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Executive compensation and internal capital market efficiency

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ABSTRACT

We document that chief executive officer (CEO) incentive compensation plays an important role in determining internal capital market (ICM) allocation efficiency. Our results suggest that CEO equity-based compensation can be effective in ameliorating inefficiencies in internal capital allocation decisions. We find that while stock grants play an important role in motivating CEOs to make more efficient internal capital allocation decisions, there is surprisingly no discernible influence of stock options. Our analysis supports the view that private benefits derived by managers are increasing in internal capital misallocation. We also document a strong positive link between CEO incentive compensation and excess value of diversified firms suggesting that the diversification discount can be ameliorated with CEO incentive compensation. The study contributes to the ICM literature and the literature on conglomerate diversification discount.

1. Introduction

Optimal allocation of scarce resources is at the heart of wealth creation in a free market economy. Efficient *external* capital markets facilitate in this process by allocating capital to the most productive investments. Similarly, efficiency of the *internal* capital market is critical to value creation in a multi-segment firm. Allocation of internal capital rests at the discretion of top managers who are expected to channel funds to segments with the highest value-added projects. Therefore, the value created from

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investments in a multi-segment firm critically hinges on how effectively internal capital is allocated among various divisions by the top managers at the corporate headquarters.

These managers have control rights that allow them the discretion of "winner-picking" when it comes to allocating capital between divisions. The ability to allocate corporate resources also presents the top executives at the headquarters (we designate the chief executive officer (CEO) to represent this group) with the opportunity to extract private benefits at the cost of misallocating corporate resources leading to value destruction for the shareholders of multi-segment firms. This study examines the link between CEO incentive compensation and the efficiency of internal capital markets. Studying this linkage will contribute to the internal capital markets literature by shedding light on the importance of CEO compensation structure in internal capital allocation efficiency.

We contend that if the costs to headquarters (HQ) managers for misallocating corporate resources are made prohibitive, or at least greater than the associated private benefits, then the managers are much less likely to engage in value destroying internal capital *mis*allocation decisions. Executive compensation can be a powerful mechanism to achieve this goal of aligning HQ managers' and shareholders' interests, and hence making it costly for these managers to misallocate capital among the various divisions of the firm.[1] It therefore begs the important, yet unaddressed, question in the internal capital markets literature as well as the vast body of literature on diversification discount: what is the role of CEO compensation in reducing agency conflicts that cause internal capital misallocation and shareholder value destruction in multi-segment firms? In other words, does CEO incentive compensation improve internal capital market (ICM) efficiency? We believe that the answer to this question is important in finding a solution to improving the efficiency of internal capital markets and thereby stemming value destruction in multi-segment firms.

Given the importance of inter-divisional capital allocation efficiency in corporate value creation, the study of internal capital markets has been the focus of many prior studies in the finance literature. The question of whether there are efficiency gains from internal capital markets remains controversial. Compelling arguments are made that support both sides of the issue. Williamson (1986) makes the case that diversification and establishment of an internal capital market will allow better sharing of inside information and more efficient allocation of capital among competing investments within the firm because information asymmetry and agency costs will render financing from external capital markets either inefficient or prohibitive (see also Alchian, 1969 and Williamson, 1970). A similar line of reasoning predicting efficiency gains from internal capital markets is adopted by Weston (1970), Gertner et al. (1994), Stein (1997) and Matsusaka and Nanda (2002). Maksimovic and Phillips (2002) provide empirical evidence that diversified firms allocate resources efficiently, while Hadlock et al. (2001) conclude that diversification improves access to external capital markets.

The opposing side of the debate on efficiency gains/losses from internal capital markets allocations suggests that diversification leads to inefficient investment (capital allocation) decisions within the different segments because of managerial agency problems and this results in a decline in firm value (e.g. Lang and Stulz, 1994 and Berger and Ofek, 1995). The general theme in this literature is that conglomerate firms destroy value due to the existence of two types of agency conflicts; one between the corporate managers at headquarters and shareholders, and the other between HQ managers and rent-seeking divisional managers. In this framework, the HQ managers (i.e. the CEO) derive private benefits of control from all divisions whereas the divisional managers extract private benefits from their divisions only.

Several studies support the view that value destruction in multi-segment firms is due to misallocation of internal capital (see Meyer et al., 1992; Rajan and Zingales, 1996; Lamont, 1997; Shin and Stulz, 1998; Scharfstein, 1998; Rajan et al., 2000; and Scharfstein and Stein, 2000). Scharfstein and Stein (2000) and Rajan et al. (2000) develop theoretical models of internal capital market based on agency conflicts. Scharfstein and Stein incorporate the two types of agency conflicts in their model to explain misallocation of resources and rent-payment by the CEO to the divisional managers who receive unjustifiably more resource allocation for their divisions. Further, Shleifer and

[1] Recent studies have documented the importance of executive compensation structure in influencing major corporate financial decisions that are value enhancing for the shareholders (see Datta et al., 2001, among others).