



# Re-examining Impact of Corporate Diversification: Solving Measurement Issue

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## Abstract:

*The Corporate Diversification has emerged as an important aspect of research. The aim of this research paper is to retrace the impact of Corporate Diversification on the firm's performance. The research paper is an attempt to explore the reasons for decision of Diversification by the firms. This paper is not only about possible association between firm performance and corporate diversification but it also identifies the benefit (if any) of the stakeholder/s from this strategy after taking account into the measurement issue.*

## 1. Introduction

Perhaps the research question that has drawn the most attention in industrial economics is the possible relationship between firm performance and its impact on diversification. There are many academic researchers, consultants, and investment bankers who believe that diversified firms destroy value.<sup>1</sup> The evidence in support of above conclusion can be found in research, most notable of which conclude that "Market return react positively if firms reduce corporate diversification;<sup>2</sup> Tobin's Q of undiversified firms observed significantly higher as compared to diversified firms;<sup>3</sup> Diversified firms trade at discounts of up to 15% as compared to undiversified firms;<sup>4</sup>

One thing is a fact which can't denied is that in today's competitive world, "all firms enter into the market as undiversified (stand-alone) except when a diversified firm establishes a subsidiary". That means all diversified firms began as stand-alone and then decided to diversify for better performance. Now the question is if there exists enough empirical evidence against diversification, then why firms are still going for diversification.

This implies that there may be some mistake in measuring the impact of diversification, something we missed which we are unable to capture. It is possible that (1) Diversified firm create value rather than destroying, but there are some issues<sup>5</sup> in measuring diversification itself so we are not able to capture the real relationship, or (2) The objective of the three main stakeholders of a firm (shareholders, managers & creditors) might differ such as: shareholders may want to invest (different business) only if risk adjusted return exceed risk adjusted return of their personal investment, Managers may prefer to diversify in the anticipation of reducing risk that affects value of their future compensation or for power and prestige, however, creditors may prefer diversification in the anticipation of reducing likelihood of illiquidity or insolvency. It might be possible that diversification creates value for one or more stakeholders and destroys for others. (3) It might be possible that highly diversified firms

<sup>1</sup>Ramanujam and Varadarajan (1989), Kaplan and Weisbach (1992), Montgomery (1994), and Berger and Ofek (1995).

<sup>2</sup>John and Ofek (1995), Daley et al. (1997), and Desai and Jain (1999).

<sup>3</sup>Wernerfelt and Montgomery (1988), Lang and Stulz (1994), Servaes (1996).

<sup>4</sup>Berger and Ofek (1995), Servaes and Lins (1999), Lamont and Polk (2002).

<sup>5</sup>Discuss later in this paper

perform better than undiversified firms, however, to reach the highly diversified stage they may have to go through a period of low and medium diversification where undiversified firm may perform better. (4) It might be possible that on an average, lower performing firms tends to diversify to improve their performance as compared to their past but are not able to surpass undiversified firms in the short run, which seems as if diversification destroys firm value as compared to undiversified firms.

## 2. Theoretical Foundation

This paper is exploring the possible association between firm performance and corporate diversification. It also tries to identify the stakeholder/s getting benefit (if any) from this strategy after taking account into the measurement issue.

Agency theory assumes that Shareholders/Owners/Principals (henceforth Shareholders) are risk neutral and Managers/Agents (henceforth Managers) are risk averse. Shareholders want managers to act in their interest, hence shareholders must monitor managers and incur monitoring cost or offer ownership to managers<sup>6</sup>. But when managers become owners (through stock option etc), they face high executive employment risk (Job loss, professional reputation, loss of compensation etc.). Now either original owners reduce this risk (through some agreement like golden handshake, golden umbrella, golden parachute) or managers may use their discretion and use resources for diversification and reduce risk<sup>7</sup>. Even managers without ownership have personal risk (Job loss, professional reputation, loss of compensation etc.) vested in company and they can take such decision which reduces their personal risk. Managers also like diversification strategy to increase their power, prestige, owners' dependency on managers (diversification in the area where managers have expertise) etc.

On the basis of the above arguments, we can say managers want to reduce risk to reduce their personal risk. Shareholders prime objective is to increase profitability of company as they can control the risk in the stock market. Now we can say that managers prime objective is to reduce risk (assuming managers first think of their benefit) and shareholders prime objective is to increase return (assuming they can manage risk in stock market).

Now with the help of decision matrix and risk return matrix we develop hypotheses.

We can develop a Managers Decision Matrix containing nine alternative decision-making situations:

1. Managers Decision's Matrix cell (1,1): In this situation, managers take decision which is good for both i.e., Shareholders and managers. Ideal outcome of this type of decision refers to cell (2,1) of risk return matrix which says increase in return and decrease in risk.

***Hypothesis 1: Higher return and lower risk related to subsequent increase in corporate diversification.***

(Corporate diversification is good for managers and shareholders)

2. Managers Decision's Matrix cell (1,2): In this situation managers take decision which is good for managers and no impact on shareholders. Ideal outcome of this type of decision refers to cell (2,3) of risk return matrix which says decrease in risk without changes return.

***Hypothesis 2: Lower risk and no change in return related to subsequent increase in corporate diversification.***

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<sup>6</sup>Jensen and Meckling (1976); Beatty and Zajac (1994); Tosi, Katz, and Gomez-Mejia (1997).

<sup>7</sup>Amihud and Lev (1981)

(Corporate diversification is good for managers as it goes with prime objective of managers i.e. lower risk, however it may be good for shareholders if they can't reduce risk from stock market cheaper than this)

3. Managers Decision's Matrix cell (1,3): In this situation we can say managers prefer self as they take decision which is good from the point of view of managers but bad from the point of view of shareholders. This is a situation where managers actually need monitoring. We can refer to cell (2,2) of risk return matrix which says decrease in risk at the cost of decrease in return.

**Hypothesis 3:** *Lower risk and lower return related to subsequent increase in corporate diversification.*

(Corporate diversification is good for managers as it goes with prime objective of manager's i.e., lower risk, however it is bad for shareholders as it reduces return also which is against the prime objective of shareholders)

4. Managers Decision's Matrix cell (2,1): In this situation, managers take decision which is good for shareholders and has no impact on managers. Ideal outcome of this type of decision refers to cell (3,1) of risk return matrix which says increase in return without changes risk.

**Hypothesis 4:** *Higher return and no change in risk related to subsequent increase in corporate diversification.*

(Corporate diversification is good for shareholders as it goes with the prime objective of shareholders i.e. higher return, however it may be good for managers also if their incentives are linked to return)

5. Managers Decision's Matrix cell (2,2): In this situation, managers take decision which may impact other stakeholders (like creditors) positively without being directly related to shareholders and managers. Ideal outcome of this type of decision refers to cell (3,3) of risk return matrix which says no direct impact on risk and return risk.

**Hypothesis 5:** *Lesser variation in cash without affecting risk and return related to subsequent increase in corporate diversification.*

(Corporate diversification may be good for other parties like creditors if lesser dip in cash as they wish so that no delay in the loan repayment.)

6. Managers Decision's Matrix cell (3,1): In this situation managers may take decision which is good for Shareholders and bad for managers (as against prime objective). Ideal outcome of this type of decision refers to cell (1,1) of risk return matrix which says increase in return and increase in risk.

**Hypothesis 6:** *High return and higher risk related to subsequent increase in corporate diversification.*

(Corporate diversification is good for shareholders as it goes with prime objective of shareholders i.e. higher return, however it may be good for managers also if their incentive/s link to return)

7. Managers Decision Matrix cell (2,3), (3,2) and (3,3): These are the situations where neither managers nor shareholders will be benefited hence managers should not take such decision. Ideal outcome of this type of decision refers to cell (1,2), (1,3) and (3,2) of risk return matrix which says either higher risk with low/no change in return or lower return with no change in risk.

**Hypothesis 7a:** *High risk and lower/no change in return related to subsequent increase in corporate diversification.*

**Hypothesis 7b:** *Lower return and no change in risk related to subsequent increase in corporate diversification.*

### 3. Managers Decision Matrix

		Shareholders		
		Good	Neutral	Bad
Managers	Good	Yes	Yes	Yes**
	Neutral	Yes	May be***	No
	Bad	No*	No	No

\* Ideally yes but normally managers don't.

\*\* Ideally no but managers can do this.

\*\*\* If other stakeholders can get benefit

The Managers decision matrix is a framework of decision taken by rational manager in general.

### 4. Risk Return Matrix

		Return		
		Increase	Decrease	NC
Risk	Increase	Shareholders*	-	-
	Decrease	Both	Managers	Managers
	NC	Shareholders	-	Others

\*if return increase more and risk increase less

The risk return matrix is a strategic outcome tool that provides an indication of prime benefited stakeholder/s with respect to change in risk and return in business.

### 5. Conclusion

Thus, the above discussion reinforces the opinion that the Corporate Diversification decision of the managers is undertaken for different reasons in different situations. It is cautiously taken by the manager keeping in mind the benefits of same for the managers and shareholders. Risk along-with related return being important factors measuring impact of the Diversification decision with proportion different in different situations.

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