative to internal capital market governance in the 1980s. First, increasing shareholder activism and changes in legal precedent regarding shareholders' rights may have increased the efficiency of governance of capital allocation decisions by shareholders relative to corporate headquarters. Second, innovations in external financial markets (e.g. the venture capital market) may have made market governance of some capital reallocation decisions more efficient.

Both of these considerations suggest that breaking up internal capital markets may have created value during the 1980s. According to the internal capital market inefficiency explanation for refocusing, firms with greater fixed asset bases should be more liable to refocus than other firms since they have historically higher levels of capital investment with the resulting potential for capital misallocation.

3.6.1.3. Relaxation of antitrust. During the 1980s, the enforcement of anti-trust legislation was relaxed, giving many firms with large market shares a new option to undertake horizontal market expansion through merger. Consequently, some firms may have found it relatively more profitable to focus by expanding lines of business in which they held large market shares at the beginning of the decade than to diversify.

3.6.1.4. Reduction in market misevaluation. Diversified firms may be more subject to misevaluation by the market than focused firms because of the difficulty of valuing synergies between lines of business.

Misevaluation of diversified firms may have intensified shareholder pressure to refocus during the 1980s. Corporate refocusing using disagreement among analysts' earnings forecasts as a proxy for misevaluation. The less analysts agree over future firm performance, the less likely it is that the firm is being valued accurately and the greater pressure to refocus. If equity market misevaluation were the primary cause of refocusing then we would also expect to see more focusing in public than in private firms.

The Costs of Refocusing:

The four explanations outlined above suggest that refocusing will increase firm value because the costs of diversification outweigh its benefits. However, other arguments suggest that diversification in the 1980s may have brought significant benefits. Liebeskind & Opler (1992) categorize these arguments into two groups:

3.6.2.1. Changing economies of scope. Diversified firms may be able to exploit economies of scope in assets which are firm-specific by using them to produce a number of different products. These assets may be tangible, such as production and distribution facilities, or intangible, such as proprietary know-how or reputational capital. In either case, synergistic or

"Related" diversification should increase the value of the firm. Diversifying investment tends to be concentrated in technology intensive industries. The value of economies of scope may have during the 1980s due to increased technological innovation. It is also possible that product market globalization during the 1980s created new sources of economies of scope for diversified firms

3.6.2.2. Increases in internal capital market efficiency. Internal capital markets may be more efficient than external capital markets, despite their costs. Allocation is more efficient in internal capital markets because there is less information asymmetry between corporate headquarters and divisional managers than there is between shareholders and managers. Thus, we entertain the hypothesis that the relative efficiency of internal capital markets increased in the 1980s. Internal capital market efficiency may have increased in the 1980s as firms changed their procedures for making divisional investments or improved the accuracy of internal performance measurement In certain cases, organizational innovations may have reduced cross subsidization problems (e.g. legal "Chinese Walls" between divisions as in National Intergroup and USX).

Conclusion and Suggestions:

We have an incomplete picture of corporate refocusing; previous research on corporate refocusing has concentrated only on two broad issues; the performance of corporate refocusing and the choice between diversification or refocusing. That is this research provided corporate refocusing from a strategic approach. We were not trying to show the effect of corporate refocusing on the firm value, but the Antecedents and history of corporate refocusing,

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corporate refocusing options like sell-off, carve-out, spin-off, split-off, split-up, or Management Buyout.the cost and benefits of corporate refocusing. Future research should focus more on corporate refocusing processes and corporate refocusing programme.

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