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# How much of the diversification discount can be explained by poor corporate governance? <sup>☆</sup>

Daniel Hoehle <sup>a,b</sup>, Markus Schmid <sup>c,\*</sup>, Ingo Walter <sup>d</sup>, David Yermack <sup>d</sup>

<sup>a</sup> Department of Finance, University of Basel, CH-4051 Basel, Switzerland

<sup>b</sup> Man Investments, Pfaffikon CH-8808, Switzerland

<sup>c</sup> University of Mannheim, Finance Area, Chair for Business Administration and Corporate Governance, D-68131 Mannheim, Germany

<sup>d</sup> Department of Finance, Stern School of Business, New York University, New York, NY 10012, USA

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## ABSTRACT

We investigate whether the diversification discount occurs partly as an artifact of poor corporate governance. In panel data models, we find that the discount narrows by 16% to 21% when we add governance variables as regression controls. We also estimate Heckman selection models that account for the endogeneity of diversification and dynamic panel generalized method of moments models that account for the endogeneity of both diversification and governance. We find that the diversification discount persists even with these controls for endogeneity. However, in selection models the discount disappears entirely when we introduce governance variables in the second stage, and in dynamic panel GMM models the discount narrows by 37% when we include governance variables.

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## 1. Introduction

A large body of corporate finance research over the past 15 years shows the low valuation of diversified companies relative to their apparent breakup values.<sup>1</sup>

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\* Corresponding author. Tel.: +49 621 181 37 54

E-mail address: [schmid@bwl.uni-mannheim.de](mailto:schmid@bwl.uni-mannheim.de) (M. Schmid).

<sup>1</sup> Lang and Stulz (1994) and Berger and Ofek (1995) are the first major papers. Laeven and Levine (2007) report a sizable diversification discount for an international sample of banks between 1998 and 2002. Schmid and Walter (2009) find a similar discount for US financial intermediaries between 1985 and 2004. Ammann, Hoehle, and Schmid (forthcoming) report a robust and significant discount of between 5% and 21% for US nonfinancial firms between 1998 and 2005.

No consensus has emerged to explain this pattern, although authors have proposed and tested many hypotheses. Lamont (1997), Shin and Stulz (1998), Rajan, Servaes, and Zingales (2000), and Ozbas and Scharfstein (2010) provide evidence of inefficient investment patterns, under which conglomerate firms operate an internal capital market that transfers cash flows between divisions, causing some businesses to be underfunded and others to be overfunded relative to the outcomes that would occur if each business raised capital externally.<sup>2</sup> Baker (1992) indicates that the administrative cost associated with an internal capital market could create a significant drag on firm value, regardless of whether capital is allocated effectively. Graham, Lemmon, and Wolf (2002) show that in diversifying takeovers firms tend to acquire low-valued assets when buying firms in

<sup>2</sup> In contrast, using plant-level data, Maksimovic and Phillips (2002) conclude that resource allocation is generally efficient in diversified firms. Stein (1997) and Matsusaka and Nanda (2002) propose models that predict that conglomerate firms benefit from more efficient capital allocation in an internal capital market.

another industry. They argue that the addition of an already discounted unit reduces the excess value of the acquiring firm even if diversification itself does not destroy value. Other explanations suggested by academics and industry observers include the poor transparency of accounting data produced by conglomerates (e.g., Bushman, Engel, and Smith, 2004), the difficulty of implementing efficient incentive compensation when contracting with divisional managers in a diversified firm (Wulf, 2002), and the increased difficulty facing shareholders investing in shares of conglomerates in their effort to create efficient asset portfolios compared with investing in single-industry firms (Vijh, 2002).

Other papers argue that the diversification discount could be illusory. An influential literature begun by Mansi and Reeb (2002) notes that most measures of firms' enterprise values rely on their book values of debt as an input to the calculation, but diversified firms' debt could trade at a premium to book value as a result of the risk-reducing effects of diversification. Campa and Kedia (2002) and Villalonga (2004b) argue that a company could choose to diversify in response to exogenous changes in the firm's environment. Hence, the diversification discount could result from neglecting this endogeneity of the diversification decision in empirical models. Villalonga (2004a) shows that estimates of the diversification discount rely on ad hoc industry segment reporting choices made by individual firms and that the discount could disappear if different industry definitions are used in place of those chosen by companies.

This paper investigates a further possible explanation for the diversification discount: poor corporate governance. Beginning with Amihud and Lev (1981), perhaps earlier, many papers have conjectured that the diversification discount arises from agency problems such as empire building, managerial hubris, managerial overconfidence, and executives' pursuit of insurance to protect the value of their human capital. See, for example, Houston, James, and Ryngaert (2001), Aggarwal and Samwick (2003), Laeven and Levine (2007), and Andreou, Doukas, Louca, and Malmendier (2010). This reasoning is supported by the empirical findings of Denis, Denis, and Sarin (1997), who show that firms with higher managerial shareholdings are significantly less likely to be diversified, that diversification is negatively related to the equity ownership of large outside blockholders, and that decreases in diversification occur due to external corporate control threats, financial distress, and management turnover. Lins and Servaes (2002) find the diversification discount in their sample – including companies from seven Asian emerging markets – to be driven by firms with managerial ownership in the 10% to 30% range, where they expect managerial entrenchment to be highest. They also find the diversification discount to be most severe when the insiders' voting rights exceed their cash flow rights by 25% or more. These findings are confirmed by Fauver, Houston, and Naranjo (2003). Taken together, these studies suggest that agency problems account partly for firms' value-reducing diversification strategies.

We construct a panel data set with a large range of corporate governance variables, and we explore how

much of the discounted value of diversified firms appears to arise from the structure of corporate governance. We take a fuller view of governance than prior studies, which focus almost exclusively on ownership variables to measure potential agency problems.<sup>3</sup> Along with chief executive officer (CEO) and institutional ownership, our analysis considers the effects of board size, board independence, board classification, board busyness, board ownership, board attendance, nominating committee independence, a powerful CEO dummy variable, pay-performance sensitivity for the CEO, the Gompers, Ishii, and Metrick (2003) index of takeover defenses, and other variables.

To estimate how much of the diversification discount can be attributed to corporate governance, we regress our measure of firm value against a dummy variable for diversified firms and a range of control variables, with the estimated coefficient on the diversification dummy serving as a baseline estimate of the discount. We then reestimate the same regressions with governance variables included, and in more than a dozen different regression models we find that the estimated diversification discount narrows and moves toward zero by an amount that is both statistically and economically significant. The magnitude of the reduction ranges from 16% to 21%, depending upon the exact specification.

Endogeneity represents a crucial issue in investigating both corporate diversification and the structure of corporate governance. Campa and Kedia (2002) and Villalonga (2004b), for example, show that diversification strategies are determined endogenously and that failing to account for this endogeneity could lead to erroneous detection of a diversification discount. Similarly, research into the valuation effects of corporate governance has shown that firm-level governance variables arise endogenously. See, for example, Agarwal and Knoeber (1996), Larcker, Richardson, and Tuna (2007), and Coles, Lemmon, and Meschke (in press).

We attempt to account for the endogeneity of the corporate diversification decision and the endogeneity of both diversification and corporate governance. We do this in four ways. First, we include firm and year fixed effects in our standard regression specifications to mitigate potential omitted variables bias. Second, we estimate a Heckman (1979) self-selection model in which the diversification decision is endogenously determined. Third, we estimate a dynamic panel generalized method of moments (GMM) estimator as proposed by Wintoki, Linck, and Netter (forthcoming). The major advantage of the GMM approach as compared with the Heckman selection model is that it allows us to account simultaneously for the potential endogeneity of diversification,

<sup>3</sup> The only exception we are aware of is Anderson, Bates, Bizjak, and Lemmon (2000), who examine the relation between corporate diversification and several corporate governance mechanisms including the sensitivity of CEO compensation to performance, shareholdings of officers and directors, outside blockholdings, the sensitivity of CEO turnover to performance, and board composition. However, that paper's sample is limited to 199 firms, and the study does not address the potential endogeneity of both corporate governance and diversification.

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