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Investment decisions and internal capital markets: Evidence from acquisitions ☆

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Abstract

In this paper, we examine the workings of internal capital markets in diversified firms that engage in related and unrelated corporate acquisitions. Our evidence indicates that bidders invest outside their core business (diversify) when the cash flows of their core business fall behind those of their non-core lines of business. However, bidders invest inside their core business (i.e., undertake non-diversifying investments) when their core business experiences superior cash flows. We also find that bidders whose core business are in industries with low growth prospects engage in diversifying acquisitions while bidders whose core business are in high growth industries undertake non-diversifying acquisitions. The pre-acquisition evidence, then, suggests that firms tend to diversify when the cash flows and the growth opportunities of their core business are considerably lower than those of their non-core business. Subsequent to acquisitions we find that diversifying bidders continue to allocate financial resources from less profitable business segments (i.e., core business) to more profitable business segments (i.e., non-core business). Given the low profitability of diversifying bidders' core business, this capital resource allocation suggests that diversification increases do not result in capital allocation inefficiencies. The evidence for non-diversifying bidders, however, supports the existence of "corporate socialism" in the sense that there is transfer of funds from the profitable (core) to the less profitable (non-core) business segments in multi-segment bidders. We find that the capital expenditures of bidders' non-core business segments rely on both core and non-core cash flows.
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1. Introduction

Several studies document that diversified firms trade at a discount relative to matched portfolios of stand-alone firms.[1] Econometric issues raised in several recent papers aside,[2] the negative association between diversity and corporate value, documented by Shin and Stulz (1998), Scharfstein (1998) and Rajan et al. (2000), is the crux of the ongoing debate on whether the so-called diversification discount is the consequence of inefficient investment policies of diversified firms.

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[1] See Lang and Stulz (1994), Berger and Ofek (1995, 1996), among others.

[2] See Whited (2001), Campa and Kedia (2002), Mansi and Reeb (2002), Villalonga (2004) and Doukas and Kan (2004) among others.

For example, Lamont (1997) provides evidence in support of inefficiencies in the internal resource allocation process of diversified firms by showing that the cash flow of the core business can influence the investment of another division.[3] Shin and Stulz (1998) report that the investment of a business segment of a diversified firm depends significantly on the cash flow of its other business segments and that a segment's investment depends less on its own cash flow than if it were a stand-alone firm. Scharfstein (1998) finds that inefficient allocation of resources between divisions is manifested when management has a low ownership stake and argues that agency costs cause distortions in divisional allocation. Scharfstein and Stein (2000) suggest that internal capital market inefficiencies stem from the presence of divisions with low growth opportunities and show how rent-seeking behavior on the part of division managers can undermine the workings of internal capital markets. Similarly, Rajan et al. (2000) model the internal power struggles between divisions for scarce corporate resources and find that greater diversity in investment opportunities among business segments leads to distorted investment decisions that harm shareholder value.

While most of the existing literature uses cross-sectional comparisons of diversified firms to examine the link between the discount and the investment policy of the firm, this methodology has been the subject of the recent debate about the diversification discount. In contrast with the previous diversification literature, our approach in this paper is to study changes in corporate diversification through acquisitions and whether such diversification changes are related with changes in the diversification discount and the investment decision of the firm. More importantly, we examine how capital resources are allocated among business segments around diversifying acquisitions in order to determine whether corporate diversity leads to inefficiencies in the allocation of internal capital recourses. Therefore, diversifying acquisitions provide a unique framework to examine whether corporate diversification exacerbates the inefficient allocation of capital resources.

Despite the fact that several papers have sought to determine the efficiency of internal capital markets following corporate spin-offs and divestitures by diversified firms (Ahn and Denis, 2004; Dittmar and Shivdasani, 2003; Gertner et al., 2002; Schlingemann et al., 2001), this paper seeks to shed light on the workings of internal capital markets from the acquisitions perspective because the forces driving diversification decreases (divestitures) are naturally different from those that drive diversification increases. Although the study of divestitures permits to examine how internal capital markets function when a firm divests to achieve greater corporate focus, divestitures may not be motivated by the need to enhance corporate focus. For example, Lang et al. (1989) argue that divestitures are often used as a financing mechanism when access to external capital markets is limited. Fluck and Lynch (1999) claim that a firm may decide to divest a business unit whenever the financing synergy ends and it has a chance to be financed as a stand-alone firm.[4] Moreover, divestitures are unlikely to occur in isolation since they may be part of a restructuring program linked to changes in the firm's internal and external control environment. Finally, the use of divestiture and/or spin-off data to study the resource allocation process of internal capital markets in diversified firms leads towards a biased sample of firms where the investment inefficiencies are more severe and, therefore, limits the researcher's ability to draw broad inferences about the population of diversified firms.

Diversifying acquisitions, however, permit to examine whether the internal resource allocation process is inefficient by analyzing firms' investment policy before and after the acquisition. Specifically, studying internal capital markets from the acquisitions perspective allows us to examine directly whether capital is allocated efficiently between the core and non-core business segments in a diversified firm. After a balanced reading of the corporate diversification literature it remains unclear (i) why firms choose to become more diversified through acquisitions and (ii) how the change in bidders' diversification impacts the allocation of financial resources among its business divisions. Specifically, we test the internal capital markets hypothesis, the external growth hypothesis and the free cash flow/agency cost hypothesis. According to the internal capital markets hypothesis, corporate diversification is expected to result in efficiency gains arising from the development of internal capital markets in diversified firms over external capital markets. According to the external growth hypothesis, firms with poor performance and lower internal growth opportunities seek to diversify into unrelated lines of businesses. The free cash flow/agency cost hypothesis predicts that managers pursue industrial diversification to build complex corporate empires at the expense of shareholders' wealth.

In this paper, we examine these issues in diversified firms when they engage in related and unrelated acquisitions. Our sample covers 742 firm-year acquisitions over the 1991–1997 period. Our evidence indicates that the core business cash flows of diversifying (non-diversifying) firms are inferior (superior) to those of non-diversifying (diversifying) firms. These results suggest that core business profitability problems are driving diversifying acquisitions. We also show that bidders whose core business are in industries with low growth prospects engage in diversifying acquisitions while bidders whose core business are in high growth industries undertake non-diversifying acquisitions. Finally, and perhaps more importantly, our findings

[3] Lamont (1997) found that investment in non-oil (non-core business) segments of diversified oil firms declined when the cash flows of oil (core business) segments decreased dramatically as a result of the large drop in oil prices in 1986.

[4] Kaplan and Weisbach (1992) argue that a firm may sell a business that it has improved or a business that it once had synergies but no longer does. In line with this view, John and Ofek (1995) find that the typical divested division is performing as well as the industry at the time of divestiture.

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