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Demerger or Break-up of Companies: A Management Strategy or Tragedy

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ABSTRACT: *The dynamism of the business environment necessitates leaders of organizations, corporate management consultants and scholars alike to delve into researches that will foster solutions to the ever changing business environment. This meta-analysis study focused on investigating the strategy or tragedy behind demergers or break-up with several cases drawn from the oil and gas and telecoms industries. Review of extant literature revealed the concept of either accepting change alongside formulating ways (strategies) to meet and beat existing competition and threat of new entrants or staying the same and becoming extinct. Though Chiplin and Wright, (1987) asserted that demerger was introduced as a business strategy, however, Cambell and Goold, (1998) see merger as the good business strategy for companies to develop competitive edge in their market segments*

Keywords: Demerger, strategy, tragedy, business environment

In many industries nowadays, where the business environment has increasingly become so dynamic and volatile due to many market factors including technology, globalization and informed consumers, it is no longer an option for management to continually seek for 'ways and means' to beat their competition and remain profitable. It is rather a core necessity of business survival. It is either you embrace change - align it with your business values and survive or resist change, stick to your status quo and extinct. Over the years, management scholars have introduced differing concepts and theories in meeting these organizational challenges including system management, tactical management, and strategic management etc. (Mintzberg, 2003). Demerger was introduced as a strategic business technique that enables a company to remain very competitive and profitable by concentrating on a core business competency rather than being Jack of all trade (Chiplin and Wright, 1987).

Many scholars and business executives (Kandula 2001; Kishore, 2003; Andrushko 2012), have attempted to define the term 'Demerger' but fail to view it from its strategic perspective. However, Rajni and Hiro (2011), perhaps gave the most clear definition of the term as it relates to business strategy and today's business environment; they defined it as "*a form of corporate restructuring in which the investors of the parent firm gain direct control over the newly established firm without any sale or purchase of shares"*. Although the shareholders remain the same, however, the new firm becomes a separate legal entity with no direct control from its parent company and becomes directly responsible for its assets and liabilities. It is widely referred to as 'spin-off'; spin-out; break-up etc. by different authors and corporate managers. However, irrespective of the different terminologies and definitions the concept remains the same.

Review of Relevant Literature

Concept of Demerger

The concept of demerger or split-up is known as 'reverse synergy', where it is argued that the value of the parts is greater than that of the whole (Hindle, 2008). Among the most recent works on this concept is that of Andriy Andrushko, 'the reverse synergy: another way of thinking.' Andrushko (2012), extending the scopes of synergy through research into what he defined as reverse synergy. He argued that while synergy – "links between business units that results in additional value creation" i.e. Merger, according to Cambell and Goold, (1998) is a good business strategy for companies to develop competitive edge in their market segment, conversely, it has a tendency of diminishing marginal output for large multi-unit companies. This argument, including that of many earlier works (Cambell and Good, 1998; Hagel and Singer, 1999; Eisenhardt and Galunic, 2000) have opened the way for the practice of demerger by many multi-functional and national companies in all market segments. A recent example is that of Conocophillips-splitting- up its group downstream segment. It is called keep it nice and simple!

Demergers of companies in the Oil and Gas Sector

More recently, there have been calls for break-ups of most oil and gas multinationals including Shell, BP, Exxonmobil, ConocoPhilips and the likes in order to unlock shareholders value and concentrate on their core business competencies. Most proponents argue that the upstream business (exploration and production) and downstream business (refining and distribution) are completely two different businesses in two different sectors (upstream and downstream) and therefore will require different management strategies in order to be profitable. While the upstream business will need more of technological advancement (technology-driven) in order to be competitive and profitable, the downstream sector will obviously be interested in service delivery (customer- driven) and therefore will need to concentrate on their products, services, branding and advertisement leadership.

Proponents of the 'oil majors' break-up argue that there is actually no interdependency between the two business segments. The downstream consumer segment (e.g. Petrol network stations) is not in any way dependent on their upstream production segment since products can actually be sourced from other available producers. Although there is value addition on the supply chain from production to consumption, nevertheless, it is not justifiable enough compared to the value from the upstream segment alone. Undoubtedly, the success of these majors (shell, BP, Exxonmobil, Cheveron, ConocoPhilips) over the past seven decades has primarily been built on their technological innovations and competencies in the upstream sector and their willingness to invest in high risk exploration projects. Briggs (2007) opined that these factors (technological innovations, Competency and High risk ventures) are undoubtedly still the competitive drive and main source of profit streams of these 'majors'.

Arguable, the downstream marketing businesses of these multi-nationals consume more resources and make little or no-profit for shareholders. This could be attributed to divided focus issues (corporate focus rather than business). They tend to focus on their internal business supply chain (their upstream feed, refining, piping and supply) branding and promoting the entire corporation rather than concentrating on their business (marketing). Another reason is the management choice of the leadership of the downstream segment. Managers of these segments are most times chosen from among their successful employees in the upstream sector with more technical background and less marketing. Because of their incompetency, when they are unable to meet their target, they argue that marketing is the poor relation of the upstream sector. Example is the recent (2012) BP first quarter profits fall. Management reason for the gross loss in profit in the downstream is the BP 2010 oil spill disaster in Gulf of Mexico amongst others.

Why Split?
Reputation Management

Generally, there is a concept that any damage to a part of integrated system will inevitability affect the entire system. On this premise and knowing the integrated nature of most of the oil companies today, it is unarguable why most oil companies suffer loss due to a segment's corporate failure. All management scholars know that good corporate image is perhaps another key for a successful and profitable company. In the oil and gas sector, virtually all the bad press most companies receive is usually from its downstream business activities. However, the upstream segment notably gas stations, suffer most of the losses due to bad press publicity and visible damage from protesters.

Demerger could be a great strategy to avoid risk of losses due to bad press publicity brought upon by a segment. Splitting the downstream consumer segment from the upstream business segment will not only remove this risk but will also help the downstream to concentrate on building a sustainable marketing strategy that will continue to move the brand upward, hence making it more competitive and profitable for shareholders. For example, the BP upstream business segment 2010 oil spillage disaster brought so much bad publicity for the entire companies across the globe, affecting sales at all their petrol stations globally.

Focus on Single Activity and Building Competency

Undoubtedly, most of the oil majors created vertically integrated business, linking the supply chain with marketing. Historically, marketing has been a core competence in the oil and gas industry. Shell and BP successes in the seventies were their marketing strengths. They had a joint venture marketing company called 'Shell Mex and BP limited'. This company was solely established for the purpose of promoting both companies products, it was not involved in either refining or production of any of their products. The single focus of this company made it a tremendous success for promotion of Shell and BP products. While Shell and BP managers and employers focused principally on managing their products and customers. Demerger could bring this focus back to the industry and companies again. When implemented, each company will concentrate on a particular business activity, ensuring competence and viable growth in profit.

Unleashing Potential and Yielding Lost Value

Some proponents of oil companies' demerger have argued in this line. They argue that the likelihood that a dedicated or segmented company would be more successful than an integrated company, reasoning that dedication unleashes hidden potentials. For instance, Tim Barrett at JP Morgan Cazenove's, believes an upstream/downstream split for BP could 'yield over £35 billion of lost value to shareholders'. His view has been welcomed by many analysts. Some have suggested that it could also unleash the potential of the downstream business making them more profitable and focus on brand and customers. Other benefits of demerger will include organizational improvement, corporate governance improvement and capital market improvement. These could be achieved through value creation, improvement and re-distribution by individual company activities (Hite and Owers, 1983).

Summarily, proponents of break-ups of most oil and gas companies argue that that the split advantages are enormous, mainly it will unlock shareholders value and will help to achieve focus and continuous building of core competencies. Recent cases of oil and gas companies demerger are already in the news, some of which include ConocoPhillips' proposed demerger, Petrofac Energy development Limited, Marathon Oil, etc. The focus for this paper is mainly on these cases in order to analyze their reasons and benefits and possible disadvantages.

Reasons and Benefits of Demerging

Although each organization may have some specific reasons for demerging, however the main aim and benefits will remain the same – to make profit for shareholders, to safeguard the interest of the organization and also to remain competitive in their business segment. However, for the purpose of analysis, it may be necessary to review it from each organization's perspective in order to make sense and evaluate the effectiveness of its application. Rajni and Hiro (2011) gave eleven generic reasons why corporate organizations may decide to demerge. These reasons are: 1). Safeguard against cash loss risks/non-profitability, 2). Separation of management of divisions, 3). Defense against hostile takeover, 4). Enhancing responsibility and accountability, 5). De-cluttering management processes, 6). Focus on core competencies and activities, 7). Counter takeover threats and opportunity creation, 8). Reduction and restriction of

Government intervention, 9). Introduction of specific business activities 10). Segregation of family business and 11). To counter diseconomies of large scale. However, in practice they may all be interwoven, hence, it is necessary to analyze from each companies perspective. While we analyzed based on organizations' perspective generally, most organizations' reasons for demerging are usually anything from the eleven mentioned above.

Nevertheless for the scope of this work, we will consider the reasons from its distinct point as we look at cases of demerger of three different oil multi-nationals. Although each organization may have one or two reasons that may differ in principle from the above but generally it could be argued and categorized along those eleven distinct reasons. Considering it from organizational points of reason, we may well want to look at their reasons as follows:

Analysis from Selected Cases

Case 1: Marathon Oil Demerger
Main Reason: to generate timely and regular return on investment for shareholders

Following the effect of the global recession, many investors are now more conscious about timing and the value they get from their investment. This has caused, more than ever before, many companies to be under intense pressure to generate timely and regular returns to shareholders otherwise lose their shareholders interest to more value generating companies. In the U.S for example, this reason led to more than 40 percent of most demergers recorded in the first half of 2010 including the reason for the spin-off of marathon oil, the fourth-biggest integrated oil and gas company in the U.S (Financial Times, 2011). Marathon oil announced plans to break into two separate entities in January, 2011; one to focus on its refinery and pipeline operations and the other – exploration and production business. By reason of their strategic splitting, it replaced a company whose valued market price was twenty three US billion dollars with two companies' worth a combined value of thirty-six billion US dollars in less than a financial year. Investors gladly received this move, causing a share price increase.

Case 2: ConocoPhilips
Main Reason: To unlock shareholders value

Similarly, with the sole aim of increasing shareholders value; ConocoPhilips, the third-largest U.S integrated company also decided in principle to split into two separate entities by July, 2012. Management plan was to divide its upstream operations – exploration and production from its downstream – refining, into separate companies. The Chairman and CEO, Jim Mulva, had argued that the rationale was to "unlock shareholders value in an intensely competitive industry". Following the break-up, ConocoPhilips Oil Company was expected to continue paying its 66-cent quarterly dividend to shareholders and the refining business (Philips 66) expected to be the largest U.S independent refiner, processing over two million barrels of crude oil per day. It was also expected to pay dividend immediately making its investors reap more in value than they currently do.

Although there was a debate over the benefits of this planned break-up, while some analyst believe that the split may not be as profitable as Marathon's following their share discounting strategy (Dabbous, 2011); however, proponents argued that considering ConocoPhilips' refining geographical diversity, the split will strengthen the refining business' arm since in principle the company will have total management capability hence concentrating on improving operations and investment which in turn will yield greater profit for investors (Dabbous, 2011). Therefore, it was not certain what the spin-off will bring in the future for ConocoPhilips' investors but going by the current trend on the implementation of this type of strategy, one could believe investors will be in for a major boom.

Case 3: Petrofac Energy Development Limited (PEDL)
Main Reason: To focus on core competencies and activities

Splitting the company business units into a separate legal entity with the aim of focusing on core activities, gives competencies and help in reducing diversion of resources thus, remaining competitive and profitable. The idea is when you concentrate on a particular business segment within a sector; you gain more knowledge and skills hence a better product, service and process which invariably give you a competitive edge over your larger business segment competitors (Bruckmann, 1971).

In this instance, we will examine a recent demerger whose main purpose was to focus the activities of demerged company into a singular focus. A typical case study is the demerger of Petrofac Energy Development Limited (PEDL) from Petrofac group in combination with its UK Continental Shelf (UKCS) oil & gas assets of Lundin Petroleum AB (Lundin) to form a new company called EnQuest PLC. Petrofac group is a leading international provider of technical support to the oil & gas upstream, midstream and downstream sectors. PEDL is a subsidiary within Petrofac's Energy Development business unit holding most of their assets in the UKCS. Some of their assets include; 60% interest in the Don Southwest oilfield, 27.7% interest in the West Don field and 100% interest in the Elke discovery.

Following the Demerger, EnQuest became independent oil & gas Production and Development Company in 2010, whose main purpose and activities is to focus on the UKCS. By focusing on a segment (oil & gas production & development) within one geographical location industry (UK subsea), it is believed that they will be able to create a 'market niche' thus guaranteeing a sustainable growth in shareholders' value.

Case 4: Carphone Warehouse - Telecommunication industry
Main Reason: **To safeguard against cash loss risks/non-profitability due to high risk.**

This could be argued a major reason for some of the spin-offs we have seen in recent times. A typical case is the demerger of UK independent mobile phones retailer, broadband and fixed line provider – Carphone Warehouse Group Plc. in July, 2010. This company prior to the demerger operated two separate business units – retail operations, fixed line and broadband operations. In May 2008, it went into 50/50 joint venture with an American specialist retailer of consumer electronics, entertainment software and appliances – Best Buy Co., Inc. This move was seen as a high risk venture following the amount of investment made. By the end of its financial year in 2009 sales dropped slightly from £1.42 billion to £1.39bn. Following the financial result of 2009 and presuming it may take at least another 2 years before they start making profit and the fact that there are actually material synergies between the two business units, it became imperative for management to initiate the idea of demerging the two business units. The thinking is that with less overhead and operational cost at stake, the two units will become more competitive and more profit for shareholders.

Therefore, the demerger was legally formalized in July, 2010. The mobile phone retail unit retaining its parent name and logo – Carphone Warehouse while the fixed phone and broadband unit - the demerged unit with trade name TalkTalk. Interestingly, the two companies are doing pretty well, both companies annual financial report shows substantial increase in share price (Carphone Warehouse, 2012 and Talktalk, 2012).

Defense against Hostile Takeover

Another reason for demerging is to avoid hostile takeover from stronger firms. The benefit is that it helps companies safeguard the attractive segment of business from competitors or new entrants. This is achieved by making the demerged company look very unattractive for new entrants and high risk for the 'big bulldozers'. A case scenario is the 1998 British American Tobacco spin-off of all its non-tobacco enterprises and consolidation on its core operations avoiding a takeover bid by Sir James Goldsmith – a British business mogul and billionaire (Cox 2000 p. 401).

Reduction and Restriction of Government Intervention

Pressure from regulatory authorities and environment watch dog groups can seriously affect a company's business operations. Demerger can be used as a strategy to free businesses from government regulatory restrictions. Montgomery, Hill and Moore (2007), argued that this was the case for the Collins Stewart Tullet demerger. The company was demerged basically to relieve its Tullet Prebon dealer broking business from regulatory and capital maintenance requirements.

It is impossible to exhaust all possible business reasons for executing a demerger. Reason being that organizations will have one reason or the other why they choose to go that route. Some other reasons could be an avenue for financial re-engineering and debt reduction. This is the case of ICI spin-off of its group to form Zeneca. Others could be accessibility to a targeted group of customers, suppliers or even competitors. The spin-off of WH Smith's news distribution and high street business division gave the newspaper and magazine distribution business a greater access to other high street retailers. These retailers had previously perceived WH Smith as a competitor hence the limitation of business access. Also employees will likely benefit, in that greater powers, controls and responsibilities will be transferred to them. Demerger also gives an opportunity to evaluate changes in size of organizations and its impact on performance. An organization which has gone through merger and acquisition (increase in size) with no tangible impact on investor's value, will be able to measure difference in performance through demerger. It also helps analyst to assess the impact of corporate focus which is a key management concept.

The Negative Side of Demergers

While demerger appears to have numerous advantages and benefits, it also has its downside. Some of its known disadvantages are:

Additional Corporate and Operating osts

Following any demerger, the spin-off company will become a separate entity. Therefore the new company will be liable to incur corporate costs, having and operating its own board of directors, shareholder registry, listing fees and all legal compliance requirements. Additional cost may also come in the form of legal, treasury, accounting and taxation services. These extra corporate burden may appear to inhibit the success of the new company knowing very well that most of these costs will have to be upset doing the initial startup of the new company.

For ConocoPhilips, corporate costs for first quarter of 2012 were $360 million after-tax compared to first quarter of 2011. Repositioning costs which is cost incurred by Philips 66, the planned spin-off business arm of ConocoPhilips which comprised of legal, accounting, IT and other consulting services was over $95 million. This cost excluded benefit-related expenses and interest expenses for Philip 66 senior notes. In total, corporate cost of repositioning Philip 66 came a little over $120 million after-tax which would have been otherwise paid out as dividend for investors.

Reduction in Size and Diversification

The splitting will normally result in decrease in size of portfolio of both companies. These companies when listed on the stock market may have less range institutional investors; hence each company will focus on particular product and services that may not appeal the interest of investors.

Personal or Corporate Bias Motive

Personal or corporate bias could be another disadvantage of demergers. Often times a split-off is initiated based on this ill motive. Managers are driven by personal needs and fail to think through the business objectives. If this is the case, then the likelihood of both parent and Spin-off companies reaping its maximum value is greatly reduced. Therefore, the decision to demerge must only be based around business requirements and should benefit the organization, its employee and customers/clients. It is however, advisable that all demergers should be in the interest of the entire stakeholders. Access to debt markets, credit rating, increase in new company interest expenses are few other disadvantages of demerger. Following the split, in respect of capital financing of new projects, each company will have to rely on its own financial performance and cash flow for them to access credit and equity markets. This could pose a major risk for smaller companies in that they will be subjected to more stringent borrowing terms compared to when they were together.

Methodology

This research was qualitatively carried out through a meta-analysis of extant literature. Literature from both the oil and gas sector, telecommunications, corporate management organizations and scholars were critically and astutely reviewed to come up with the selected cases in here analyzed. Findings showed that, although the oil and gas sector is considered to be one by many oil and gas experts, on the other hand, many others believe it to be two separate businesses between the upstream and downstream sectors and should be demerged or broken-up for better performance and profitability to increase shareholders value. Corporate managers see demerger to be a very vital move if strategically done and could be the managers worst tragedy if not astutely analyzed and implemented carefully with the bigger picture in mind.

Conclusion and Recommendations

Considering the analyses made above- reasons, benefits and disadvantages, it is clear that with the continuous dynamism and competition in the business world and factors such as technology, informed consumers and shareholders profit consideration, more companies will continue to demerge. Although with its known disadvantages, it is however considered a less risky option than mergers or acquisitions. As considered above, as well as increasing shareholders value, a demerger can help organizations achieve its strategic business objectives easily compared to merger in that it gives management opportunity to ease of close understanding of their core competencies, which when developed will be a competitive edge over their competitors.

Arguably, one can also conclude that although there isn’t a clear answer as to whether demerger is a better corporate strategy in terms of value addition - increase in investors return and business competitiveness or another corporate tragedy but suffice to say that as long as its benefits outweighs its disadvantages in terms of increasing shareholders profit and business competitiveness, it is smart for any company to continue with the strategy in order to explore its strengths for the benefits of all shareholders and employees rather than being jack of all trade.

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