BRQ Business Research Quarterly (2015) 18, 259–274

BUSINESS RESEARCH QUARTERLY

www.elsevier.es/brq

ARTICLE

Diversification and control in emerging markets: The case of Chilean firms[☆]

Mauricio Jara-Bertin[a,*], Félix J. López-Iturriaga[b,c,1], Christian Espinosa[d]

[a] School of Economics and Business, Universidad de Chile, Diagonal Paraguay 257, Santiago, Chile
[b] Department of Financial Economics and Accounting, Universidad de Valladolid, Avda. Valle del Esgueva 6, Valladolid, Spain
[c] Laboratory of Intangible-driven Economy, NRU Higher School of Economics, 38 Studencheskaya Ulitsa, Perm, Russia
[d] Faculty of Management and Economics, University of Santiago of Chile, Av. L.B. O'Higgins, 3363 Santiago, Chile

Received 20 February 2014; accepted 17 January 2015
Available online 12 March 2015

JEL CLASSIFICATION
G30;
G32;
G34

KEYWORDS
Business diversification;
Chile;
Emerging Latin-American markets;
Ownership structure;
Firm value

Abstract We analyze the effect of two types of corporate diversification (business diversification and ownership diversification) on the market value of the Chilean firms. For a sample of 83 nonfinancial firms listed on the Santiago Stock Market from 2005 to 2013, we find a discount for both business and ownership diversification, which is consistent with that reported for other economic or institutional settings. Second, we find that the business diversification discount is related to the ownership structure and is due to the excess of the largest shareholders' control rights. Third, we find that the ownership diversification discount becomes a premium when the ownership diversification enables the control of the affiliated firms. This effect can be explained by the improvement of internal capital markets that allows overcoming the limitations of Chilean external capital markets.

☆ The authors appreciate the financial support of the Chilean Fondecyt Grant No. 11110021 and the Spanish Ministry of Science and Innovation (ECO2011-29144-C03-01) is gratefully acknowledged. Early versions of this study were presented at ENEFA 2012 and CLADEA 2012. We are grateful for the suggestions of Jose Luis Ruiz (Universidad de Chile), David Diaz (Universidad de Chile) and Carlos Maquieira Villanueva, Alisa Larson, and two anonymous referees for their comments on previous versions of this work. Any possible errors are our responsibility.
* Corresponding author. Tel.: +56 29783701.
E-mail addresses: mjara@unegocios.cl (M. Jara-Bertin), flopez@eco.uva.es (F.J. López-Iturriaga), christian.espinosa@usach.cl (C. Espinosa).
[1] Tel.: +34 983184395.

http://dx.doi.org/10.1016/j.brq.2015.01.002

Introduction

The allegedly beneficial or detrimental effects of diversification on the value of the firm have remained in the core of the business research for long time (Tong, 2011). Recent literature on corporate governance and finance has underlined the effect of corporate ownership, showing that the corporate diversification discount is more pronounced among firms with low managerial ownership and controlled by dominant shareholders (Aggarwal and Samwick, 2003; Laeven and Levine, 2007). Nevertheless, the effect of pyramidal ownership structures, which amplify the control of dominant shareholders, is not yet clear.

Using this control enhancing mechanism, the involved shareholders can engage in diversification strategies by drawing a control chain that enable them to achieve control benefits and maximize the value of the *base*[2] company of the chain at the expense of the minority shareholders of the subsidiary firms (Claessens et al., 2000; Faccio and Lang, 2002; Laeven and Levine, 2008; Ruiz-Mallorquí and Santana-Martín, 2009).

The effect of the ownership structure on the relation between diversification and firm value can be more relevant in institutional frameworks where the investor protection is weak (La Porta et al., 1998, 1999). The previous research is inconclusive and has led to a need for researchers examining how diversification strategy affects firm performance in different institutional environments and market conditions (Lodh et al., 2014; Yigit and Behram, 2013). Prior studies have focused on developed markets and East Asia emerging countries. However, the literature on emerging South American economies is lacking.

We focus on the Chilean context due to some specific institutional features that makes an interesting case analysis. These characteristics are substantially different compared to other developed countries and emerging economies in which the literature has shown the existence of a diversification discount (Berger and Ofek, 1995; Campa and Kedia, 2002; Hoechle et al., 2012; Lang and Stulz, 1994; Lins and Servaes, 1999; Rajan et al., 2000).

First, Chile is an emerging economy with a bank-oriented corporate system, where banks play an important role in comparison with the capital markets (Fernández et al., 2010; Fernández, 2005). Even the firms belonging to economic groups or holdings, despite of having developed internal capital markets, keep a close long-run relation with the banks or own a bank in their economic groups (Majluf et al., 1998). Despite of the small size of the Chilean capital markets, compared with other South American countries, Chile presents a lower country-risk premium, lower corruptions levels, and open financial markets.

Second, partially explained by the political process at the second half of the 80s[3] and as a natural response of the historical less enforcement of law, Chilean firms present a high ownership concentration, primarily in the hands of individual shareholders or well-diversified conglomerates, that give rise to pyramidal structures (Hachette, 2000; Larraín and Vergara, 2000; Lefort and González, 2008; Lefort and Walker, 2000a, 2000b). Despite the growth of the capital markets in recent decades, the legal system has not given enough protection to the investors to avoid these concentration levels. On the contrary, the Chilean legal system has traditionally operated in a reactive way toward increasing the protection of existing pension systems administrators (Iglesias, 2000).

Third, in order to improve corporate governance practices, Chilean regulators have recently adopted several capital markets rules as the corporate governance Law (Law 20.382, 2009) and the Law on transactions with related parties in limited liability firms (Law 18.046, 2010), to improve the informational transparency about corporate governance.

Our study analyzes the effect of two types of diversification (business diversification and ownership diversification) on the market value of the Chilean quoted firms. The business diversification refers to the firm segments in different sectors, and the ownership diversification[4] refers to the firm holding a fraction of the ownership of other companies. For a sample of 83 nonfinancial companies listed on the Santiago Stock Market from 2005 to 2013, our main result is the evidence of a discount for both business and ownership diversification, which is consistent with that reported for other economic or institutional settings. Second, we find that the business diversification discount is related to the ownership structure and is due to the excess of the largest shareholders' control rights. Third, we find that the ownership diversification discount becomes a premium when the diversification enhances the control of other firms. This effect can be explained by the improvement of internal capital markets that allow overcoming the limitations of external capital markets.

Our work contributes to the financial literature in three ways. First, this study is the first to analyze the impact of nonrelated diversification on the value of companies in an emerging South American economy. Second, our results extend previous works that have analyzed agency problems from high concentrated ownership structures and weaker law investor protection (Lefort and Urzúa, 2008; Majluf et al., 2006; Silva and Majluf, 2008). Finally, we use the method of control chains, which allows to draw the whole ownership pyramid and to identify the ultimate shareholders of the firms. Consequently, we compute the difference between voting rights and control rights that can result in potential tunneling problems.

The remainder of the paper is organized as follows. The second section develops the analytical framework, which includes the literature review and hypotheses development. The third section provides the description of the study sample and describes the method and variables used in the analysis. The fourth section presents the results. The final section summarizes our main conclusions.

[2] *Base* company is defined as the firm that invests in the ownership of other companies.

[3] This phenomenon, called ''popular capitalism'', resulted in the privatization of several of the most important firms in stock markets.

[4] Ownership diversification or participation in ownership is defined as the base firm participation in the ownership of other companies, which are either subsidiaries or affiliates, in both related and unrelated industrial segments.