

## **An Analysis of the Effectiveness of the M&A Strategy of a Diversified Company (Unilever Group Case Study)**

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**Abstract:** The development of the company via the procedure of Mergers and Acquisitions (M&A) can have the negative impact on its appreciation by business groups, analysts and investors and it can be estimated as value destruction. This problem is relevant today because each diversified corporate structure (the diversified company) is a unique phenomenon. Therefore for the diversified companies, developing by the M&A strategy, the question about value creation or destruction and the market perception of their corporate conception demand to be studied in the framework of the individual approach. This study deals with an analysis of the M&A strategy utilized by Unilever Group, as well as with issues relating to identifying the factors defining the value of a diversified company. To these ends, there are particular methods that can be applied to Unilever Group. Because the structure of this diversified company is rather complex, it makes sense to determine whether the company has been accurately valued by the market (if it is overvalued/undervalued), as well as to define the way the market responds to M&A transactions effected by this company. This study includes an estimation of the effectiveness of Unilever Group's mergers and acquisitions strategy, aimed at creating the optimum business portfolio within the diversified corporate structure (company) by how it affects value of the company. The general hypothesis assumes that diversification does not have a destructive effect on the value of an international multi-business company that builds its portfolio based on the success of certain brands and business areas.

**Key words:** Company value, diversified company, merger and acquisition transactions, strategy effectiveness, expected rate of return on invested capital

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### **INTRODUCTION**

Researchers have come to contradictory conclusions, as how corporate diversification impacts company value. The diversification strategy of itself has been subject to harsh criticism over the past 20-30 years. There is an opinion, however that in emerging markets, company value is positively affected by diversification. Many large international companies tend not only to enter emerging markets with their products but also to acquire promising assets in such countries. This especially refers to companies in the consumer sector that realized that local brands are often much more competitive compared to products already in a company's business portfolio. Thus, despite the trend toward focused business, internationally, diversification is being extensively exercised with the M&A strategy being the basic implementation mechanism thereof.

The problem considered in this study is how company development through the mergers and acquisitions process may in itself have an adverse effect the company's reputation in the business community and

among analysts and investors and may be deemed as destructive to its value. The pertinence of this issue is confirmed by the unique nature of each individual diversified corporate structure which is why an individual approach must be taken by diversified companies developing through an M&A strategy when it comes to the issue of increased and decreased in value and what is more important, how such a corporate concept is perceived by the market.

The general hypothesis of the study assumes that diversification results in no value destruction of an international multi-business company building up its portfolio based on the success of certain brands and areas of business. The significance of this impact is manifested in improved overall competitiveness and the long-term key competencies of a purchasing company on the local market.

The study is significant in that it summarizes the experience gained by Unilever Group in the area of implementing its mergers and acquisitions strategy. The theoretical importance of this study includes the possibility of the further application of the approach

developed to the analysis of other diversified companies. A strong emphasis is placed on the issue of how the value of diversified companies is affected by M&A transactions which may later be rematerialize in the development of a new model for estimating the value of such structures taking into account their corporate strategies. The practical value here is connected to the ability of the management of a diversified company being able to use the obtained results to increase the value and significance of the company for market participants.

Unilever was originally created, as a result of the consolidation of 2 independent companies: A Dutch margarine manufacturer and a british chemical enterprise. The consolidation took place in 1930. This unification was deemed a relational diversification based on a common resource, namely the palm oil. Figure 1 shows the legal structure of the parent companies of today's Unilever. Unilever NV represents the Dutch side and Unilever PLC the British side.

Throughout Unilever's operating history, mergers and acquisitions have been a key tool for the company's development and expansion. The company is quite active in managing its business portfolio which includes such areas as food, refreshment (beverages), personal care and home care. Unilever acquires and sells products and brands all over the world. For instance, over the period from 1995 through 2009, the company carried out 210 disposals and 250 acquisitions (official site of Unilever Group). Moreover, brands that accounted for 40% of Unilever's total income in 1995 were no longer part of the company's portfolio in 2009. And 40% of the revenue received by the company in 2009 was carried by brands that were added to the portfolio after 1995. At present, the company's portfolio comprises over 400 brands represented in 190 countries.

The company's key markets in terms of disposals are emerging markets, accounting for >55% of disposals. BRIC countries are considered the most promising for Unilever. Unilever is currently ahead of its competitors in terms of its share of sales within emerging markets. The company ranks first, ahead of such companies as Danone, Rockitt Benckise, Nestle, P&G and L'Oreal.

However in the late 1990s, Unilever Group was in stagnation. Years of dampened growth, the absence of a clear and strong corporate strategy many brands with poor sales results, weak international presence compared to competitors and rather mediocre indicators in emerging markets resulted in the launch of a 5 years development plan called path to growth. The plan's basic provisions came down to the portfolio being reduced to 400 key brands, focusing on the development of the leading brands (R&D and advertising), innovative product

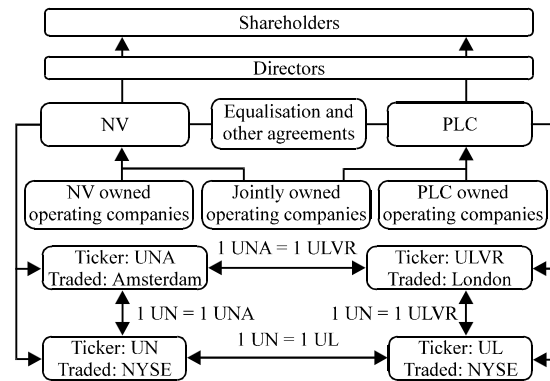


Fig. 1: Legal structure of Unilever Group (the official site of Unilever Group)

development to attain internal growth and maintenance of growth through mergers and acquisitions. This plan was being implemented within the period from 2000-2004.

The plan's implementation resulted in unsuccessful brands being removed from the portfolio whereas the share of revenue from leading brands increased from 75-93%. There was considerable improvement in a number of indicators in financial reports. Nevertheless at the end of 2004, the decision was made to discontinue this plan. In 2004, sales grew by only 4%. It also became evident that Unilever Group was significantly inferior to its competitors in terms of such aspects as marketing and innovation. The company's activities were somewhat disjointed and corporate strategy was not kept track of which resulted in the company failing to make any profits expected in any area of business. Analysts criticized the company for its limited presence in emerging markets. Because of this, the company was not so attractive to investors, despite the scale of the company's business and production.

Now, the company has attempted to optimize its business and now positions itself as a household product and cosmetics manufacturer. Portfolio formation is due to M&A transactions involving local brands with no funds being spent on transactions relating to the acquisition of regional (local) manufacturing companies.

In 2010, the company adopted a new long-term strategy: Its 20 years development programme titled 'Sustainable Living Plan'. The plan primarily focuses on the company's operation in emerging markets, innovations within brand portfolios and the achievement of a more competitive cost structure. The last item is linked to the identification and use of synergy as a result of M&A. In addition, operations in emerging markets are connected not only to including local brands in the company's portfolio but also with the characteristics of

global brands being modified to correspond to the local environment. It enables the company record growth in these markets, thus compensating for the slowdown observed in developed markets.

When analyzing Unilever Group’s corporate strategy, some researchers have come to the conclusion that during throughout the company’s history, it has mostly benefited from periods when it focused on long-term results (in the form of income from added shareholder value) (Jones and Miskell, 2007). As for Unilever Group’s M&A strategy, it can be assumed that success of the strategy in the company may be explained by the gradual integration of new businesses. The basic guiding principle is the acquisition of businesses that are complementary (supplemental) rather than directly related: It is these businesses that add value. A specific feature of companies representing the sector of Fast Moving Consumer Goods (FMCG) is their complementary nature. It is commonly known that the products themselves generate comparatively low profits but wholesales of related products may lead to aggregate profits being considerable. That is why, the logic behind Unilever Group’s corporate diversification seems rather obvious. It should be noted that by optimizing its portfolio optimization forming a clear-cut corporate management model, the company intends to remain at the development stage. This permanent development is largely achieved due to the implementation of its mergers and acquisitions strategy. When it comes to specific company products, Unilever Group aims to build up a portfolio of developing brands that will be high income for a given period of time. As soon as, a product starts leaving the stage of prosperity and stability and heads toward stagnation, it is either subjected to innovation (preservation of the brand itself but changing product characteristics) or to removal from the portfolio (the sale both of entire businesses and of individual brands or certain products released under said brands).

The company’s position in the diversification validation matrix (Table 1) should be described as follows: It has well-balanced presence in both existing and the new markets and offers both old and new products (or rather brands).

Unilever group is now simultaneously at several life cycle stages which is a specific feature of this diversified corporate structure. The company is also implementing a number of types of local strategies for trying to enter the market and to maintain and develop its presence in different markets and in various product classes.

Table 1: Diversification validation matrix (DePamphilis, 2010)

| Products | Market                   |                          |
|----------|--------------------------|--------------------------|
|          | Existing                 | New                      |
| Existing | Damped growth/low risk   | Rapid growth/higher risk |
| New      | Rapid growth/higher risk | Rapid growth/higher risk |

**Literature review:** Corporate diversification can be represented as modeling the mergers and acquisitions strategy which implies the acquisition of businesses in sectors that are not at the core of a given company’s activities. The question is raised as to what caused such business development decisions. About 2 key reasons for corporate diversification are often cited (DePamphilis, 2010). The first one is the attempt to stabilize gross income by means of mitigating shareholders’ risk. The second reason for diversification is to update an enterprise’s offerings and entering more prospective markets. Growth is another oft-mentioned validation of corporate diversification (Grant, 2012). The reasons listed are interrelated to a great extent and moreover, they correspond to the types of diversification strategies considered earlier. In fact, the reasons given to justify diversification are what result in the diversification strategy.

Growth itself, as the reason for diversification is an example of an agency problem, as it occurs as a result of profitability and may even lead to hostile take-overs. It is pointed out that the potential of a hostile take-over is a disciplinary mechanism moving company management to act with the intention to raise the company’s value (Shleifer and Vishny, 1988). To some extent, increased profitability goes hand in hand with the decision to update product lines and enter new markets.

As decisions on corporate diversification should be taken, as part of the framework for creating shareholder value, various effects testing methods can be applied. For example, it is possible to use an approach aimed at determining the attractiveness of a sector, as well as the cost of entry and incremental increases in welfare. It is necessary to point out potential sources for of value creation under corporate diversification, as they are likewise considered to be the justification for such diversification.

The main factor behind value creation in a diversified company is the relationships between different business types (Grant, 2012). This means that the creation and use of such interrelationships result in the company’s competitive edge. The creation and use of connections mean the distribution of resources and capabilities among various businesses. Figure 2 represents, the sub-factors forming the competitive edge of a diversified company and constituting potential sources for value creation.

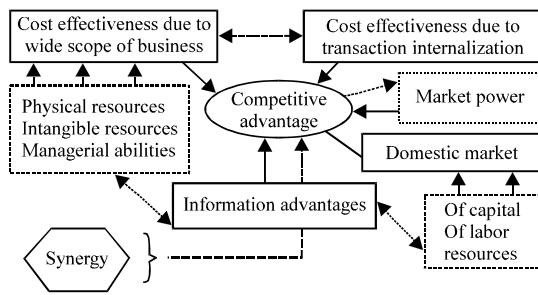


Fig. 2: Competitive edge based on diversification (Grant, 2012)

From the viewpoint of corporate finance, a company's value is largely affected by the realization of the synergistic effect. The presence of a synergistic effect and what is more important, the ability to manage it, forms the specific competitive edge of a diversified company. Synergy reveals itself in the form of improved business effectiveness (profitability) for instance due to the shared use of resources, infrastructure and business areas. The synergistic effect will be described in detail in the next chapter. For now, researchers would like to note that synergy is divided into financial and operational. The implementation of operational synergy is more typical of related diversification (Shamraeva, 2010).

The arrangement of the scheme shown in Fig. 2 has room for improvement. It is proposed that value factors of a diversified company be divided into 3 groups: Economic, financial and administrative (Shamraeva, 2010). Economic factors include an increase in market strength and the effective use of resources. The financial factors of a diversified company's value comprise the following: The domestic capital market, a potential increase in debt burden (on account of risk mitigation), tax advantages and reduced transaction costs. Administrative factors comprise both different management techniques (including those dependent the stage of the company's life cycle) and making decisions on scale of the business, managing the coordination controlling expenses, counteracting information asymmetry, motivation issues and creating an efficient organizational structure.

It is assumed that if a given resource is used in several areas of business (that harmonize well with each other) and it leads to reduced expenses, cost-effectiveness is present due to the breadth of the area of business. Similar to cost-effectiveness owing to scale, expenses are also reduced by increases in production and the number of product types. This factor is also related to cost-effectiveness due to the internalization of transactions which is achieved by reducing or eliminating entirely the possibility of adverse

external effects being transformed into internal effects. Thus, market contracts may be ineffective for the protection of a company's resource value and competencies that result in a company making diversification decisions aimed at their independent use. As regards effective resource use, it should be noted that the company might afford a greater degree of diversification while possessing fewer specific resources. It has been pointed out that the improved market strength, as a factor behind a diversified company's value is a consequence of strategy rather than the cause behind companies' adherence to the strategy (Shamraeva, 2010). In general, when it pertains to the positive and negative effects on a company's value caused by corporate diversification, researchers have no choice but to refer to the empirical studies available on the subject.

For a long time, the diversification strategy has been considered to be a rational and effective business development pattern (Grigoriady, 2009) But later, the strategy began to be severely criticized due to empirical studies that have shown that a company's value is adversely affected by diversification. Undervaluation resulting from diversification occurs primarily due to diversification discounts. In practice, companies began eliminating non-core areas of business, building up a business portfolio around the company's key competencies. The diversification strategy was transformed. Nevertheless, there is no clear-cut opinion as to the whether corporate diversification is a rational choice.

A considerable number of studies on this subject reveal the negative impact of diversification on a company's value through reduction of shareholder value. Studies proving the reduction of shareholder value in diversified companies' include classic works by Berger and Ofek (1995), Lang and Stulz (1994), Rajan, Servaes and Zingales (Kuppuswamy, 2010). Summarizing evidence of the hypothesis of shareholder value destruction, the following findings can be singled out:

- Diversified firms tend to have a lower Tobin's Q ratio
- They are traded at a discount amounting to 15% compared to portfolios made up of comparable independent companies
- They face the increasing possibility of dissolution through reorganization (this possibility is directly dependent on the amount of the discount)
- The stock market responds positively strengthened corporate concentration policies (Maksimovic and Phillips, 2001)

The reasons behind the failures experienced by multi-business companies may be explained by the

workings of the internal capital market which turns out to be ineffective when resources are distributed within the company. This was proven by Scharfstein and Stein (2000) who rely on the agency problem. Maksimovic and Phillips (2001) arrive at the conclusion that even if the factor of the agency problem is excluded, conglomerates appear to be less effective in their distribution of resources depending on the stage they are in their life cycle and responses to industry shocks that are the focus of other firms of the same size.

In their subsequent research, Maksimovic and Phillips (2006) made an attempt by the results obtained by them and by their colleagues, to make a clear-cut conclusion regarding the ability of conglomerate structures' to distribute resources. They came to the conclusion that diversified firms primarily behave, as value maximizers, providing conditions for high productivity and that their internal capital markets ensure efficient distribution of resources. However, they emphasize that such a conclusion is not to be regarded, as correct for the majority of conglomerate firms. Besides, the conclusion that internal capital markets are on average not exposed to ineffective distribution does not mean that the firms are not exposed to the agency problem. That means that managers may make provisions for effective resource distribution but at the same time expropriate shareholder value by using the same resources, for instance to purchase another company at a significant premium.

Erdorf *et al.* (2013) believe that the impact on the value is different from one firm to another and that corporate diversification is not the only factor leading to a discount or a premium. The influence of factors specific to a particular industry, economic conditions and management structure cannot to be excluded.

There are studies where the researchers conclude that corporate diversification does not destroy shareholder value and even creates it. The arguments connecting diversification and discounts arising from it are based on the idea that conglomerate firms somehow differ from themselves before the diversification program began (Maksimovic and Phillips, 2001). Formally, the opinion that companies adhering to a diversification strategy are systematically different from typical focused firms and errors in identifying endogenous grounds for diversification result in inaccurate conclusions.

This statement is supported by observations that have revealed that diversified firms tend to have been traded at a discount prior to diversification. This is confirmed by the research of Graham *et al.* (2002) and Villalonga (1999) where the discount is explained by the features specific to the companies acquired in the course of diversification. Graham and others estimate the

pre-diversification value of companies acquired by conglomerates. They discovered that companies to be acquired are sold at an average discount of about 15% during the final year of their independent operation.

This hypothesis is also supported in the research of Campa and Kedia (2002), though the discount here is explained by internal factors (Brigham, 2004). They have found that conglomerate structures differ from firms operating in a single segment in terms of, such features as for instance their size, the relationship of capital costs, EBIT and R&D costs to revenue and also by the industry growth rate. They have also discovered that prior to following a diversification strategy they are sold at a discount. Therefore, if such differences are controlled in the course of diversification, the resulting discount can be significantly reduced or completely excluded.

Villalonga espouses the view that diversified firms are traded at a premium and that the opposite results obtained by other researchers are due to their use of different databases which in her opinion have a number of shortcomings. For example, the firms are actually more diversified than is recognized in sector financial reports. It may be explained, for instance by the fact that diversified companies may have easier access to capital markets than focused firms which is explained by the challenges investors face due to information asymmetry.

The same researcher and others have determined that the value of corporate diversification itself grew during the 2007-2009 financial crisis, as it provided companies with both financial and investment advantages (Kuppuswamy, 2010). They conclude that corporate diversification still performs an important insurance function for investors.

Moreover, a number of studies are focused on specific types of diversification. For the most part, there are works devoted to industrial and international (including geographical) diversification and their effect on company value. These studies differ in terms of their results: They include conclusions both on lost value and on the lack of diversification related discounts. For example, Fauver *et al.* (2004) and others have found that American companies are traded at a discount compared to companies doing business solely within the domestic market. At the same time, they discovered that international diversification makes no impact on the value of German and British companies. As far as, industrial diversification is concerned, it has an adverse effect on American and British companies but no influence on German companies.

Doukas and Kan (2006)'s study is of interest as well. Using the example of American companies, they come to the conclusion that global diversification does not lead to

lost company value. They recognize the existence of a global diversification discount. However, they rely on the viewpoint of the theory of contingent claims which claims that global diversification has a positive effect on a company's debt value. Shareholder value is simultaneously destroyed but this reduction is compensated for by the increased debt value.

A study concerning markets already under development and namely, Malaysian public companies is given in a study by Li and Khoo (Lee *et al.*, 2012). They found no evidence of any significant impact from global diversification on company value. They also established that industrial diversification has a slight positive effect on company value.

Villalonga in their study of a selection of diversified companies from 38 countries have found that the value of these companies (as compared to focused firms) is higher in countries where capital and labour markets are less effective (Kuppuswamy *et al.*, 2012).

An overview of studies on the topics in question testifies to the current relevance of the subject matter. It also makes it possible to select the methods that are applied in the practical part of this study to analyze diversification within the context of mergers and acquisitions.

## MATERIALS AND METHODS

The rate of Return on Invested Capital (ROIC) is one of the key factors underlying value. The concept of market/investor-expected rate of Return on Invested Capital (ROIC<sub>e</sub>) assumes that the market valuation of public companies constitutes their intrinsic value. The method includes the following stages:

At the 1st step, the historic value of ROIC is estimated according to the formula:

$$ROIC_t = \frac{EBIT \times (1 - T)}{CI} \quad (1)$$

Where:

- EBIT = The Earnings Before Interest and Taxes
- T = Corporate Tax
- CI = The value of Capital Investment

At the 2nd stage, the expected ROIC is estimated. The weighted average of capital costs during the period from 2002, through 2012 has been estimated for Unilever Group that is the focus of this study. The required return on equity capital is estimated in accordance with the CAPM Model and the required return on loan capital is estimated as the sum of the risk-free rate and the credit margin.

At the 3rd stage, estimated market value added is calculated as the difference between value on the equity capital market and the balance sheet value ( $E_{bv}$ ). It should be noted that the study makes the assumption that the economic value added is constant in the long-term (Mielcarz and Roman, 2012). Thus, the value of the expected ROIC can be obtained using the following formula:

$$ROIC_e = \frac{(MV - CI) \times WACC}{CI} + WACC \quad (2)$$

Where:

- MV = The Market Value (calculated as the sum of equity capital plus joint debt values)
- WACC = The Weighted Average Capital Cost

The final stage consists of comparing the expected ROIC with the actual amount. For illustrative purposes, an ROIC tree is built as a model showing the effectiveness of current corporate strategy at a glance.

The cumulative abnormal return method is used as an additional study method for confirming a proposed hypothesis. The Cumulative Abnormal Return (CAR) has been chosen by Unilever Group as a general indicator for estimating the effectiveness of M&A.

Data for the period from January, 2000 through April, 2013 (about 13 years) taken from the Zephyr database and Unilever Group's official website were used in the study. That particular period of time was chosen because 2 vital events for the company occurred during that span of time: The 5 years path to growth strategy was implemented, as well as the 20 years strategic 'Sustainable Living Plan'. Both plans rely on the active application of the M&A strategy to optimize a subset of the company's businesses.

The resulting sample includes transactions executed worldwide by companies that are part of Unilever Group. It also comprises mergers and demergers of the company's major units. Because, the M&A strategy for Unilever Group, also includes selling businesses (or company-owned brands), at first a sample of 247 transactions was selected where a company acted as buyer, a seller or object of sale. Transactions included into such sample were divided in terms of their current status: Completed, announced or pending. Each transaction was defined as an acquisition, merger or demerger. About samples were highlighted out of the sample: M&A transactions and disposals which comprised 79 and 168 transactions, respectively.

Figure 3 and 4 represent, respectively the number of business acquisition and disposal transactions in accordance with the company's consolidated statements and the distribution of transactions on acquisitions and disposals based on Zephyr data.

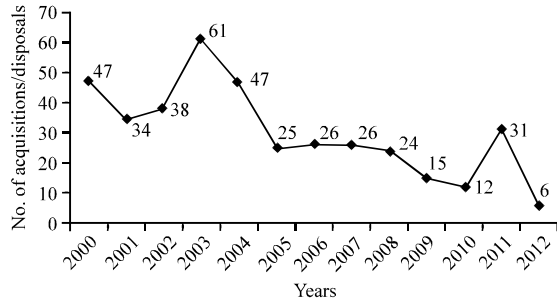


Fig. 3: No. of acquisition and disposal transactions, 2000-2012 (official site of Unilever Group)

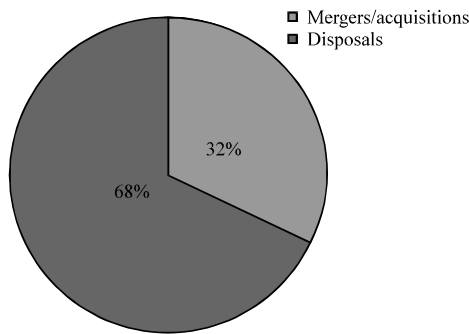


Fig. 4: Distribution of transactions for acquisitions and disposals, 2000-2013 (1st quarter) (official site of Bureau van Dijk)

It was further decided to perform an analysis with only mergers and acquisitions transactions. Notably, the sample included only transactions where over 15% of shares were acquired and Unilever Group’s participatory interest after the completion of the transaction amounted to no <51% (Unilever’s minimum participatory interest was 65%). Thus, a sample of 56 transactions was compiled which included 19 transactions with known costs.

Cumulative abnormal return values have been estimated based on the method described in the research of MacKinlay (1997) and Grigoriady (2009).

In this research, cumulative abnormal return is the average value of abnormal return for all transactions effected by Unilever Group over the period of time under analysis. A positive CAR value means that the event (M&A transaction) is perceived as effective by the market. In other words if  $CAR \geq 0$ , this corporate decision has not resulted in value destruction. It should also be established whether the obtained value is statistically significant which can be checked using the t-test. Thus, the hypothesis for the empirical analysis at hand is formulated as follows: M&A transactions, effected by Unilever Group, being a diversified corporate structure, cause no value destruction ( $CAR \geq 0$ ).

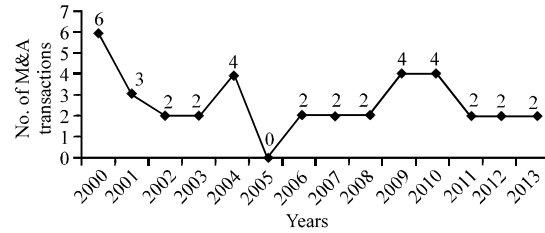


Fig. 5: Distribution of transactions based on year-by-year sample (official site of Bureau van Dijk)

An vital issue is determining the estimation period and event window. The estimation period is the period of time during which normal share price movement is expected, i.e., the transaction under study (the event) has no impact on quotations. The event window is the period of time when quotations are expected to be influenced by a transaction. The transaction announcement day considered the day of the event. Payment of dividends and stock splits were expected to be regarded, as significant events, also effecting the quotations. Stock splits took place twice for the analyzed period. The event window is 5 days: 2 days before the event and 2 days after it (-2; +2). The estimation period is 20 days (-20; 0). This length for the estimation period and event window has been selected in order to exclude where possible, the impact of vital events, such as other transactions announcements. Transactions announcements made within the same day were considered a single event. The sample was therefore further reduced down to 37 transactions. Figure 5 shows the year-by-year breakdown.

Thus, Abnormal Returns (AR) on shares are to be calculated at the 1st step. Because, Unilever Group’s corporate centre is a double structure (Fig. 1), the shares of the British Unilever PLC Corporate Centre, the basic trading platform for which is London Stock Exchange were selected as the shares with CAR to be calculated. It was previously revealed that Unilever PLC accounted for the maximum share in Unilever Group’s total capitalization. CAR is the difference between actual and normal return on a share, calculated on a daily basis:

$$r_{jt} = R_{jt} - \hat{R}_{jt} \quad (3)$$

Where:

- $r_{jt}$  = An abnormal share return for the jth transaction on the day of event window t
- $R_{jt}$  = The actual return on the share
- $\hat{R}_{jt}$  = The normal return on the share

The actual return was calculated as the growth rate of Unilever PLC’s share price within the event window.

Normal return has been estimated using 3 methods: The method of mean adjusted return model, the market model and the market-adjusted return model. In the 1st case, normal return represents the average return value for the estimation period. The market model is based on the following formula:

$$R_{jt} = \alpha_j + \beta_j R_{mt} + \varepsilon_{jt} \quad (4)$$

Where:

- $R_{mt}$  = The market return in the estimation period
- $\alpha_j$  = The return not explained by the market
- $\beta_j$  = The quoted to the market return
- $\varepsilon_{jt}$  = The statistical error

Market return is estimated based on the FTSE 100 index. First, estimation period data are used to find estimates  $\hat{\alpha}_j$  and  $\hat{\beta}_j$ . The estimates obtained for 37 transactions are used to arrive at the expected return for the event window under the following formula (the market return is calculated, as the FTSE 100 growth rate within the event window):

$$\hat{R}_{jt} = \hat{\alpha}_j + \hat{\beta}_j R_{mt} \quad (5)$$

Researchers find the estimate  $\hat{\beta}_j$  for the adjusted market model as  $\hat{\alpha}_j = 0$ . The results of the abnormal return values are aggregated at the 2nd step. This can be done in several ways. The average abnormal return value is calculated according to the following formula (N is the number of transactions):

$$AR_t = \frac{\sum_j r_{jt}}{N} \quad (6)$$

And finally, the cumulative abnormal return shall be calculated as the sum of the aggregated values of the abnormal return for the estimation period (-m; m):

$$CAR = \sum_{t=-m}^m AR_t \quad (7)$$

Let us summarize the foregoing in respect of the approach applied to analyze the cost and effectiveness of the M&A strategy used by Unilever Group. As the diversified company in question has a complex corporate structure, represented not only in numerous business segments but also geographically diversified, it causes certain problems when it comes to its cost estimation. As far as, globally diversified companies are concerned, it turns out to be quite a challenging process to develop a cost estimation model which enables the

creation of company value under various prescribed conditions and at the same time to monitor the contribution of each business area, primarily due to the limited information.

The cost estimation approach based on the comparison of forecast and historical ROIC makes it possible to reveal a gap between the real value of the company and its market valuation. A CAR-based analysis enables preliminary conclusions on the efficiency of the mergers and acquisitions strategy.

The techniques considered first make possible an approximation that identifies the value of diversified companies, the market under/overvaluation of the company and the effect that the concluded M&A transactions have on the market's perception of the company. The techniques are applicable both to the course of events aimed increasing a company's value and to strengthening a firm's market positions.

## RESULTS AND DISCUSSION

To calculate historical ROIC the following prerequisites are used. The invested capital value is estimated as the average for the period (a year was taken as the period). The results are given in Table 2.

To calculate the expected ROIC the following information was used: Unilever Group's weighted average capital expenses were calculated for the period from 2002-2012. Unilever Group's aggregate market capitalization was used as the equity capital cost (capitalization, E) (Official site of Unilever Group). As the company follows IFRS standards when preparing its financial statements, the long-and short-term debts posted to the statements are considered to be the company's fair value. The tax rate applied (T) was calculated as the effective tax rate. The return on 10 years bonds of the UK government shall be used as the risk-free rate. The risk premium amount is taken from the researches of Fernandez. The value of the beta coefficient for Unilever PLC was taken from data provided by Damodaran. The return required for the equity capital was calculated according to the CAPM Model. The return on loan capital required shall be calculated as the sum of the risk-free rate plus the credit margin which in the case of the company's margin has an A+ rating assigned to it. The results are presented in Table 3.

The following information is used for the 3rd step and namely to estimate the market value added: The market value added is the difference between the market and the balance sheet value of the equity capital. The assumption is made that the generated value-added growth rate is permanent in the long run. The market value is calculated as the sum of equity capital plus debt amounts. The results are provided in Table 4.



Table 2: ROIC historical values 2002-2012

| Variables            | ROIC <sub>t</sub> = EBIT×(1-T)/CI |        |        |        |        |        |        |        |        |        |        |        |
|----------------------|-----------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
|                      | 2001                              | 2002   | 2003   | 2004   | 2005   | 2006   | 2007   | 2008   | 2009   | 2010   | 2011   | 2012   |
| IBD                  | 26,305                            | 20,511 | 16,564 | 12,487 | 12,788 | 9,096  | 9,853  | 11,380 | 10,219 | 9,832  | 14,005 | 10,621 |
| Ebv                  | 7,859                             | 5,321  | 6,360  | 7,629  | 8,765  | 11,672 | 12,819 | 10,372 | 12,536 | 15,078 | 14,921 | 15,716 |
| CI                   | -                                 | 29,998 | 24,378 | 21,520 | 20,835 | 21,161 | 21,720 | 22,212 | 22,254 | 23,833 | 26,918 | 27,632 |
| EBIT                 | 4,946                             | 5,007  | 5,483  | 4,239  | 5,074  | 5,408  | 5,245  | 7,167  | 5,020  | 6,339  | 6,433  | 6,989  |
| T (%)                | 44.18                             | 39.60  | 33.65  | 21.87  | 26.15  | 23.72  | 21.76  | 25.87  | 25.57  | 25.02  | 25.97  | 25.96  |
| NOPAT                | 2,761                             | 3,024  | 3,638  | 3,312  | 3,747  | 4,125  | 4,104  | 5,313  | 3,736  | 4,753  | 4,762  | 5,175  |
| ROIC historical (%)  | -                                 | 10.08  | 14.92  | 15.39  | 17.98  | 19.49  | 18.89  | 23.92  | 16.79  | 19.94  | 17.69  | 18.73  |
| ROIC average (%)     | -                                 | 17.62  |        |        |        |        |        |        |        |        |        |        |
| Economic Profit (EP) | -                                 | 1,073  | 1,556  | 917    | 1,639  | 1,929  | 2,010  | 3,886  | 2,356  | 3,373  | 3,548  | 4,003  |

Table 3: Unilever Group weighted average capital cost (2002-2012)

| Variables                 | 2001   | 2002   | 2003   | 2004   | 2005   | 2006   | 2007   | 2008   | 2009   | 2010   | 2011   | 2012   |
|---------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Capitalization (mln Euro) | 64,519 | 59,917 | 51,060 | 46,991 | 54,757 | 60,538 | 72,501 | 46,882 | 63,409 | 64,803 | 73,949 | 81,858 |
| Debt cost (mln Euro)      | 26,305 | 20,511 | 16,564 | 12,487 | 12,788 | 9,096  | 9,853  | 11,380 | 10,219 | 9,832  | 14,005 | 10,621 |
| Share of equity (%)       | 71.04  | 74.50  | 75.51  | 79.01  | 81.07  | 86.94  | 88.04  | 80.47  | 86.12  | 86.83  | 84.08  | 88.52  |
| Share of debt (%)         | 28.96  | 25.50  | 24.49  | 20.99  | 18.93  | 13.06  | 11.96  | 19.53  | 13.88  | 13.17  | 15.92  | 11.48  |
| T (%)                     | 44.18  | 39.60  | 33.65  | 21.87  | 26.15  | 23.72  | 21.76  | 25.87  | 25.57  | 25.02  | 25.97  | 25.96  |
| r <sub>f</sub> (%)        | 4.94   | 4.49   | 4.94   | 4.58   | 4.27   | 4.54   | 4.70   | 3.36   | 3.60   | 3.34   | 1.81   | 1.60   |
| Premium (%)               | -      | 4.70   | 6.30   | 6.10   | 6.05   | 5.96   | 5.30   | 5.50   | 5.30   | 5.20   | 5.30   | 5.50   |
| Beta                      | -      | 0.65   | 0.8    | 1.36   | 1.2    | 1.13   | 1.06   | 0.69   | 0.57   | 0.54   | 0.59   | 0.53   |
| r <sub>e</sub> (%)        | -      | 7.55   | 9.98   | 12.88  | 11.53  | 11.27  | 10.32  | 7.16   | 6.62   | 6.15   | 4.94   | 4.52   |
| Long-term credit rating   | A+     | A+     | A+     | A+     | A+     | A+     | A+     | A+     | A+     | A+     | A+     | A+     |
| Credit margin (%)         | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   |
| r <sub>d</sub> (%)        | 6.19   | 5.74   | 6.19   | 5.83   | 5.52   | 5.79   | 5.95   | 4.61   | 4.85   | 4.59   | 3.06   | 2.85   |
| WACC (%)                  | -      | 6.51   | 8.54   | 11.13  | 10.12  | 10.38  | 9.64   | 6.42   | 6.20   | 5.79   | 4.51   | 4.24   |

Table 4: Estimation of Market Value Added (MVA) and ROIC expected (2002-2012)

| Variables                           | ROIC <sub>e</sub> = (MV - CI)×WACC/CI+WACC |        |        |        |        |        |        |        |        |        |        |        |
|-------------------------------------|--------------------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
|                                     | 2001                                       | 2002   | 2003   | 2004   | 2005   | 2006   | 2007   | 2008   | 2009   | 2010   | 2011   | 2012   |
| Capitalization (E) (mln Euro)       | 64,519                                     | 59,917 | 51,060 | 46,991 | 54,757 | 60,538 | 72,501 | 46,882 | 63,409 | 64,803 | 73,949 | 81,858 |
| Debt (IBD) (mln Euro)               | 26,305                                     | 20,511 | 16,564 | 12,487 | 12,788 | 9,096  | 9,853  | 11,380 | 10,219 | 9,832  | 14,005 | 10,621 |
| Market Value (MV) (mln Euro)        | 90,824                                     | 80,428 | 67,624 | 59,478 | 67,545 | 69,634 | 82,354 | 58,262 | 73,628 | 74,635 | 87,954 | 92,479 |
| Equity (Ebv) (mln Euro)             | 7,859                                      | 5,321  | 6,360  | 7,629  | 8,765  | 11,672 | 12,819 | 10,372 | 12,536 | 15,078 | 14,921 | 15,716 |
| Market Value Added (MVA) (mln Euro) | 56,660                                     | 54,596 | 44,700 | 39,362 | 45,992 | 48,866 | 59,682 | 36,510 | 50,873 | 49,725 | 59,028 | 66,142 |
| Capital Invested (CI) (mln Euro)    | -                                          | 29,998 | 24,378 | 21,520 | 20,835 | 21,161 | 21,720 | 22,212 | 22,254 | 23,833 | 26,918 | 27,632 |
| WACC (%)                            | -                                          | 6.51   | 8.54   | 11.13  | 10.12  | 10.38  | 9.64   | 6.42   | 6.20   | 5.79   | 4.51   | 4.24   |
| ROIC expected (%)                   | -                                          | 17.44  | 23.69  | 30.76  | 32.81  | 34.15  | 36.55  | 16.85  | 20.52  | 18.14  | 14.74  | 14.19  |
| ROIC average (%)                    | -                                          | 23.62  |        |        |        |        |        |        |        |        |        |        |

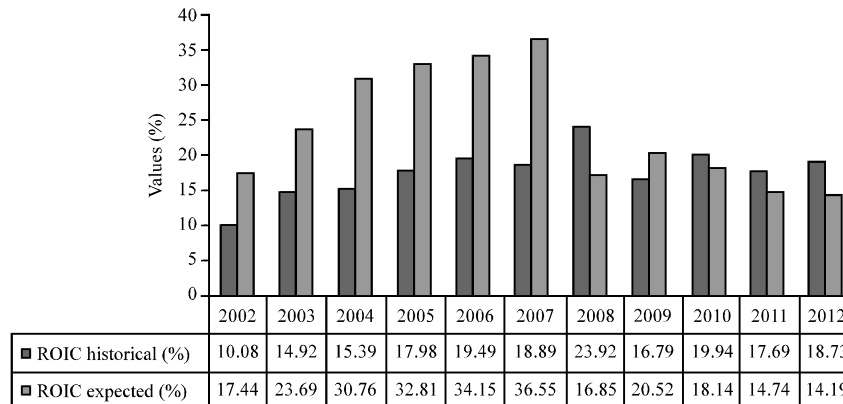


Fig. 6: Comparison between historical and expected ROIC (2002-2012)

Figure 6 shows that from 2002-2007, the expected ROIC significantly exceeded the actual value. This means

that investor expectations regarding the company's ability to achieve a higher ROIC value in the future exceeded the

Table 5: Unilever Group cost estimate based on ROIC historic, 2002-2012

| Variables                        | V = CI+(ROIC-WACC)×CI/WACC |        |        |        |        |        |        |        |        |        |         |         |
|----------------------------------|----------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------|---------|
|                                  | 2001                       | 2002   | 2003   | 2004   | 2005   | 2006   | 2007   | 2008   | 2009   | 2010   | 2011    | 2012    |
| WACC (%)                         | -                          | 6.51   | 8.54   | 11.13  | 10.12  | 10.38  | 9.64   | 6.42   | 6.20   | 5.79   | 4.51    | 4.24    |
| Capital invested (CI) (mln Euro) | -                          | 29,998 | 24,378 | 21,520 | 20,835 | 21,161 | 21,720 | 22,212 | 22,254 | 23,833 | 26,918  | 27,632  |
| ROIC (with cash)                 | -                          | 10.08  | 14.92  | 15.39  | 17.98  | 19.49  | 18.89  | 23.92  | 16.79  | 19.94  | 17.69   | 18.73   |
| V+cash                           | -                          | 46,491 | 42,592 | 29,760 | 37,031 | 39,745 | 42,568 | 82,695 | 60,235 | 82,072 | 105,555 | 122,076 |
| Debt (IBD) (mln Euro)            | 26,305                     | 20,511 | 16,564 | 12,487 | 12,788 | 9,096  | 9,853  | 11,380 | 10,219 | 9,832  | 14,005  | 10,621  |
| Equity (E) (mln Euro)            | -                          | 25,980 | 26,028 | 17,273 | 24,243 | 30,649 | 32,715 | 71,315 | 50,016 | 72,240 | 91,550  | 111,455 |
| Share of Unilever PLC (mln Euro) | -                          | 8,054  | 7,808  | 5,182  | 6,546  | 9,501  | 10,469 | 22,821 | 15,505 | 21,672 | 27,465  | 31,207  |

Table 6: Combined market capitalization of Unilever Group (2002-2012)

| Variables                                 | 2001   | 2002   | 2003   | 2004   | 2005   | 2006   | 2007   | 2008   | 2009   | 2010   | 2011   | 2012   |
|-------------------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Combined Market Capitalization (mln Euro) | 64,519 | 59,917 | 51,060 | 46,991 | 54,757 | 60,538 | 72,501 | 46,882 | 63,409 | 64,803 | 73,949 | 81,858 |
| Share of Unilever PLC (%)                 | 32     | 31     | 30     | 30     | 27     | 31     | 32     | 32     | 31     | 30     | 30     | 28     |
| Share of Unilever PLC (mln Euro)          | 20,646 | 18,574 | 15,318 | 14,097 | 14,784 | 18,767 | 23,200 | 15,002 | 19,657 | 19,441 | 22,185 | 22,920 |

Table 7: Unilever Group ROIC tree

| Variables         | ROIC = bT×(1 - T) |       |       |       |       |       |       |       |
|-------------------|-------------------|-------|-------|-------|-------|-------|-------|-------|
|                   | 2005              | 2006  | 2007  | 2008  | 2009  | 2010  | 2011  | 2012  |
| IBD               | 12788             | 9096  | 9853  | 11380 | 10219 | 9832  | 14005 | 10621 |
| Ebv               | 8765              | 11672 | 12819 | 10372 | 12536 | 15078 | 14921 | 15716 |
| CI                | 20835             | 21161 | 21720 | 22212 | 22254 | 23833 | 26918 | 27632 |
| EBIT              | 5074              | 5408  | 5245  | 7167  | 5020  | 6339  | 6433  | 6989  |
| T                 | 26                | 24    | 22    | 26    | 26    | 26    | 25    | 26    |
| NOPT              | 3747              | 4125  | 4104  | 5313  | 3736  | 4753  | 4762  | 5175  |
| ROIC <sub>i</sub> | 17,98             | 19,49 | 18,89 | 23,92 | 16,79 | 19,94 | 17,69 | 18,73 |
| historical (%)    |                   |       |       |       |       |       |       |       |
| Control (%)       | 0.00              | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  |
| EBIT/CI (%)       | 24                | 25    | 24    | 32    | 23    | 27    | 24    | 25    |

values that were actually achieved for the specified period of time. In other words, the company was overestimated. In 2009, the investors' expectations also exceeded real outcomes though not to the same extent as from 2002-2007.

In 2008, the company achieved its highest ROIC value for the period under analysis which clearly exceeded investor expectations. Over the past 3 years, the actual and expected ROIC values have nearly equalized. Nevertheless, expected ROIC tends to decrease which has been particularly apparent in the past year. Therefore, it is reasonable to speak of Unilever Group being underestimated by the market.

Table 5 and 6 reveal Unilever Group being estimated on the basis of ROIC historical and actual value of the company market capitalization. Figure 7 illustrates the gap between the actual value of the company and its market valuation during the period in question.

The ROIC tree was further built up based on the data of the consolidated financial statements. The calculations are provided in Table 7. Because the revenue report in the consolidated financial reports is given in a summarized form and because the notes, also stop short of identifying the factors behind the operating margin: The report formats are changed nearly every year by the company and this segment of the ROIC tree is represented only by general numbers.

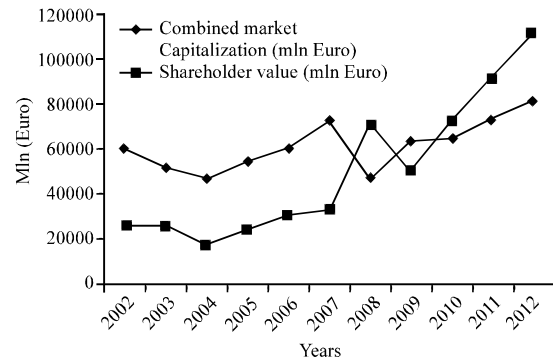


Fig. 7: Unilever Group shareholder value (2002-2012)

The building of the ROIC has shown that the company has a shortage of working capital. It is caused by the M&A strategy followed by Unilever Group. That means that the market undervaluation that revealed earlier was the result of the peculiarities of specified strategy: Funds from core activities are diverted by the company. For example, Unilever Rus buys fewer and fewer spare equipment parts from outside suppliers. Currently nearly all parts are manufactured by the internal repair services save for elements requiring high adjustment accuracy. In other words, Unilever Group's capitalization is made up mainly of brands contained in its portfolio rather than its products or business areas as such. This has also been confirmed by the fact that the share of intangible assets among property assets is practically equivalent to the share of fixed assets.

Thus, the general hypothesis presented in this study has already been confirmed. The results of the analysis following the cumulative abnormal return method which will finally confirm or invalidate the hypothesis this study covers.

Let, us consider the results obtained on the basis of the cumulative abnormal return method. Table 8 represents the results of the calculation of the cumulative

Table 8: Cumulative abnormal return estimates for Unilever Group M&A transactions (2000-2013)

| Variables                 | Mean adjusted return model | Market model | Adjusted market model |
|---------------------------|----------------------------|--------------|-----------------------|
| CAR average (%)           | 0.487                      | 0.349        | 0.494                 |
| Observation number        | 37.000                     | 37.000       | 37.000                |
| t-statistics              | 2.160                      | 1.640        | 2.350                 |
| Level of significance (%) | 12.000                     | 22.000       | 12.000                |

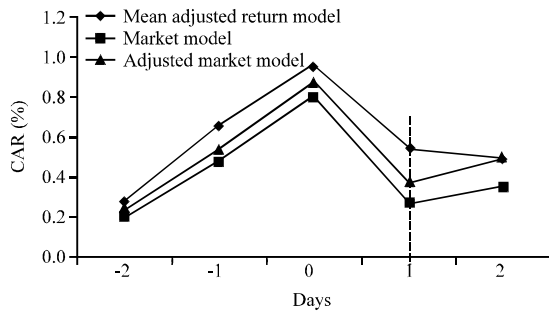


Fig. 8: CAR values in the event window

abnormal return for 37 transactions included in the sampling, covering a time period from 2000 to the Q1 2013. The estimations from the 3 methods of normal return calculations are provided.

It is evident from Table 8 that the results obtained turn out to be significant at the level of >10%. First, such a result is accounted for by the low scale of the sample. Second for Unilever, M&A strategy is closely connected to selling businesses or particular brands that is why more statistically significant results could have been obtained for the sample including both acquisition and disposal transactions. They could further be divided into 2 sub-samples and the results obtained separately could be compared. However within this study, the decision was made to focus upon M&A transactions.

It should be concluded that the hypothesis that the M&A transactions executed by Unilever Group’s diversified corporate structure do not result in value destruction cannot be discarded at a 12% level of significance for the mean adjusted return model and the adjusted market model. For the market model, this hypothesis cannot be discarded at 22% significance level.

As can be seen from Fig. 8, the highest CAR value is achieved on the transaction announcement date for all 3 models. But, it may be observed that growth occurs at the beginning of the event window, declining afterwards. The result obtained may be connected with a short event window selected that hinders clearly tracking the trend. However, it may be due to the specifics of the company itself and of its corporate strategy.

A cost estimation approach based on comparing expected and historical ROIC has made it possible to reveal a gap between the actual value of the company and

its market valuation. Up until 2008, Unilever Group was valued at much higher than its true value, i.e., the market provided a premium. At the moment, the situation has changed and the company receives a discount from the market.

The CAR analysis showed that it is impossible to make a clear-cut conclusion as to efficiency of the mergers and acquisitions strategy followed by Unilever Group. Though the obtained CAR values are positive and may be deemed significant at a certain level, there are still doubts as to whether it is correct to consider only mergers and acquisitions transactions. That means that the structure of Unilever Group’s optimal portfolio is also closely related to the disposal of some businesses and brands and if full information (particularly insider information) is available, the estimate may be more accurate.

### CONCLUSION

Following the analysis, recommendations may be given to Unilever Group to modify its M&A strategy with the focus placed on market development. Unilever market development strategy should combine the group’s global presence and also local its features which implies the following:

- The company should maintain the same diversification in terms of its portfolio categories (food products, personal care, drinks and home care)
- These categories should be enhanced both by means of local brand acquisitions and by developing products with specific characteristics corresponding to local preferences
- Key competencies should be developed, including local knowledge obtained due to M&A which will be expressed as positive synergy
- Presence should be expanded in underserved markets not only by involving more consumers with different needs and opportunities but also by involving local small businesspeople being involved in the supply network (local producers of raw materials, small distributors of finished products) which will allow the company to strengthen its position in terms of the distribution of its products and its resource base
- Investments should be redirected into brand support and at the same time into research and development on the company’s products and technologies
- The actual results should be demonstrated of implementation of the sustainable development plan improved living standards in particular regions which will provide for a strengthening of Unilever Group’s goodwill among local stakeholders and potential employees, i.e., the company will be granted access both to human and financial resources

All this should be finally perceived positively by the market and lead to a reduction in the gap between the company's market capitalization and its actual value. In this case, diversification may be considered the factor behind the creation of value by the company:

Unilever Group's business portfolio is structured of how well the businesses complement each other. This creates added value to a greater extent than that created on the basis of affinity. In this case, the key complementary asset is local knowledge to be obtained in the course of successive mergers and acquisitions in different regions and within various business areas.

Portfolio optimization and the creation of a clearly defined corporate management model will be able to provide Unilever Group with constant development. Unilever Group is at several life cycle stages simultaneously which is specific to this diversified corporate structure. To a great extent, this has been achieved due to the implementation of the M&A strategy. The company is also implementing a number of local strategy types, trying to penetrate the market and maintain and grow its presence in different markets and in different product classes.

The estimate of the expected ROIC revealed that Unilever Group has had a gap between the actual value of the company and its market valuation over the past 10 years. Expected ROIC tends to decrease over the last years. This is indicative of Unilever Group being undervalued by the market.

Undervaluation of Unilever Group has, also been caused by specifics of the strategy practiced by the company: Core activity funds are diverted by the company and are transferred to effecting M&A. Therefore, Unilever Group capitalization is formed mostly due to the brands included into its portfolio rather than its products or business areas themselves.

An analysis of the effectiveness of Unilever Group's M&A strategy has revealed that it causes no value destruction but researchers cannot consider this result as statistically significant to a high degree of significance.

The structured research hypothesis that diversification has no destructive impact on value of the international multi-business company building up its portfolio under success of particular brands and business areas should not be rejected, especially as it pertains to brand portfolio formation.

#### **IMPLEMENTATIONS**

Unilever Group is implementing an M&A strategy that at least causes no value destruction. The

long-term planning horizon used by company management in its corporate management practice must be combined with sufficient mobility ensuring timely modification of the company's package of businesses and brands. The company implements M&A strategy by forming the optimal combination of its business portfolio which enables it to be at a number of life cycle stages simultaneously.

This study is expected to be further supplemented and developed through an analysis of transactions related to the disposal of Unilever Group's businesses and brands. It will make it possible to obtain a comprehensive picture both of the of this company's corporate management practice and of the specifics of the added value resulting from it.

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