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Corporate governance, shareholder rights and firm diversification: An empirical analysis

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Abstract

Grounded in agency theory, this study investigates how the strength of shareholder rights influences the extent of firm diversification and the excess value attributable to diversification. The empirical evidence reveals that the strength of shareholder rights is inversely related to the probability to diversify. Furthermore, firms where shareholder rights are more suppressed by restrictive corporate governance suffer a deeper diversification discount. Specifically, we document a 1.1–1.4% decline in firm value for each additional governance provision imposed on shareholders. An explicit distinction is made between global and industrial diversification. Our results support agency theory as an explanation for the value reduction in diversified firms. The evidence in favor of agency theory appears to be more pronounced for industrial diversification than for global diversification.

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1. Introduction

Considerable research has explored the issue of corporate diversification. One critical question is whether corporate diversification enhances or destroys value. Early researchers argued in favor of diversification citing factors such as greater operating efficiency, the presence of an internal capital market, greater debt capacity, and lower taxes (for example, Fluck and Lynch, 1999; Bradley et al., 1998; Kaplan and Weisbach, 1992; Porter, 1987; Ravenscraft, 1987, among others).

On the contrary, several academic studies in the 1990's provide evidence on the destructive effect on firm value of corporate diversification (for example, Comment and Jarrell, 1995; Liebeskind and Opler, 1995; Lang and Stulz, 1994; Servaes, 1996; Berger and Ofek, 1995; Denis et al., 2002, among others). More recently, arguments have been advanced and new evidence presented that diversification may be beneficial or, at the minimum, not value-destroying (Villalonga, 2004; Whited, 2001; Campa and Kedia, 2002; Mansi and Reeb, 2002). Others have suggested that it may be the acquisition of poorly performing units (Graham et al., 2002) or miscalculations of Tobin's q (Whited, 2001) that explain the diversification discount. Hence, the debate on the impact of diversification still continues in the literature.

Motivated by agency theory, we contribute to the literature in this area by exploring the role of the agency costs in explaining the value discount (or premium?) caused by diversification. In so doing, we examine the relation between firm value, corporate governance, shareholder rights and the propensity to diversify. We employ the governance index developed by Gompers et al. (2003) to represent the strength of shareholder rights. Gompers et al. (2003) construct a governance index on the basis of how many corporate governance provisions exist that restrict shareholder rights, with a higher index indicating weaker shareholder rights.

This study examines the influence of shareholder rights both on the extent of diversification and on the excess value arising from diversification. First, we investigate the relation between the propensity to diversify and the strength of shareholder rights. We find evidence that firms where shareholder rights are weak are more likely to be industrially diversified. This evidence is in favor of the explanation that managers exploit the weak shareholder rights and diversify the firm unwisely. As a result, industrially diversified firms exhibit a reduction in value. The evidence on global diversification, however, is more ambiguous. We find no relation between the strength of shareholder rights and the propensity to be diversified globally. Hence, global diversification does not appear to be motivated by managers taking advantage of weak shareholder rights. The value reduction affiliated with global diversification (Denis et al., 2002), therefore, may not be explained by the agency cost perspective.

Second, we investigate the impact of shareholder rights on firm value. To measure the valuation effects, we use the concept of excess value, first developed by Berger and Ofek (1995). We document that more restrictive corporate governance is associated with lower