

DIVIDE AND CONQUER: AN EXAMINATION OF EXPLANATIONS FOR THE DIVERSIFICATION DISCOUNT USING SUBSAMPLES

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ABSTRACT

The two main explanations of the diversification discount are likely related to each other. We attempt to separate these two explanations by studying sub-samples of all-equity and pseudo conglomerate multi-segment firms. The subsample of all-equity diversified firms allows us to focus on the inefficient internal capital markets hypothesis because the coinsurance effect is only relevant for levered firms. The subsample of pseudo conglomerates allows us to separate out the coinsurance effect because all divisions of pseudo conglomerates operate in the same finely defined industry and have the same investment opportunities. We find support for both explanations, but excess returns for multi-segment firms is better explained by inefficient internal capital markets than the coinsurance effect.

Keywords: *diversification discount; inefficient internal capital markets; coinsurance effect*

1. INTRODUCTION

Multi-segment firms are shown by many empirical studies to have lower value than the sum of the imputed values of the firm's segments. For example, Lang and Stulz (1994) show that multi-segment firms have lower Tobin's q than single-segment firms, while Berger and Ofek (1995), Servaes (1996), and Matsusaka and Wang (2015) report negative excess value for diversified firms. This negative excess value is often termed a diversification discount. The existence of a diversification discount is further supported by the findings of Comment and Jarrell (1995) and Daley, Lane, Vikas, and Ranjini (1997) who show firms who refocus exhibit increased firm value. Papers such as Berger and Ofek (1999) view the increased value of refocusing as indicative of managerial efforts to correct previous diversification mistakes. Many of the original and subsequent papers in the area try to determine the reasons behind the diversification discount with significant attention devoted to potentially inefficient internal capital markets and a coinsurance effect or transfer of value from stockholders to bondholders.

Research focused on inefficient internal capital markets can be traced to Berger and Ofek (1995) who indicate that the lower diversified firm excess value is partly due to the over funding segments whose growth opportunities are poor. Rajan, Servaes, and Zingales (2000), Scharfstein and Stein (2000), and Ozbas and Scharfstein (2010) argue that battles for influence and reward in diversified firms cause investment misallocation across divisions resulting in lowered excess value. Xuan (2009) indicates that CEOs use the capital allocation process to build stronger relationships with less connected divisional managers. Hyder and Khoshnoud (2023) suggest agency control issues make it more difficult for investors to understand managerial choices. Rajan, Servaes, and Zingales (2000) shows that diversified firms have less efficient investments and lower excess value due to investment opportunity diversity. Their model indicates that diverse investment opportunities across a firm's divisions cause suboptimal capital allocation. They show that larger distortions in the resource allocation process are induced by higher diversity of investment opportunities across divisions. The result is that value is decreased due to cross-subsidization of inefficient divisions due to bargaining and internal power struggles.

The coinsurance effect is another potential explanation for the diversification discount. The rationale is that the risk of multi-segment firms is lower than for focused firms since the cash flows for the different business segments are not perfectly correlated. Viewed in an option pricing framework as in Black and Scholes (1973), the equity position is a call option. Decreasing firm risk lowers the value of the call option causing a wealth transfer from shareholders to bondholders. An implication of this line of reasoning is that the