



The effects of institutional ownership on the value and risk of diversified firms



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ABSTRACT

We study the link between institutional ownership and firms' diversification strategy, value and risk. Our sample includes US-listed firms with segment data from 1998 to 2012. We find that not all kinds of diversification are value-destroying; unlike industrially-diversified firms, global single-segment firms are trading at a premium relative to their imputed value. The presence of institutional investors and the stability of their shareholdings positively influence the likelihood that a firm is diversified. The proportion (volatility) of institutional ownership is higher (lower) among diversified firms compared to domestic single-segment firms. More importantly, the higher the proportions of institutional shareholdings, the higher the excess value of the diversified firm and the lower the firm idiosyncratic risk. Institutional ownership volatility, on the other hand, is inversely related to a firm excess value but positively related to its idiosyncratic risk. Thus, the presence of long-term stable institutional investors enhances the value of diversified firms. Our findings remain robust to various model specifications and estimation techniques.

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1. Introduction

The effect of diversification on firm value continues to attract considerable research interest. There are two main types of diversification: product- and geographic diversification (Vachani, 1991; Martin, 2008). Product diversification refers to the degree to which firms are involved in different industries (we refer to them as business segments). Geographic diversification refers to the extent to which firms are involved in different countries (we refer to them as geographic segments). Bodnar, Tang, and Weintrop (1997) find that global diversification is associated with higher firm value. In contrast, Denis, Denis, and Yost (2002) find that diversification decreases firm value. Other studies that suggest that diversification adversely affects firm value include Berger and Ofek (1995), Fauver, Houston, and Naranjo (2004); and Kim and Mathur (2008).

Corporate diversification is appealing to investors. Under the premise that corporations are better at diversification than shareholders, corporate diversification should lower shareholders' investment risk at a fraction of the cost incurred by individual investors (see Agmon and Lessard (1977); Doukas and Travlos (1988); Harris and Ravenscraft

(1991); Sanders and Carpenter (1998)). However, the diversity of operations at conglomerate firms makes it harder for ordinary investors to monitor them (Fatemi, 1984), opening the possibility for management to pursue self-interest objectives at the expense of the shareholders (Palich, Cardinal, & Miller, 2000). Such agency problems will reduce shareholders' return on investment and/or increase their risk. As a consequence, if there is a group out there who is better at monitoring managers, it is better to follow their lead. Jensen and Meckling (1976), and Shleifer and Vishny (1986) suggest that large investors could well be that group. We propose to consider the contribution to firm value and risk brought about by such an important group of investors at diversified firms, i.e., institutional investors.

Institutional investors – including mutual funds, hedge funds, pension funds, banks and insurance companies – are leading players in the financial markets as well as the primary owners of US corporate equity (Gillan & Starks, 2000). Estimates of their shareholdings at US firms range from 35% in the 1980s and 60% in the 2000s (Clay, 2002) to 66% by the end of 2010 (Blume & Keim, 2012). Given the size of their equity investments, they tend to exert considerable pressure on management to create wealth for investors (see also, Shleifer and Vishny (1986)). Jarrell and Poulsen (1987), Brickley, Lease, and Smith (1988); Agrawal and Mandelker (1990) suggest a direct link between institutional investors and shareholders' wealth. Consequently, managers pay a lot of attention to meet the financial targets set by these investors (Easley & O'hara, 1987; Kyle, 1985; Clay, 2002). Actions taken by

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the investors tend to generate a lot of press and media attention, especially at large and diversified firms. Many institutional investors believe that diversified firms can generate more profit by restructuring their divisions; examples include campaigns by investors demanding restructuring at big firms like PepsiCo, Sony, Timken, and McGraw-Hill.¹

Do institutional investors — as effective monitors of firm performance — support diversification and add value to diversified firms by virtue of their presence? We attempt to answer the question and analyze the importance of two measures of institutional ownership on diversified firms' value and risk, i.e., the proportion of the shares held by the institutional investors (*IOPr*) and the institutional ownership volatility (*IOV*). The first measure is extensively used in the literature (see, for instance, Bhojraj and Sengupta (2003); McConnell and Servaes (1990); Wright, Ferris, Sarin, and Awasthi (1996); Holderness, Kroszner, and Sheehan (1999); Woitke (2002); Cornett, Marcus, Saunders, and Tehranian (2007)), though mostly focused on domestic firms. An emerging literature on the effects of institutional ownership on firm value suggests that in addition to the proportion of shares held by investors, it is equally important to consider institutional ownership stability (Gaspar, Massa, & Matos, 2005; Chen, Harford, & Li, 2007; Yan & Zhang, 2009; Elyasiani & Jia, 2010; Elyasiani, Jia, & Mao, 2010; Attig, Cleary, El Ghouli, & Guedhami, 2012; Callen & Fang, 2013). They argue that not all institutional investors stay with a firm for the long-term. Some are short-term and would leave at the first sign of trouble. Elyasiani and Jia (2010), and Callen and Fang (2013) argue that “stable” institutional investors are more incentivized to monitor target firms and improve shareholder welfare.

To the extent that diversification destroys value while institutional investors add value, we test whether their presence at diversified firms adds value. We hypothesize that diversified firms with higher proportions of shares held by institutional investors (*IOPr*) and lower variability in the proportions (*IOV*) are associated with higher excess values. Similarly, we posit that firm risk is inversely related to *IOPr* and positively related to *IOV*. Managers would be under scrutiny not to cripple the firm with non-value added diversifications when more shares are held by institutional investors (*IOPr*). Conversely, if a firm pursues the wrong type of diversification, then there is little reason for the investors to hold onto their shares. Thus, we should observe a higher volatility in institutional shareholdings (*IOV*) among this subgroup of firms.

We examine the universe of firms listed in COMPUSTAT from 1998 to 2012. We break the universe of COMPUSTAT firms into four groups: (i) domestic single-segment firms (*DS*), (ii) domestic multi-segment firms (*DM*), (iii) global single-segment firms (*GS*) and (iv) global multi-segment firms (*GM*). We find that unlike domestic firms, the trend is to go global, i.e., we observe a fall in the number of domestic firms and a rise in the number of global firms over time. We find that not all kinds of diversification are associated with negative excess values. As opposed to industrially-diversified firms, global single-segment firms trade at a premium relative to their matched domestic single-segment firms. The idiosyncratic risk levels are lower for diversified firms compared to domestic single-segment firms.

The proportion of shares held by institutional investors (*IOPr*) is higher and the volatility in those proportions (*IOV*) is lower at diversified firms compared to domestic single-segment firms. Using probit regressions, we find that the likelihood to diversify is positively associated with the proportion of shares held by institutional investors (*IOPr*) and inversely related to its volatility (*IOV*).

Univariate analyses suggest the existence of a positive relationship between *IOPr* and firm's excess value and an inverse relationship

between *IOPr* and firm's idiosyncratic risk. Conversely, *IOV* is inversely related to excess value and positively related to idiosyncratic risk. The evidence suggests that there exists a significant relationship between the presence of long-term stable institutional investors and the ability of diversified firms to create wealth.

Consistent with the univariate findings, the coefficient of *IOPr* is positive and that of *IOV* is negative in panel fixed-effect regressions of firms' excess values. The coefficients of *DM* and *GM*, representing domestic multi-segment firms and globally diversified multi-segment firms, respectively, are both negative and highly significant. On the other hand, global single segment (*GS*) firms are associated with higher excess values.

In regressions of firms' idiosyncratic risk, the coefficients of *IOV* and *IOPr* are positive and negative, respectively, suggesting that firms with lower proportions of equity held by institutional investors and higher volatility in that proportion are perceived as riskier and carrying more idiosyncratic risk. Overall, the empirical evidence suggests that diversified firm value is linked to investors with considerable and stable shareholdings. Furthermore, the absence of stable, long-term institutional investors increases the idiosyncratic risk of diversified firms. Our empirical findings are robust to alternative control variables, various model specifications and estimation techniques.

Beyond complementing and extending the literature on the diversification discount, this study also contributes to the emerging literature on the role of institutional ownership stability on firm governance and performance. To the best of our knowledge, our study is the first to assess the impact of institutional ownership stability among diversified firms. We consider the effect of institutional investors in lessening the diversification discount. We also examine the link between institutional investors and firm risk. The remainder of the paper is organized as follows. Section 2 reviews the literature and formulates the hypotheses. Section 3 presents the data. Section 4 presents the methods used. We present and discuss the findings in Section 5, and conclude the paper in the final section.

2. Literature review and hypotheses development

At the firm level, institutional investors tend to resist counterproductive strategies while supporting beneficial ones, especially shareholder driven ones (Bethel & Liebeskind, 1993; Hill & Snell, 1988; Holderness & Sheehan, 1985; Mikkelsen & Ruback, 1991). They tend to lobby senior executives to implement restructuring strategies that are beneficial to all the shareholders (see also Bethel and Liebeskind (1993)). Attig et al. (2012) argue that long-term institutional investors have greater incentives and efficiencies — economies of scale in the collection and processing of corporate information — to engage in effective monitoring, which in turn mitigate the asymmetric information dilemma and associated agency problems.

Barclay, Holderness, and Pontiff (1993) find that investors value the skills and demands of block purchasers and that firm value increases following a block trade. They document a high turnover in management following these trades and a decline in firm value when the block holders either fail to achieve control and/or face resistance from management. Navissi and Naiker (2006) find that shareholding by active institutional investors of up to 30% positively influences corporate value. Beyond 30%, the ownership tends to reduce firm value, which suggests that there exists a non-linear relationship between the two. When these shareholders become too large, there exists a significant risk that they will join forces with management to safeguard their common interests at the expense of the other shareholders, especially minority/individual ones. The authors find that passive investors do not affect firm value. Cornett et al. (2007) find that the percentages of institutional investor involvement in a firm, as well as their numbers, are associated with better operating cash flow returns. However, the findings only hold when the investors have no business relation with the firm; else there is no

¹ For instance: <http://www.ics.com/resources/news/2014/01/24/9746821/commentary-activists-targeting-us-diversified-chemical-companies-is-in-vogue/>; https://www.bcgperspectives.com/content/articles/value_creation_strategy_do_it_yourself_activism/.

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