Abstract

While many existing studies report that corporate diversification destroys shareholder value, several recent studies challenge these findings. Schoar [Schoar, A. (2002). Effects of corporate diversification on productivity. The Journal of Finance, 57, 2379–2403] finds that plants in conglomerates are more productive than those in comparable single-segment firms, although conglomerates are traded at discounts. Villalonga [Villalonga, B. (2004a). Diversification discount or premium? New evidence from the business information tracking services. The Journal of Finance, 59, 479–506; Villalonga, B. (2004b). Does diversification cause the “diversification discount”. Financial Management, 33, 5–27] employs a more comprehensive database and statistical techniques than those used in the prior studies, and shows that there is a diversification premium, rather than discount. This paper develops a model that highlights the costs and benefits of corporate diversification. The diversified firm trades off the benefits of more efficient resource allocation through its internal capital market against the costs of information rents to division managers, which are necessary for effective workings of the internal capital market. We provide an argument supporting Schoar’s findings, and identify conditions under which there can be a diversification discount or a premium.

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1. Introduction

The benefits and costs of corporate diversification have been the subject of extensive research.\(^1\) Diversified firms can rely on internal capital markets that enable them to pool and reallocate corporate resources more efficiently through ‘winner picking’ than through external financing (Stein, 1997; Williamson, 1975). They may also enjoy economies of scope, and gain strategic benefits by extending market power from one segment to another, and by facilitating tacit collusion through multi-market interactions. On the other hand, corporate diversification can exacerbate managerial agency problems (Jensen, 1986, 1993). How do these benefits and costs weigh up against each other? When are diversified firms more likely to perform better or worse than their stand-alone counterparts?

Earlier empirical studies on the effect of corporate diversification on firm performance find that diversified firms tend to have lower Tobin’s Q, and are traded at discounts of up to 15 percent relative to comparable profiles of single-segment firms (Berger & Ofek, 1995; Lang & Stulz, 1994; Servaes, 1996). This has been known as the diversification discount, confirming the conventional wisdom that corporate diversification destroys shareholder value. Several theoretical studies offer explanations of the diversification discount based on agency theory (e.g., Matsusaka & Nanda, 2002; Stulz, 1990). They argue that the free cash flow problem can be more severe in conglomerates since they have larger investment opportunities and more accessible resources to do so if diversification can relax budget constraints imposed by imperfect capital markets. Although this theory focusing on the agency problem at the level of CEOs can explain overinvestment, it cannot address the issue of fund misallocation within conglomerates.

To analyze resource allocation within multidivisional firms, several studies look at the internal capital market of a multidivisional firm and identify the source of inefficient cross-subsidization. Scharfstein and Stein (2000) present a model illustrating the interaction between the CEO and the division managers within a multidivisional firm where both the CEO and the division managers enjoy private benefits of control by remaining on the job. In their model, the manager of a weak division has a lower opportunity cost of rent-seeking than the manager of a strong division. By rent-seeking, the manager of a weak division can increase bargaining power, to which the CEO reacts by distorting capital budgeting allocations in favor of the weak division. In Rajan, Servaes, & Zingales (2000), internal power struggles in diversified firms lead to misallocation of resources. When the divisions are similar in their resources and investment opportunities, there is no distortion in resource allocation. However, when the divisions are sufficiently diversified, the struggles result in resources flowing toward the most inefficient division, because it makes the weak division behave more cooperatively in joint production with other divisions.\(^2\) Inderst and Laux (2005) show how competition for scarce corporate resources can enhance managerial incentives to work hard when the divisions are symmetric in cash endowments and growth potentials. But when the divisions are asymmetric, competition may reduce incentives for some managers and lower total firm value. In sum, one can take these explanations as a possible answer for the diversification discount, which is positively related to the extent to which the divisions are asymmetric in their resources and investment opportunities.

Although Campello (2002) documents empirical evidence suggesting that the frictions between conglomerate headquarters and external capital markets are responsible for the inefficiency of

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\(^1\) See, for example, Martin and Sayarak (2003) for a survey of the literature. Throughout the paper, we use the term ‘diversified firms’ interchangeably with ‘multidivisional firms’ or ‘conglomerates’.

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