NORTH-HOLLAND

International Review of Financial Analysis
9 (2000) 315–326

IRFA
INTERNATIONAL REVIEW OF
Financial Analysis

Corporate diversification, ownership structure, and firm value The Singapore evidence

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Abstract

We provide international evidence on the level and value of corporate diversification using a sample of 145 Singapore firms. We find that the level of diversification is positively related to firm size and negatively related to the equity ownership of outside blockholders. However, we find no evidence that insider ownership has a significant impact on the level of diversification. We find significant value loss from diversification only for those firms with low managerial ownership, suggesting that value-reducing diversification stems from agency problems. Outside block ownership does not have a significant impact on the value of diversification. Thus, while outside blockholders may act as a deterrent on the level of diversification, there is no evidence that they can effectively reduce the agency problems for those firms with low managerial ownership. © 2000 Elsevier Science Inc. All rights reserved.

Keywords: Corporate diversification; Ownership structure; Firm value

1. Introduction

Corporate diversification has both benefits and costs. Firms can benefit from diversification through the creation of internal capital markets (Williamson, 1970),[1] higher debt capacity (Lewellen, 1971; Shleifer & Vishny, 1992) and economies of scope (Teece,

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[1] The potential benefit of internal capital markets is greater when the information asymmetry between the firm and potential investors is larger (Myers & Majluf, 1984).

PII: S1057-5219(00)00032-6

1980). The costs of diversification stem mainly from agency problems. Managers may diversify to protect their human capital (Amihud & Lev, 1981), to increase their private benefits (Jensen, 1986; Morck et al., 1990), or to entrench themselves (Shleifer & Vishny, 1989). Within a diversified firm, managers may have easy access to capital through cross-subsidization (Meyer et al., 1992), which may lead to over-investment (Jensen, 1986; Stulz, 1990; Berger & Ofek, 1995).

Recent literature shows that corporate diversification strategies are associated with significant value loss and that increasing corporate focus is value-enhancing. Examples of these studies include Lang and Stulz (1994), Liebeskind and Opler (1994), Berger and Ofek (1995, 1996), Comment and Jarrell (1995), John and Ofek (1995), Servaes (1996), and Denis et al. (1997).[2] The evidence in these studies suggests that the costs of diversification outweigh the benefits. Given the extensive evidence that diversification is associated with a reduction in firm value, why do firms remain diversified? Denis et al. (1997) test an agency cost explanation for this by relating the level of, and value loss from, diversification to the ownership structure of the firm.[3] They find that higher managerial and blockholder ownership are associated with reduced levels of diversification, but not with more valuable diversification.[4] They argue that the recent trend toward increased corporate focus is attributable to market disciplinary forces.

The existing literature on corporate diversification bases mainly on US data, which may reflect the US corporate behavior and capital market environment. Very little is known about corporate diversification and its value outside the US, especially in the emerging markets, where the capital markets are less developed. To contribute to the literature, we examine the level and value of corporate diversification for a sample of Singapore firms. Singapore provides an interesting setting to examine corporate diversification because it has a small and open economy. Singapore firms may need to diversify because of the small size of the market. Further, Singapore's capital markets are not as developed as those in the US and other developed economies.[5] The lack of depth in the capital markets suggests that there may be beneficial effects from diversification due to a more efficient internal capital market. Finally,

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[2] The recent spate of research on corporate diversification is in response to a trend in the US toward corporate focus in the 1980s. Bhide (1990) suggests that information asymmetries may have become less of a problem in the 1980s because of economic, technological, and regulatory changes. The costs of diversification may have started to outweigh the benefits in the 1980s. Morck et al. (1990) provide empirical support for this argument. They find that the markets react negatively to unrelated acquisitions during the 1980s but not during the 1970s. However, a recent study by Servaes (1996) finds no evidence that diversified companies were valued at a premium over single-segment firms during the 1960s and 1970s.

[3] The agency cost hypothesis is that managers derive private benefits from diversification that exceed their private costs.

[4] Servaes (1996) finds that insider ownership was negatively related to diversification during the 1960s, but when the diversification discount declined, firms with high insider ownership were the first to diversify. He argues that insider ownership was an effective deterrent to diversification when it was costly to shareholders. However, when the cost to shareholders was negligible, the firms with high ownership were the first to diversify, possibly because insiders wanted to lower their exposure to firm-specific risk.

[5] Singapore corporations traditionally rely on equity and bank debt to finance investments. The corporate bond market in Singapore is very small and illiquid although there are recent efforts to develop this market.