

Impact of Demerger Announcement on Shareholder Value: Evidences from India

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Abstract

Demergers of conglomerates are a common phenomenon in financial markets across the world. Carried out with different motives generally, in a share demerger program, the company distributes the shares of demerged entity to the existing shareholders without any consideration. Demergers in Indian companies are over a decade old phenomena, with many companies opting for the same. This paper examines the demergers and the announcement period price reaction of demergers during the year 2012-2014. The authors have studied total 51 demergers of companies listed in India and tried to establish that demergers results into abnormal returns for the shareholders of the parent company. Using event study methodology the authors have analyzed the security price performance of the announcement day effect 10 days prior to the announcement to 10 days post demerger announcement. They have found significant out-performance of the security over the benchmark index post demerger announcement ranging from 1.74% average abnormal return for a demerger announcement to 0.16% average abnormal return 10 days following the announcement.

Keywords: Demergers, Spin-offs, Event study, Stock returns

Introduction

Business corporations are core to economic activity, growth, and prosperity at both the national and global levels. In 2013, there were 64 corporations in the world that had revenues in excess of \$100 billion -- Nineteen of them are American, five Japanese, six German, Four Chinese and two British, and one British-Dutch. Of the world's 50 biggest employers – ranging from Wal-Mart, with 2,200,000 employees to Peugeot with 198,600 employees – 18 were American, nine French, seven German, six Chinese, few Japanese-British, Russian and Swiss.

Some of these corporations did not even exist historically and grew large over time by developing the productive capabilities of their investments in physical and human capital and then realizing returns on these investments through the sale of goods and services, thus enjoying the benefits of scale, size, and scope. Corporate growth story in India is no different, companies in India came into existence long ago during colonial rule, however, real growth began from liberalizing policies of the government of India from 1991. In historical retrospect, that growth was not inevitable, and one cannot assume that any particular corporation will be able to sustain its current levels of revenue, growth and employment in the times to come. Industrial corporations that have grown large and many a times have undergone a major restructuring.

According to Lazonic (2003), as distinct from growth, corporate restructuring entails a significant (and ostensibly permanent) reduction in the resources that a corporation allocates to those *product markets or process activities or geographical locations* in which it had previously been engaged. Such a reduction may be part of a process of reallocating corporate resources to new growth areas, but, by definition, corporate restructuring always entails a retrenchment of resource commitments to one or more markets, activities, and/or locations compared with the commitments that had been made in the past. Corporate restructuring can, therefore, have Reorganization of ownership and assets (e.g... Asset Sales, Equity Carve-outs, and demergers) or Reorganization of financial claims (e.g... Debt-equity exchange offers, leveraged recapitalizations, Financial reorganization (bankruptcy), Liquidation) or Other Strategies (e.g... ESOPs, Using international markets (GDRs and ADRs), Share Repurchase programs (Buyback). It is a matter of perennial debate that whether these restructuring transactions create value for the shareholders or destroys value for the shareholder.

This study focuses on the shareholder value created out of corporate restructuring transactions in general and demergers in particular in India during the period of three years 2012 – 2014.

A divestiture occurs when a company sells or disposes of its assets. Most of the divestitures are either demerger, sell-offs, or equity carve-outs. Divestitures can be voluntary or involuntary. Involuntary divestitures are a result of anti-trust agencies or the judicial system, whereas voluntary divestitures are the result of a management decision to realign its business focus. The main objective for divestitures is the belief that “sum of parts is greater than the whole” (Frank, 2001). In a demerger, commonly known as spin-offs in the US, a firm is broken up into two or more independent entities.

In this process of restructuring, a wholly owned subsidiary becomes an independent company generally a listed entity in the stock markets, with its shares being distributed to the shareholders of the parent company on a pro-rata basis for no consideration. This process is considered to be a non-cash dividend by the parent firm and is usually tax- free.

Literature Review

Accounting Standard 14 – Accounting for Demergers and International Financial Reporting Standards (IFRS) 3 -Business Combinations, in India-specifically deal with accounting for demergers. In spite of this, accounting for demerger is uniform and quite simple.

Demerger does not result in a purchase or sale transaction but is just a division of an existing entity, the demerged company. There is no reason to restate the carrying amount of assets and liabilities. Therefore, demerger is accounted for at the recorded book values of the assets and liabilities transferred to the new entity. In a demerger, a new company is formed and all the assets and liabilities of an undertaking of the demerged company are transferred to the new company. This new company, which has an economic and legal identity separate from the demerged company, issues shares to shareholders of the demerged company without receiving cash. As a result, a substantial number of shareholders of the demerged company become shareholders of the new company. The face value of new shares has no economic significance.

Value creation is a prime measure by which a corporation's performance is evaluated. However it is a matter of debate within academicians, researchers and practitioners on what is the most appropriate type of value for the corporation to create. Is it the value shown in the balance sheet? Or the value that the stock market gives to the company? Or something based on its expected future performance – profits or Cash. Following the shareholder value approach as described by Rappaport (1986), an increase in shareholder value for a listed company can be measured by the increase in market capitalization or more specifically by the total return to shareholders. According to Lamont and Thaler (2001), two key principles of the efficient market hypothesis are that first it is not easy to earn excess returns and second it is not easy to earn excess returns and the price correct reflecting fundamental values.

There is a broad consensus in both the academic and the popular literature that demergers – Spin-offs tend to create value for shareholders. This consensus is based on evidence from a number of studies indicating that, on average, the announcement of a spin-off by a US firm is associated with a positive abnormal stock return.

It looks far from obvious that how a simple break-up of an organization into smaller unit/s would create value. "If there are no synergies between the parent and the subsidiary, the sum of the post-divestitures' cash flows would equal the combined cash flow had the two units remained as one" Hite and Owers (1983), and the aggregate value of the two units would be same as the value of the parent undivided organization unless there exists some negative synergies in the units separated.

According to Hite and Owers (1983) In the case of mergers the arithmetic is often expressed as '2+2=5' whereas for spin-offs it is '4-2=3". While the potential gains from mergers might arise from synergy, for example, it is less obvious with spinoffs why the aggregate market value of the shares of the two units trading separately should exceed the market value as a single unit.

The one of the earliest empirical paper on this subject was published by Miles and Rosenfeld (1983), analyzing announcement effects of 55 demergers/spin-offs between 1963 and 1980. Analyzing a time period ranging from 120 trading days before, to 60 trading days after, the demerger announcement, they found a statistically significant cumulative average adjusted return of 22%. Measuring the announcement effect (i.e. at day zero and day one) they found the average abnormal return of +3.3%, for the longer period from day -10 to day +10 it is +7.6%. This indicates a noteworthy positive assessment of demergers by the market.

Schipper and Smith (1983), conducted a study of 93 voluntary demerger announcements between 1963 and 1981. Using a market model (CAPM), they established a significantly positive announcement effect of approximately +2.8% for a two-day announcement period. They also noted that most spun-off subsidiaries (72 out of the total of 93 firms) were operating in dissimilar industries to the parent firm.

Hite and Owers (1983), found the security price reactions of 123 voluntary demergers between 1963 and 1981 and established a statistically significant positive cumulative abnormal return of +7% for the period ranging from 50 days prior to the announcement through to the completion date. Of this, +3.3% took place in the two-day period from day -1 to day 0.

Chemmanur and Yan (2003), show that spin-offs announcements are associated positive announcement effects and increases in long-term operating performance. Certain categories of spinoffs will exhibit long-term positive abnormal stock returns based on the consideration of incumbent and rival firm performance. Veld and Veld-Merkoulova (2004), studied announcement effects and long-run performance for a sample of 156 European spin-offs announced from January 1987 to September 2000. They found that the announcement of a subsequently completed spin-off is associated with a positive abnormal return of 2.66% over a three-day window.

Singh *et.al.* (2009), studied demergers in India to measure the wealth effect of demerger before and after the announcement. They found that after demerger there is an increase in the total wealth of the shareholders in almost all the case and conclude that demergers remove negative synergy and the value is unlocked, resulting into the wealth of the shareholders. Khurana and Gupta (2013), studied a few demergers in India to establish that the demerger resulted in significant increase in total market capitalization of the firms involved and the reason attributed is the improved focus. However, the motive of wealth maximization is questionable.

It can be therefore concluded, that the demerger announcements and execution are associated with strongly significant abnormal returns that range from 1.32% to 5.56% depending upon the

geography studied and the time period. However, one in the study by Murray (2000), for the UK, who reports a non-significant abnormal return of -0.19% for the event window from the day -1 to day 1 surrounding the demerger. Interestingly, the study by Schauten (2001), for the same country and for the same event window shows an abnormal return of 2.13%.

Therefore, as discussed the empirical literature about demergers is dominated by studies conducted on demergers in US and UK and a few studies that depict the impact of demergers on shareholder value in Europe (except the UK) and East Asian countries. Study of the effect of demergers on the shareholder value is very limited and case based than the sample based in Indian demergers.

Methodology

To evaluate the announcement performance of demerger well established event study methodology has been used in this research. Event studies have a long history. The first published study was of James Dolley (1933) since then event study has a long history to its credit. Over the decades from the early 1930s until the late 1960s the level of sophistication of event studies increased. John H. Myers and Archie Bakay (1948), C. Austin Barker (1956, 1957, 1958), and John Ashley (1962), have significantly contributed to event studies during this time period. In the late 1960s seminal studies by Ray Ball and Philip Brown (1968), and Eugene Fama et al. (1969) introduced the methodology that is essentially the same as that which is in use today.

The initial task of conducting an event study is to define the event of interest and identify the period over which the security prices of the firms involved in this event will be examined this is called the event window. In this research, the event that is under study is the announcement of demerger by a company. As is customary to define the event window to be larger than the specific period of interest the paper takes 10 days prior and post announcement of demerger – event under study. This permits examination of periods surrounding the event. After identifying the event, it is necessary to determine the selection criteria for the inclusion of a given firm in the study. The criteria may involve restrictions imposed by data availability such as listing on the Bombay Stock Exchange or National Stock Exchange in Indian context or may involve restrictions such as membership in a specific industry.

To find the effect of demergers of the listed company, the list of the company which has declared corporate action under section 391-394 of the Companies Act, Amalgamation and Demergers has been taken from database Capital Line and ACE Equity. Then the data has been filtered and cleaned by re-checking from the NSE website and for those company which are not listed on NSE, BSE website has been used from their exact announcement date and the stage of the demerger has been confirmed. Share prices and the benchmark index values have been taken from ACE Equity. For this study, the price taken for shares are the adjusted closing prices of the shares.

This study classifies the demergers into four categories viz. Large Demergers – Demergers arising out of large capitalization companies i.e. the company having Marketed capitalization of

more than Rs. 5000 crore, Small Demergers - Demergers arising out of small cap (Rs. <5000) companies, Private Demergers – Demergers where the demerged entity is a private limited company and shareholders of listed entity does not get the shares of demerged entity. Listed demergers are those demergers where the demerged company gets listed on the stock exchange and the shareholder gets the share of both new demerged entity as well as the parent company.

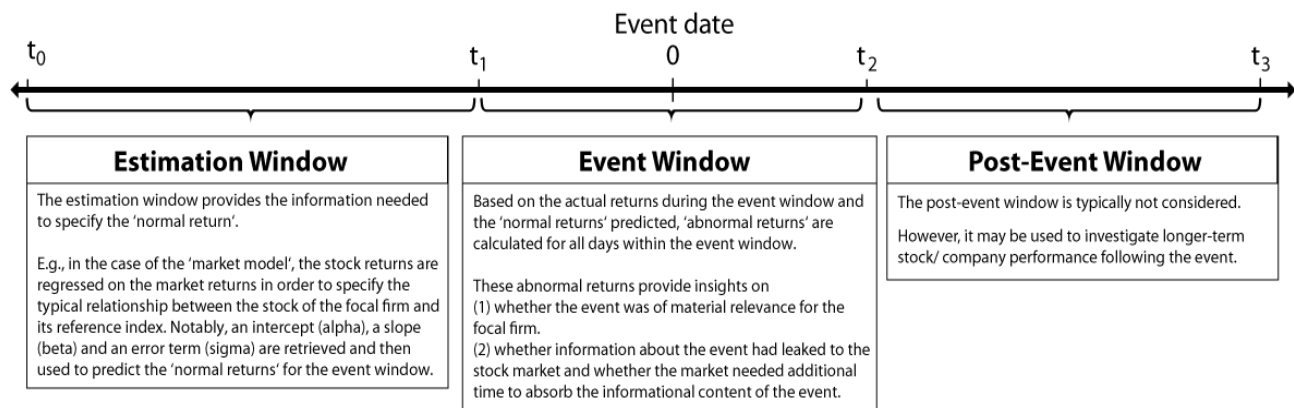
Table I: No. of Demerger Announcements per Year

Year	# of events
2012	12
2013	28
2014	11

Table II: Total no. of Categorical Demerger Announced in Each Year

No. of demergers (yearwise)	2012	2013	2014	Total
Large	1	8	1	10
Small	11	20	10	41
Total	12	28	11	51
Private	4	21	9	34
Listed Demergers	8	7	2	17
Total	12	28	11	51

Appraisal of the event’s impact requires a measure of the abnormal return. The abnormal return is the actual ex-post return of the security over the event window minus the normal return of the firm over the event window. The normal return is defined as the expected return without conditioning on the event taking place.



[Adapted from Benninga (2008: 372)]

The 'market model' is one of the most common models used. It builds on the actual returns of a reference market and the correlation of the firm's stock with the reference market. Equation (1) describes the model formally, The abnormal return on a distinct day within the event window represents the difference between the actual stock return $R_{i,t}$ on that day and the normal return, which is predicted based on two inputs; the typical relationship between the firm's stock and its reference index (expressed by the α and β parameters), and the actual reference market's return ($R_{m,t}$).

$$AR_{i,t} = R_{i,t} - \beta_i R_{m,t}$$

In the above equation, β_i is the Beta is the measure of a stock's sensitivity of returns to changes in the market. $R_{m,t}$ is the return on the market i.e. nifty index return over the period time t .

$$\beta = \frac{\text{covariance of stock to the market}}{\text{variance of the market}}$$

$$\beta = \frac{\text{cov}(R_i, R_m)}{\sigma^2}$$

As per the market return model given by Mac Kinlay (1997), event study methodology β is taken as 1, because of the following reasons (1) fundamental issue in calculating beta, (2) beta in this period is quite distorted (3) there is no data to estimate future beta of the subsidiary (4) Pre-transaction beta does not reflect the post-transaction risk-return profile.

Such an analysis performed for multiple events of the same event type (i.e., a sample study) may yield typical stock market response patterns, which have been at the center of prior academic research. Typical abnormal returns associated with a distinct point of time before or after the event day are defined as follows.

$$AAR = \frac{1}{N} \sum_{i=1}^N AR_{i,t}$$

To measure the total impact of an event over a particular period of time (termed the 'event window'), one can add up individual abnormal returns to create a 'cumulative average abnormal return'. Equation (2) formally shows this practice.

$$CAAR(t_1, t_2) = \sum_{t=t_1}^{t_2} AAR_{i,t}$$

To check the statistical significance of the abnormal return, t-test has been used.

$$t = \frac{AAR}{\hat{\sigma}_{ar}}$$

Where, $\hat{\sigma}_{ar}$ is an estimate of a the standard deviation of the average security's return. It is calculated from the -10 to 10 day's pre and post announcement of the demerger. A t-statistic

with a p-value (i.e. the observed significance level) less than or equal to 0.05 is considered to be significant.

Data Analysis

Table III reflects the abnormal returns for all demerger announcements during the period 2012-2014, Over the 21 day observation period, the cumulative average abnormal return (CAAR) is 2.59%, and there are significant Average Abnormal Returns (AARs) immediately surrounding and including day 0 with a t-score of 3.3604.

On the day 0, AARs appear to vary randomly, indicating that the demerger news is fully impounded in stock prices within a relatively short time. It is also depicted that from day +1 the AAR are going down on the followed day the AAR is reduced to 1.07%.

Table III: Abnormal Return on ALL Demergers

Day	AAR	CAAR	t
-10	-0.05%	-0.05%	-0.0717
-9	-0.61%	-0.66%	-0.8155
-8	0.02%	-0.64%	0.0326
-7	-1.24%	-1.87%	-1.6543**
-6	0.04%	-1.84%	0.0510
-5	-0.18%	-2.01%	-0.2361
-4	0.22%	-1.79%	0.2937
-3	0.65%	-1.15%	0.8656
-2	0.47%	-0.68%	0.6295
-1	0.82%	0.15%	1.1043
0	2.51%	2.66%	3.3604***
1	1.07%	3.73%	1.4359*
2	-0.60%	3.13%	-0.8094
3	-0.17%	2.96%	-0.2244
4	0.13%	3.09%	0.1735
5	-0.37%	2.72%	-0.4983
6	-0.04%	2.67%	-0.0598
7	0.01%	2.68%	0.0168
8	-0.08%	2.61%	-0.1041
9	-0.31%	2.30%	-0.4130
10	0.29%	2.59%	0.3916

* significant at 10% level, ** significant at 5% level, *** significant at 1% level

This paper further analyzes the demerger announcements by dividing the entire sample into two parts viz. large demergers and small demergers, depending upon the market capitalization (cap) of the parent company. For all those companies whose MCap is more than Rs. 5000

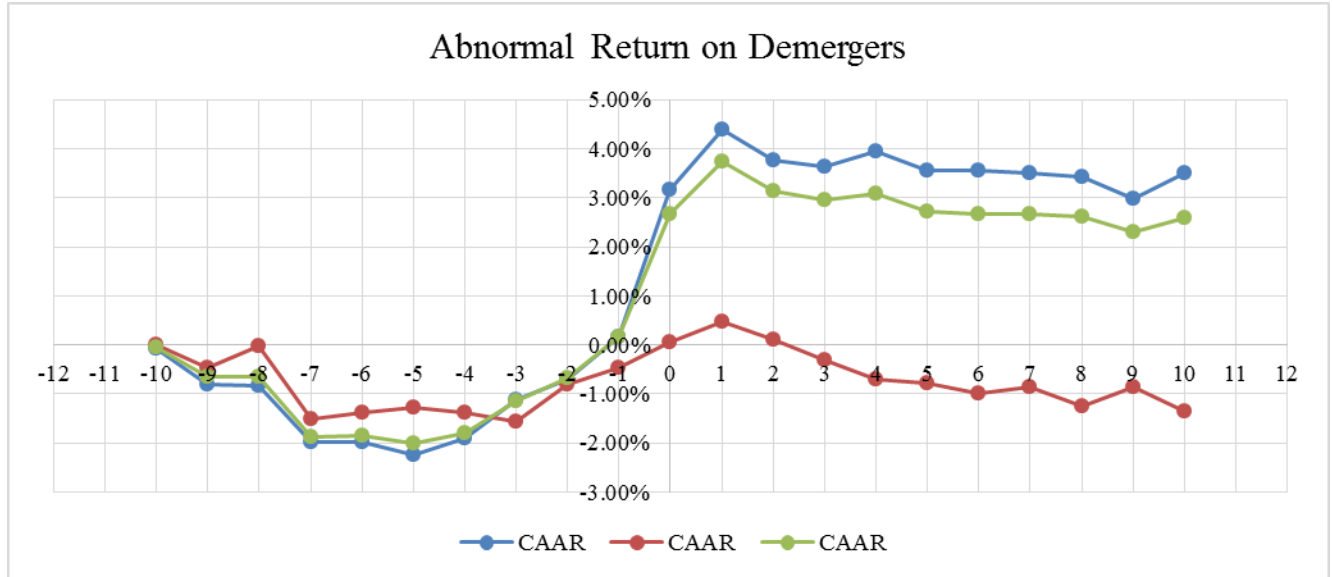
Crores is considered to be large cap stocks thereby categorizing demerger announcement by them as large demergers and, rest of the demerger announcements as small demergers.

Table IV records the result of large and small demergers. The small demerges, 41 observations in total, generates 3.50% CAAR in 21 days surrounding the announcement whereas 10 observations that are categorized as large demerger are generated -1.35% CAAR during the aforesaid period. On the day, 0 small demerger draws 3.17% CAAR with an AAR of 3.02% and the t-score value of AAR is 3.5601 which is highly significant, while large demerger generates 0.06% CAAR with AAR of 0.52% and t-value of 0.8739 that is statistically non-significant.

Table IV: Abnormal return on large and small demerger

Large Demergers				Small Demergers			
Day	AAR	CAAR	t	Day	AAR	CAAR	t
-10	0.01%	0.01%	0.0235	-10	-0.07%	-0.07%	-0.0874
-9	-0.47%	-0.46%	-0.7951	-9	-0.73%	-0.80%	-0.8567
-8	0.44%	-0.01%	0.7541	-8	-0.03%	-0.83%	-0.0389
-7	-1.50%	-1.51%	-2.5341 ^{***}	-7	-1.15%	-1.99%	-1.3580 [*]
-6	0.13%	-1.37%	0.2222	-6	0.00%	-1.99%	-0.0038
-5	0.11%	-1.27%	0.1816	-5	-0.26%	-2.25%	-0.3079
-4	-0.12%	-1.39%	-0.2052	-4	0.35%	-1.90%	0.4147
-3	-0.16%	-1.55%	-0.2688	-3	0.79%	-1.11%	0.9315
-2	0.74%	-0.81%	1.2536	-2	0.42%	-0.69%	0.4952
-1	0.35%	-0.46%	0.5876	-1	0.84%	0.15%	0.9930
0	0.52%	0.06%	0.8739	0	3.02%	3.17%	3.5601 ^{***}
1	0.41%	0.47%	0.6959	1	1.21%	4.39%	1.4293 [*]
2	-0.36%	0.11%	-0.6025	2	-0.61%	3.77%	-0.7195
3	-0.41%	-0.30%	-0.6897	3	-0.15%	3.63%	-0.1714
4	-0.41%	-0.71%	-0.6943	4	0.31%	3.94%	0.3639
5	-0.08%	-0.78%	-0.1303	5	-0.37%	3.56%	-0.4402
6	-0.21%	-0.99%	-0.3531	6	-0.01%	3.55%	-0.0169
7	0.15%	-0.85%	0.2466	7	-0.04%	3.51%	-0.0501
8	-0.41%	-1.26%	-0.6936	8	-0.09%	3.42%	-0.1031
9	0.40%	-0.86%	0.6786	9	-0.43%	2.99%	-0.5089
10	-0.49%	-1.35%	-0.8325	10	0.51%	3.50%	0.6043

* significant at 10% level, ** significant at 5% level, *** significant at 1% level



Analyzing further, this study divides all observations into two parts private demerger and listed demerger. Private demergers are those in which the demerged entity would become a private limited company wherein, the shares of such private limited company are not allotted to the shareholder of parent public listed company and listed demerger are those in which the demerged entity gets would be a public listed company, listed on the stock market and the shareholder parent company gets shares of the new company in proportion to their holding without paying any consideration.

As per the results mentioned in table V private demerges draws 4.38% CAAR with an AAR of 1.83% on day 0 and the *t*-score is highly significant with 2.0787, listed demergers generates to a negative CAAR of 1.07% on day 0 with an AAR of 3.92%. For the entire 21 Days' period private demergers are giving CAAR of 2.10% while public demergers give 3.44% CAAR. This would be probably because the shareholders realize the value generation of the upcoming new entities.

Table V: Return on Private and Listed demergers

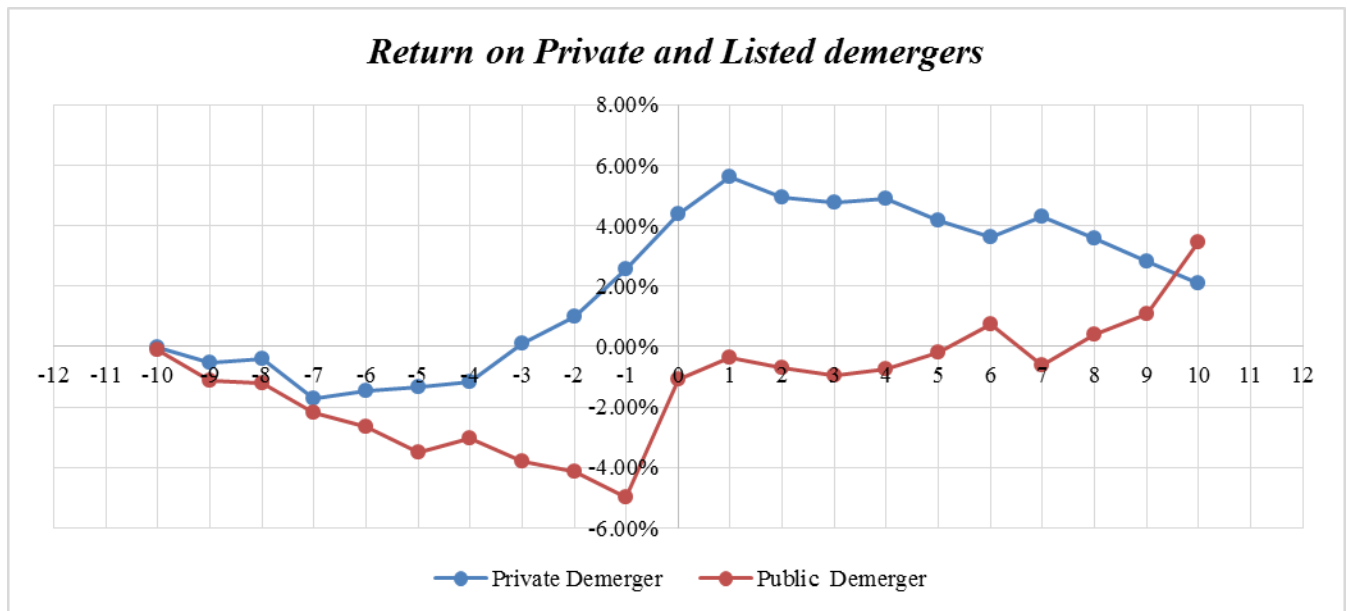
Private Demergers			
Day	AAR	CAAR	<i>t</i>
-10	-0.03%	-0.03%	-0.0294
-9	-0.51%	-0.53%	-0.5755
-8	0.14%	-0.39%	0.1599
-7	-1.35%	-1.74%	-1.5300*
-6	0.27%	-1.47%	0.3058
-5	0.14%	-1.34%	0.1545
-4	0.15%	-1.19%	0.1706
-3	1.29%	0.11%	1.4670*
-2	0.91%	1.01%	1.0263

Listed Demergers			
Day	AAR	CAAR	<i>t</i>
-10	-0.12%	-0.12%	-0.0971
-9	-1.01%	-1.13%	-0.8278
-8	-0.10%	-1.23%	-0.0817
-7	-0.96%	-2.19%	-0.7829
-6	-0.47%	-2.66%	-0.3842
-5	-0.84%	-3.50%	-0.6859
-4	0.48%	-3.02%	0.3891
-3	-0.78%	-3.80%	-0.6343
-2	-0.36%	-4.16%	-0.2964

-1	1.53%	2.55%	1.7371**
0	1.83%	4.38%	2.0787**
1	1.23%	5.61%	1.3908*
2	-0.67%	4.93%	-0.7642
3	-0.15%	4.78%	-0.1743
4	0.13%	4.90%	0.1429
5	-0.74%	4.16%	-0.8426
6	-0.54%	3.62%	-0.6102
7	0.66%	4.29%	0.7516
8	-0.72%	3.56%	-0.8177
9	-0.76%	2.81%	-0.8565
10	-0.70%	2.10%	-0.7983

-1	-0.83%	-4.99%	-0.6780
0	3.92%	-1.07%	3.2017***
1	0.71%	-0.36%	0.5812
2	-0.33%	-0.70%	-0.2717
3	-0.28%	-0.98%	-0.2308
4	0.25%	-0.73%	0.2053
5	0.54%	-0.19%	0.4420
6	0.92%	0.73%	0.7515
7	-1.34%	-0.61%	-1.0975
8	0.99%	0.38%	0.8099
9	0.71%	1.09%	0.5768
10	2.36%	3.44%	1.9249**

* Significant at 10% of level, ** significant at 5% of level, *** significant at 1% of level

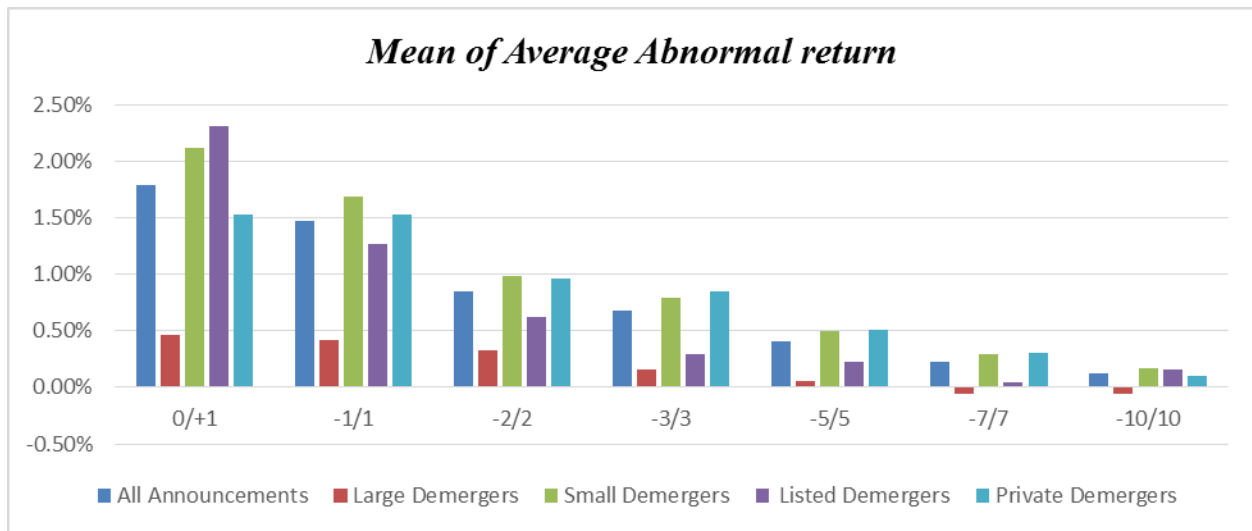


Further, this out-performance of demerger announcement is analyzed into smaller intervals within the total no. of days analyzed. On a two-day interval, Day 0 and Day 1 post announcement all demerger announcements under study give a CAAR of 1.79% with small, listed and private demerger gives a CAAR of 2.12%, 2.31%, and 1.53% respectively which are statistically highly significant. On a three day interval of -1 to +1 days, five-day interval of -2 to +2 days, to 15-day interval of -7 to +7 days surrounding the demerger announcement the study finds significant outperformance by small, listed and private demergers over its peers. However, over a 21-day interval of -10 to +10 days the return diminishes and the price adjust to the market and the information is well absorbed by the market and securities as suggested by Fama (1969) in the efficient market hypotheses.

Table VI: Mean of Average Abnormal returns

Mean	Announcement Effects of Demergers				
No. of Days	All Demergers	Large Demergers	Small Demergers	Listed Demergers	Private Demergers
0/+1	1.79%***	0.46%	2.12%***	2.31%***	1.53%***
-1/1	1.47%***	0.42%	1.69%***	1.27%***	1.53%***
-2/2	0.85%***	0.33%	0.98%***	0.62%**	0.96%***
-3/+3	0.68%**	0.16%	0.79%***	0.29%	0.85%***
-5/+5	0.41%**	0.05%	0.50%**	0.22%	0.51%**
-7/+7	0.22%	-0.06%	0.29%*	0.04%	0.31%*
-10/+10	0.12%	-0.06%	0.17%	0.16%	0.10%

* Significant at 10% of level, ** significant at 5% of level, *** significant at 1% of level



Summary and Conclusion

The results for the complete sample of 51 demergers show that demerger announcements have a positive effect on shareholder wealth and as discussed by Rappaport (1986), and such announcement increases shareholder value. It is clear from the above results that over a period of two days Day 0 and Day 1 small, private and public demergers give significant abnormal returns; large demergers too give abnormal returns over the benchmark however they are not statistically significant.

This outperformance continues for up to 7 days event window i.e. 3 days pre-announcement to 3 days post announcement, however, the out-performance over indices gradually diminishes. Over the 10 days observation period, the CAAR is 2.6%. This suggests that demerger announcements, on average, precede a period of abnormally positive returns. Furthermore, there is a clustering of significantly positive AARs around the announcement day. The random

movements of the AARs after day +1 provide evidence that the market is efficient in a semi-strong sense with respect to this particular event.

This study highlights very interesting phenomena, which is widely researched in developed economies of Europe and US. Indian contextual research is inadequate. It is suggested that further research in demerger announcements and execution may be carried out. It would also be quite interesting to know whether these results stand valid over demergers of many more years and maybe with different methodology.

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