



Does it really matter how a firm diversifies? Assets-in-place diversification versus growth options diversification



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ABSTRACT

This study analyses whether the effect of corporate diversification on a firm's market value depends on how this strategy is implemented. According to the real options approach, two opposite diversification strategies may be implemented: one based on fully exercising available options (assets-in-place diversification) and the other aimed at seeding new opportunities for future growth in multiple businesses (growth options diversification). We propose an index to measure these two diversification patterns and we explore their impact on firm market value for a sample of U.S. firms during 1998–2014. We find that as a firm's diversification strategy shifts towards a growth options pattern, it becomes a more value-enhancing strategy.

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1. Introduction

The linkage between diversification and firm value has constituted a prolific area of research. Existing literature offers abundant yet inconclusive evidence on the topic, with the research question becoming widely known as the *diversification puzzle*.¹ Although the bulk of the research provides evidence that diversified firms trade at a discount relative to non-diversified companies in their industries (Berger and Ofek, 1995; Servaes, 1996; Stowe and Xing, 2006; Borghesi et al., 2007; Hoechle et al., 2012; Kuppusswamy and Villalonga, 2016), other works call these findings into question, and report a non-statistically significant relationship (Villalonga, 2004b; Elsas et al., 2010), a quadratic relationship (Palich et al., 2000; Andrés et al., 2014), or even premiums for diversifying (Campa and Kedia, 2002; Villalonga, 2004a).

Some studies have suggested that these inconsistent findings may be due to one or more of the following three reasons: biases in data (Villalonga, 2004a), methodological issues (Campa and Kedia, 2002; Villalonga, 2004b), or the presence of moderating factors in the diversification-value relationship (Rajan et al., 2000). The identification of moderating factors suggests that the impact of this strategy on performance may not be homogeneous across firms but rather dependent on aspects that might enable certain enterprises

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¹ Martin and Sayrak (2003), Erdorf et al. (2013), and Ahuja and Novelli (2016) provide three complementary surveys of the corporate diversification literature.

to create more value than others. Such moderating factors could be classified into three categories: market and institutional level factors (Fauver et al., 2003; Rudolph and Schwetzler, 2013), industry level factors (Santaló and Becerra, 2008), and firm level factors (Rajan et al., 2000).

Among the firm-specific characteristics that may account for differences in diversification value outcomes, one strand of literature explores the role of a firm's growth opportunities. Bernardo and Chowdhry (2002) attribute a significant role to growth opportunities when accounting for the diversification discount: unisegment firms have more options to expand whereas diversified firms may have exhausted some of these. Concurring with this line of thinking, Borghesi et al. (2007) claim that pure-play firms and their diversified industry-peers exhibit different growth potential. Once the age of the firm, used as a proxy for growth opportunities, is controlled for, the initially displayed discount decreases. Andrés et al. (2016) report that growth options partly mediate the relationship between diversification and a firm's value, with said strategy being more value-enhancing insofar as it increases growth options to a greater extent. In a similar vein, Ferris et al. (2002) analyse diversification for a sample of international joint ventures and show that diversification is only value-destroying in enterprises that have a poor set of growth opportunities. Alternatively, Stowe and Xing (2006) offer evidence that differences in growth opportunities are not the main driver of the diversification discount, since the discount persists even after such differences are controlled for. Finally, Holder and Zhao (2015) argue that prior evidence on the diversification discount fails to consider the impact of diversification on changes in the value of a firm's growth options. They find that the diversification discount may be the joint result of the increase in value in below-average performers exploring new growth opportunities through unrelated diversification, and the decrease in value in above-average performers exploiting their current growth opportunities through related diversification.

In light of these findings, there appears to be a need to examine the role played by growth options in the diversification-value puzzle in greater depth. Specifically, two further questions arise: first, whether diversification strategies can differ depending on their divergent effect when shaping a firm's growth options portfolio; and second, whether such differences might have an impact on corporate value. We adopt a real options approach to identify two contrasting diversification patterns: one based on fully committed entry into new markets (assets-in-place diversification), and the other aimed at seeding simultaneous growth options in multiple businesses (growth options diversification). Logically, no firm adopts either of these 'extreme' diversification patterns but rather an intermediate one, which might be closer to one or the other. Measuring the proximity to one of these extreme patterns is no easy task since neither a firm's strategy nor its real options portfolio are directly observable.² To address this problem, we propose a proxy that can reflect some of the key effects that emerge from each strategy. To the best of our knowledge, no prior research has attempted to measure this diversification pattern.³

Assets-in-place (AiP, hereafter) diversification would be reflected in a firm's portfolio characterised by a highly uniform distribution of the firm's activity across segments and a relevant commitment in each. In contrast, growth options (GO, hereafter) diversification would show an unequal distribution across businesses with a low commitment in a number of them. Taking the concept of fit as *profile deviation* (Venkatraman, 1989), we propose a two-dimensional index, which combines an inequality-based measure of a firm's sales distribution across divisions (inter-segment component) and a measure of the scale of commitment in each (intra-segment component).

The question we can then ask is whether the proximity to one of these poles makes any difference to the value of diversification. Amihud and Lev (1981) argue that the critical issue for the valuation effect of diversification is what kind of risk is reduced by diversification and whether stockholders could diversify this in their individual portfolios. If investors can diversify at a lower cost than enterprises, corporate diversification would destroy value. However, diversification aimed at providing the firm with growth options might not be so easily replicated. A GO diversification strategy boosts the firm's flexibility to adjust its decisions as uncertainty is resolved, and is geared towards exploring further opportunities in new industries before fully committing. As a result of this flexibility, corporate diversification may reduce risk and serve as 'strategic insurance' (Raynor, 2002), which cannot be replicated by investors. The most an individual investor could hope to achieve is to replicate the options portfolio by acquiring the stocks of such firms. However, the value of this replicating portfolio would be less than the value of the diversified firm's options portfolio since the optimal joint exercise of an options portfolio always proves more efficient than the sum of the individual optimal exercise of each option. Such arguments lead us to hypothesise that GO diversification might have a positive effect on value.

Some prior research results seem to support the superiority of the GO diversification strategy for creating value over the AiP strategy. For example, Teplensky et al. (1993) find that incremental strategies lead to better performance in uncertain and dynamic environments, such as emerging markets, since they avoid full commitment of resources, while past performance acts as a feedback mechanism for future strategic decisions. In a similar vein, Andreou et al. (2016) report a discount among enterprises moving one time from a single segment to multiple ones and a premium among enterprises that undertake this strategy several times. Mitton and Vorkink (2010) also concur with these findings and show that the valuation effect of diversification is positively related to return skewness, which is consistent with superiority of the GO pattern insofar as positive skewness of a firm's stock returns approximates real options relevance in its total asset mix (Trigeorgis and Lambertides, 2014).⁴ Overall, this empirical evidence suggests that GO diversification may be more value enhancing than AiP diversification.

² As is well known, unobservability is by no means an uncommon issue in social sciences, since most variables in their models are unobservable and proxies are used instead.

³ The only related precedent is Klingebiel and Adner (2015), who develop a classification of product innovation strategies to distinguish between real options logic and alternative resource allocation regimes.

⁴ Mitton and Vorkink's explanation is not based on RO. They argue that corporate diversification reduces stock return skewness as a consequence of return compensation, similar to what happens when combining stocks in a portfolio. Should investors prefer positive skewness, a firm's relative value would be discounted as skewness is reduced by segment diversification.

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