European Research on Management and Business Economics 24 (2018) 63–70

European Research on Management and Business Economics

www.elsevier.es/ermbe

Multibusiness firms and performance in Italy. What role does relatedness play?

Maurizio La Rocca[a,*], Tiziana La Rocca[b], F. Javier Sánchez Vidal[c]

[a] Department of Economics, Statistics and Finance, University of Calabria, Via Pietro Bucci, Edificio Cubo 3/C, Arcavacata di Rende 87036, Cosenza, Italy
[b] Department of Economics, University of Messina, Piazza Pugliatti, 1 - 98122 Messina, Italy
[c] Department of Accounting and Finance, Technical University of Cartagena, C/ Real, 3 30201, Cartagena, Murcia, Spain

ARTICLE INFO

Article history:
Received 13 October 2016
Received in revised form 21 December 2017
Accepted 12 January 2018
Available online 1 February 2018

JEL classification:
L25
M10

Keywords:
Product diversification
Multi-business firm
Relatedness
Firm performance
Firm value

ABSTRACT

This paper evaluates the effect of diversification strategy on corporate value for a sample of Italian companies. It accounts for both the level of diversification and relatedness components. Empirical analyses show a U-shaped curvilinear relationship between diversification and value. In contrast to the mainstream literature, our results highlight that related diversification has a negative effect, while unrelated diversification is a value-creating strategy.

1. Introduction

The relationship between diversification strategies and firm performance has been the object of scientific investigation for several decades and by a wide variety of authors. Until the end of the 1990s, the vast majority of corporate finance studies on the subject agreed with the conclusion that diversified firms are generally traded at a discount compared to focused firms operating in the same business (Scharfstein & Stein, 2000, p. 2537). However, in the last few years, a growing number of studies have challenged these conclusions, thus contributing to a renewed interest among the scientific community in this area of research (He, 2009; Hoechle, Schmid, Walter, & Yermack, 2012; Kuppuswamy & Villalonga, 2016; Villalonga, 2004a, 2004b).

On a geographic basis, many analyses have been conducted (Claessens, Djankov, Fan, & Lang, 1999; Fauver, Houston, & Naranjo, 2003; Fuente & Velasco, 2015; Hernández-Trasobares & Galve-Górriz, 2017; Lins & Servaes, 1999, 2002) with the aim of verifying the emerging hypotheses, but no analysis has been conducted on the Italian market. The aim of this paper is to fill this gap by testing the main hypotheses proposed in the literature on the Italian industrial context. The Italian context seems to be particularly rich and of special interest for research application on account of the many peculiarities that distinguish it not only from the countries of Anglo-Saxon tradition but also from other countries in continental Europe.

First of all, the Italian governance structure is characterized by the large number of family-owned businesses (Barca & Becht, 2001; La Porta, Lopez de Silanes, Shleifer, & Vishny, 1999), with others in the hands of business groups that, in agreement with financial institutions and by means of pyramidal systems and non-voting shares, control a large number of firms with a relatively small amount of capital. The main agency problem concerns the conflict of interest between large shareholders and minority shareholders. In this regard, diversification may mitigate or exacerbate such opportunistic problems.

Secondly, the Italian economic environment presents a large number of elements of inefficiency in the allocation of funds: the number of listed firms is relatively small in comparison to that of other countries which have a similar gross domestic product (Carpenter & Rondi, 2000). Italy has a bank-based economy with a low presence of institutional investors in the financial markets. In

* Corresponding author.
E-mail addresses: m.larocca@unical.it (M. La Rocca), elviratiziana.larocca@unime.it (T. La Rocca), javier.sanchez@upct.es (F.J.S. Vidal).

https://doi.org/10.1016/j.iedeen.2018.01.001

this context, the combination of benefits and costs related to diversification could be significant (Prowse, 1990). The benefits provided by diversification strategies which arise from internal capital markets can be larger with such significant external capital market constraint and imperfections (Khanna & Palepu, 1997).

The paper focuses on a sample of 76 Italian listed firms from 1987 to 2007, with the aim of investigating the relationship between diversification, both related and unrelated, and firm performance. Controlling for endogeneity problems, we demonstrate that the role of product diversification in shaping firm value is different compared to the main results based on US data. It shows that diversification can have a negative effect, mainly due to inefficient decision-making with regards to diversifying into related segments. By contrast, becoming a conglomerate improves the value of the firm, due to the poor financial market that characterizes Italy and the benefits provided by an internal capital market. In our view, contributing toward the research literature on the heterogeneity of the value of diversification across different geographical and/or institutional contexts is of great interest. Given the dominance of US data, this paper presents some very interesting evidence with respect to the Italian context.

The present work is structured as follows: in Section 1, we present a literature review which identifies the main hypotheses. In Section 2, the methodology, the models applied and the variables used are described. In Section 3, we present the data, the sample selection and the descriptives. Section 4 presents the main findings. Finally, the last section summarizes and concludes the paper.

2. Literature review and hypothesis

The relationship between diversification and performance has long been a central topic of research on strategic management (Ansoff, 1958; Datta, Rajagopalan, & Rasheed, 1991; He, 2009; Hoechle et al., 2012; Hoskisson & Hitt, 1990; Kuppuswamy & Villalonga, 2016; Palich, Cardinal, & Miller, 2000; Ramanujam & Varadarajan, 1989). In spite of the persistent efforts from researchers over the years, clear-cut conclusions remain evasive. Although a few papers, including the article published by Hernández-Trasobares and Galve-Górriz (2017), did not find any statistically significant linkage, the connection between diversification and performance depends on the way in which the benefits and costs related to this corporate strategy are combined. Firms choose to diversify their activities in more businesses when the benefits of diversification overcome its costs, while if the opposite occurs, companies prefer to stay focused. Hoechle et al. (2012, p. 43) find a significant diversification discount and a large amount of this discount can be explained by corporate governance variables, ". . . better corporate governance is associated with less value destruction (or more value creation) when diversifying mergers occur".

A short overview of the literature follows, in accordance with the need to explain the research hypothesis, while a broad review of the literature is provided by Ramanujam and Varadarajan (1989), Hoskisson and Hitt (1990), Datta et al. (1991) and more recently by Martin and Sayrak (2003) and He (2009, 2012). In particular, the main effect of diversification as a whole on firm value is explained in Appendix A.

2.1. Positive relationship between diversification and value

One stream of research points to diversification as a value-increasing strategy for the firm. In this case, the hypothesis is that "corporate diversification has a positive impact on firm value." According to this view, the benefits of diversification outweigh the possible costs (Gertner, Scharfstein, & Stein, 1994; Villalonga, 2004b). This was the traditional view in the industrial organization literature that considered diversification and performance to be linearly and positively related (Gort, 1962). From the resource-based perspective, diversification provides operational synergies (Markides & Williamson, 1994) based on economies of scale and scope (Panzar & Willig, 1981), increasing efficient ways of organizing economic activities. From a market power perspective, diversification can be based on anticompetitive motives against competitors (Seth, 1990). According to a financial approach, there should be a coinsurance effect, providing risk reduction derived from combining businesses whose cash flows are less than perfectly correlated (Lewellen, 1971). In addition, the diversification strategy provides a superior means of funding an internal capital market (Lamont, 1997; Stein, 1997).[1] Consistent with the internal capital market hypothesis, He (2009) finds that diversification leads to a value premium in the post-1997 period. In addition, Kuppuswamy and Villalonga (2016) provide new evidence on the efficiency of internal capital markets during the 2007–2009 financial crisis.

H1. Product diversification has a positive effect on firm value.

2.2. Negative relationship between diversification and value

An opposite stream of research that theorizes a prevalence of the costs of diversification rather than its benefits is based on the evidence obtained in the corporate finance literature. It considers diversification to be a value-destroying strategy, and multi-segment firms are traded at a discount (Berger & Ofek, 1995; Lamont & Polk, 2000; Lang & Stulz, 1994; Rajan, Servaes, & Zingales, 2000; Servaes, 1996). Due to the fact that the costs of diversification outweigh the possible benefits, it is assumed that "corporate diversification has a negative impact on firm value". According to an inefficiency narrative, diversified firms do a worse job of allocating their resources than focused firms (Lamont, 1997; Rajan et al., 2000; Seth, 1990) as a result of information asymmetry between headquarters and divisions, power struggles between divisions and, in general, higher coordination and control costs over the managers. With regard to the agency theory, diversification can somehow exacerbate managerial agency problems that result from the pursuit of managerial self-interest strategies at the expense of stockholders (Denis, Denis, & Sarin, 1997; Fama & Jensen, 1983; Lang & Stulz, 1994).

H2. Product diversification has a negative effect on firm value.

2.3. Curvilinear relationship between diversification and value

The combination of benefits and costs can provide a changing net result according to the different levels of diversification. In particular, it is possible to observe a non-linear relationship between diversification and firm value by identifying an optimum level of diversification and balancing the benefits and costs of a diversification strategy (Jones & Hill, 1988). For low levels of diversification, expansion into product lines could be expected to improve firm value by better exploiting economies of scale and scope. However, we might observe diminishing marginal returns owing to costs arising from potential organizational inefficiencies, coordination and governance costs, and shirking (imperfect monitoring). Therefore, we should observe an inverted-U shape (Grant, Jammine, & Thomas,

[1] The creation and exploitation of the internal capital market is typical of large unrelated diversified firms (Stein, 1997). While there have been opposite conclusions proposed in the literature (Lamont, 1997; Rajan et al., 2000; Scharfstein & Stein, 2000), it is the common opinion (Gertner et al., 1994; Stein, 1997; Williamson, 1985) that internal capital markets have a positive influence on the creation of firm value thanks to improved capital budgeting procedures.