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Institutional investors as monitors of corporate diversification decisions: Evidence from real estate investment trusts ☆

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ABSTRACT

Determining whether diversification adds or destroys value is notoriously difficult, leaving open the question of the degree to which any diversification discount can be affected by management quality and oversight. This study uses the unique setting of real estate investment trusts (REITs), which can diversify over property types as well as locations, to examine this issue. We find that REITs that diversify by investing in more locations tend to be valued lower than REITs with a tighter geographical focus. More importantly, our results suggest that the diversification discount is lower for firms with more institutional ownership, especially institutional types that tend to be more active monitors.

1. Introduction

The impact of diversification on firm value has been widely studied and debated. As early research emphasized, there are a number of reasons why diversification can enhance value, including coinsurance effects that can lead to greater debt capacity, as well as an increase in the liquidity of the diversified firm's equity.[1] In addition, as we stress in this study, diversification can provide managers with potentially valuable timing options, allowing them to move factors of production (e.g., capital and labor) to more productive uses in response to external shocks. The timing option, however, adds value only when the firm is effectively managed in the interests of their shareholders. Poorly managed firms may have a tendency to move resources in perverse ways, such as using resources from their best performing business units to subsidize their weak performers.[2] Hence, the benefit of diversification is likely to be affected by both the ability and incentives of managers to exploit timing options in ways that benefit shareholders.

This study examines diversification within the context of Real Estate Investment Trusts (REITs), a setting that is advantageous for several reasons. In particular, as we discuss below, it is relatively straightforward to measure the diversification of REITs. In contrast, it is notoriously difficult to accurately measure the extent to which most firms are diversified (Villalonga, 2004a)) and it is equally difficult to control for other differences across firms, such as growth opportunities, and other aspects of firm quality

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[1] Lewellen (1971) discusses the coinsurance effect and Hadlock et al. (2001) document benefits to diversification due to a reduction in adverse selection problems around equity offerings.

[2] See Stein (2003) for a review of theoretical and empirical work on internal capital allocation. Berger and Ofek (1995), Lang and Stulz (1994), Comment and Jarrell (1995) and many others find evidence of a diversification discount for a broad set of firms, while Laeven and Levine (2007) find evidence of a diversification discount for financial institutions.

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(e.g., Campa and Kedia (2002), Graham et al. (2002), Villalonga (2004b)). These difficulties have led to a long-standing debate over whether a diversification discount exists (on average), with results dependent upon the specific time period studied and the econometric approach taken. More importantly, these difficulties also imply that it is difficult to test hypotheses about cross-sectional variation in the value of diversification using a broad cross-section of very different firms. One can argue (as in Stein (2003)) that this is where the more interesting questions regarding the value of diversification lie – in the variation of such effects across firms or over time, rather than simply measuring the average effect.

REITs present significant advantages for testing the influence of managerial quality and incentives on the costs and benefits of diversification. REIT investments are observable – i.e., ownership of income-producing commercial real estate – and one can easily ascertain the degree to which they are diversified across property types (e.g., retail versus apartments) and/or geography (e.g., Dallas versus Detroit). This is in stark contrast to the standard corporate case, where segment data can be suspect (Villalonga (2004a)). In addition, holding property type and location constant, REITs enjoy similar if not identical growth opportunities. This implies that observed differences in valuation are likely to stem from differences in managerial quality and their investment and operating decisions. Thus, REITs provide more precise measures of diversification as well as more accurate measures of relative value.[3]

We also exploit the fact that the investments made by REIT managers are likely to be subject to varying degrees of scrutiny. Because REITs must distribute at least 90% of their income to maintain their favored tax status, they are heavily dependent upon the capital markets.[4] Specifically, to finance growth they must return to the capital markets, providing investors with frequent opportunities to scrutinize management's plans – including their plans to move resources into new markets or to reallocate resources across markets. As a result, REITs may be more influenced by external monitoring than typical corporations.

We begin our analysis by examining whether diversification influences REIT values over our sample period, from 1995 through 2008. Using measures of diversification across both property types and locations, and controlling for a wide range of firm characteristics, we find that REIT value is negatively related to the degree of geographic diversification. In contrast, we do not find a reliable relation between diversification across property types and firm values, but it is likely that this non-result is due to the fact that very few REITs are diversified across property types.

Having documented the presence of a geographical diversification discount, we then turn to our primary question – whether the ability and incentives of managers determine whether the timing options associated with diversification create or destroy value for shareholders. To test this hypothesis, we use institutional ownership as a proxy for the quality of managerial choices. Specifically, we assume that REITs with greater institutional ownership tend to be better managed, and are thus better positioned to exploit the benefits of the timing options.

Institutional ownership can be related to managerial quality for two reasons. The first, our selection hypothesis, is that the best-managed REITs attract more institutional investors, who have a comparative advantage relative to individual investors in evaluating management quality. The second, our monitoring hypothesis, is that REITs owned by more institutional investors tend to be more carefully scrutinized by their shareholders, and are thus likely to make better allocations of capital.[5]

Our second set of regressions includes interactions between the degree of diversification and institutional holdings. Here, we find that the geographical diversification discount is mitigated when institutions have a greater equity stake. Moreover, the relation between institutional ownership and the diversification discount tends to be driven by the holdings of the more active institutions, i.e., investment advisers and investment companies, which are likely to have a comparative advantage in the evaluation and monitoring of REIT managers.

To further explore the relation between active investors and the diversification discount, we examine whether the diversification discount is more closely related to the number of active institutions versus the percentage owned by active institutions. Evidence that the diversification discount is substantially mitigated for REITs with a large number of active institutions supports the idea that institutions are better able to identify higher quality managers. However, if the diversification discount is more closely related to the presence of a smaller number of highly-concentrated active institutions, then we would conclude that it is active monitoring that contributes to a reduction in the diversification discount. Our evidence tends to support the monitoring rather than the selection hypothesis. Specifically, the diversification discount is only present for the subsamples with low institutional ownership and less concentrated ownership and we find no significant difference in the discount across the two subsamples based on the number of active institutions.

Having established an association between value, diversification, and institutional ownership, we next ask whether we can predict which REITs will increase or decrease their degree of geographic diversification. We find a significant positive relation between a REIT's relative valuation and the probability that it diversifies in subsequent years. This is consistent with either highly-valued REITs capitalizing on their valuations and expanding into new territories, or high-quality REITs leveraging their managerial skills across markets. To examine this further, we include the interaction of institutional ownership and relative value as a determinant of diversification and find negative point estimates for the coefficient on that interaction term across

[3] Gentry and Mayer (2006) and Hartzell et al. (2006) make similar arguments for the advantages of studying REITs in related contexts.

[4] REITs are essentially able to shield the income that they distribute to shareholders from corporate-level taxes, as long as they meet several additional requirements: 1. 75% or more of a REIT's total assets must be real estate, mortgages, cash or U.S. government securities, 2. At least 75% of the REIT's annual gross income must be derived directly or indirectly from real property ownership, 3. Five or fewer shareholders cannot hold more than 50% of a REIT's stock, and it must have at least 100 shareholders, and 4. A REIT must not be classified as a property dealer (i.e., it cannot "flip" properties too frequently). For a detailed discussion of the tax rules faced by REITs and the effects these rules have on dividend policy, see Boudry (2011).

[5] The incentive for large investors to monitor has been discussed by many – see Huddart (1993) or Shleifer and Vishny (1986), for example. Hartzell and Starks (2003) present an example of monitoring by institutional investors, while Greenwood and Schor (2009) provide evidence of activism by hedge funds.