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Diversification and cash dynamics*

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Abstract

Why do diversified firms hold significantly less cash than focused firms? We study this question using a dynamic model of corporate investment, saving, and diversification decisions. We find that investment dynamics are more important in explaining the cash differences than financing frictions. More efficient internal capital markets increase cash differences and are especially valuable when a firm diversifies or refocuses. Contrary to static models, more diverse conglomerates have lower cash differences. Endogenous selection (diversifying firms are larger and have better growth opportunities) accounts for 68% of the cash difference, and the diversification event itself reduces cash holdings by 32%.

JEL classification: G31, G32, G34
Keywords: Diversification, Organizational structure, Corporate saving, Internal capital markets, Investment

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