J. Finan. Intermediation 23 (2014) 348–375

Contents lists available at ScienceDirect

J. Finan. Intermediation

journal homepage: www.elsevier.com/locate/jfi

Managerial expertise, corporate decisions and firm value: Evidence from corporate refocusing

Sheng Huang *

Singapore Management University, Singapore

A R T I C L E I N F O

Article history:
Received 10 November 2011
Available online 20 April 2014

JEL classification:
G30
G34

Keywords:
CEO characteristics
Managerial expertise
Refocus
Diversification
Divestiture

A B S T R A C T

This paper investigates how managerial expertise—specifically, industry expertise—affects firm value through divestiture. Using CEOs' managerial experiences in industries throughout their careers as a measure of their industry expertise, I find that CEOs in diversified conglomerates are more likely to divest divisions in industries in which they have less experience. This finding is consistent with CEOs who divest such divisions in order to refocus on those divisions in which they have specialized—that is, to achieve a better match between their expertise and their firms' retained assets. Firms that divest for a better CEO-firm match experience significant improvements in operating performance, as well as significant abnormal stock returns that persist for an average of three years following a divestiture. Further, among firms that divest for a better match, those firms with more experienced CEOs realize greater gains in firm value. In contrast, divestitures that increase corporate focus, but do not improve the expertise-asset match, do not lead to long-run increases in firm value.

1. Introduction

Managers have contrasting styles. For example, when Contel Corporation announced its choice of John N. Lemasters as the firm's new CEO, the board commented that his "technical savvy sets him

* Fax: +65 68280427.
E-mail address: shenghuang@smu.edu.sg

http://dx.doi.org/10.1016/j.jfi.2014.04.003
1042-9573/

apart from other Contel executives, most of whom are accountants by training. He is a hip guy technologically . . . a man who can manage the final stage of transition." In contrast, James V. Napier, Contel's departing CEO and president, was described as having "exclusively financial" strengths.

Financial economists have recently started to evaluate the influence of manager-specific attributes on firm behavior (e.g., Bertrand and Schoar, 2003; Goel and Thakor, 2008, 2010; Graham et al., 2013; Malmendier and Tate, 2005, 2008, 2009).[1] While it is well acknowledged in corporate theories that managers differ in their management skills, few empirical studies have examined how managerial expertise may affect corporate decisions and firm value. One of the underlying empirical difficulties is that it is hard to measure managerial expertise. Moreover, there is often a lack of empirical identification that can clearly distinguish the effects of managerial expertise on firm value from other unobservable factors.[2]

I attempt here to circumvent these empirical difficulties by focusing on a measurable aspect of managerial expertise—industry expertise—and demonstrate how a CEO's industry expertise affects a conglomerate's divestiture decisions and firm value. My findings are based on hand-collected data about CEOs' industry exposure along their career paths, which is used to measure the extent of their industry expertise. While I do not suggest that the importance of a CEO's industry expertise always supersedes the effects of other CEO characteristics—such as age, education, and compensation—on a firm's decision making and performance, I argue that it is of particular relevance for a conglomerate's strategic reshuffling between industries.

My hypothesis is as follows. Conglomerates operate with multiple divisions and span various industries. As a result, some divisions may lie outside a CEO's domain of expertise. The literature (e.g., Gopalan et al., 2010) suggests that one of the CEO's key roles is to select the strategy that will determine the firm's exposure to sector performance—so a lack of expertise in the divisions involved will undermine the CEO's ability in that regard. As a result, the CEO may seek to divest these divisions if the firm decides to refocus. An examination of refocusing divestitures, therefore, provides the opportunity to study the impact of a CEO's industry expertise.

Of course, a CEO's industry specialization does not necessarily lead to divestitures. We expect firms to optimize in their selection of a CEO and to balance many factors; a CEO's industry expertise is just one. Furthermore, the literature has also suggested that CEOs may prefer to manage large and highly diversified firms due to greater compensation, being perceived as highly capable, or gaining higher visibility, so long as the firms' conditions and governance forces (both internal and external) do not necessitate downsizing or focusing (e.g., Shepard and Rose, 1997). Therefore, I do not suggest that a divestiture is more likely whenever divisions do not match a CEO's expertise or that a CEO who has expertise with certain divisions, but not others, is always more likely to divest than a CEO who is equally experienced (or inexperienced) in all divisions.[3]

Firms refocus for a variety of reasons—operational, financial, or strategic—and when they seek to refocus, but have a choice of divisions upon which to focus, divestitures are likely to involve those divisions in which the CEO has less experience. Divestitures of such divisions allow the firm to refocus on those assets that are better matched with its CEO's expertise, and this improved expertise-asset match leads to an increase in firm value (the *divest-for-better-match hypothesis*). Empirically, conditional on a firm's divestiture decision, I examine whether a CEO's industry expertise has any *incremental* power to explain whether a segment has been divested or retained above and beyond those well-documented factors.

The sample consists of 367 diversified firms that divested at least one business segment (mostly through asset sales) between 1981 and 2004 (a total of 423 divesting firm-years for which information about CEOs' industry expertise is available). In 137 of the divesting firm-years, CEOs have an average of more than six years of managerial experience in some of their firm's divisions (or related industries), but no experience in their firm's other divisions, prior to taking office as CEO (hereinafter

[1] See also Chemmanur and Paeglis (2005), Kaplan et al. (2012), and Malmendier et al. (2011) among others.

[2] This is likely why previous studies have focused on the effects of changes in management (e.g., Weisbach, 1995; Huson et al., 2004).

[3] In fact, as I will demonstrate later, empirical evidence shows that more divestitures are conducted by CEOs who are not specialized in any of the industries in which their firms operate, and also, that CEOs with industry specialization in one area do not necessarily divest all divisions in which they are not specialized.