Corporate Diversification of British and German Non-Financial Firms

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Empirical studies are yet to answer the basic question regarding why firms diversify and what affects this choice. The present study attempts to answer this question using data from British and German firms. The results show different effects of ownership concentration and financial variables on the decision to diversify. It is also observed that in the UK, diversification reduces firm performance, while in Germany, diversification improves firm performance.

Introduction

While the consolidated, but still controversial, scientific debate about the relationship between diversification strategies and corporate value is predominant in literature (Martin and Sayrak, 2003; and Villalonga, 2003), one of the related stream of inquiry concerns the understanding of why firms diversify. Previous studies relating firm value (often measured by Tobin's Q) to diversification found it to be value-destroying giving rise to the term diversification discount (Lang and Stulz, 1994; Berger and Ofek, 1995; and Denis *et al*., 1997 and 2002). Nevertheless, the diversification discounts have been shown to lessen, disappear, or become premiums in recent financial literature considering alternative indicators other than the excess value methodology (Singh *et al*., 2007; Jiraporn *et al*., 2008; Marinelli, 2008; and Tong, 2010). The foundation of the existent controversial results concerns the source of the discount (or premium) caused by diversification decisions, that has to be better understood by analyzing the motivation to diversify. A first theoretical perspective, based on the effect of risk reduction and private benefits explanations, considers diversification as a decision taken for opportunistic reasons (Jensen and Meckling, 1976; Amihud and Lev, 1981; Jensen, 1986; Shleifer and Vishny, 1989; and Stulz, 1990). This explanation is consistent with a negative effect of diversification on firm performance. Many authors (Lang and Stulz, 1994; Berger and Ofek, 1995; Comment and Jarrell, 1995; Servaes, 1996; Denis *et al*., 1997; and Aggarwal and Samwick, 2003) have shown that firm

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value decreases with diversification due to this motivation. A second perspective concerns the advantages of corporate diversification. The financial synergies perspective predicts that diversification provides financial viability to firm's investment, avoiding transaction costs as well as the costs of information asymmetry associated with external finance and, in general, avoiding problems of financial constraint (Stein, 1997; and Rajan *et al*., 2000). These are two main competing arguments in financial studies. Although both are based on managerial discretion, they consider diversification decisions differently: as an output of opportunistic behaviors and as a way to promote firms' efficiency respectively (Hyland and Diltz, 2002; and Doukas and Kan, 2008).[1]

The main objective of this paper is to provide an investigation of various issues related to the diversification decision using cross-sectional data at the company level for the UK and Germany. We first review the insights on the determinants of the diversification decision that can be obtained from the theoretical literature. We then document how different firms' characteristics are related to diversification choices by estimating a diversification equation and interpreting them in the light of the theoretical predictions. Finally, we examine the relation between diversification and performance to better understand the consequences of financial antecedents of diversification on performance. This paper contributes to the above debate, investigating these issues using a sample of British and German unlisted firms. The advantage of investigating these issues for the two selected countries is related to the differences in the legal and financial systems of these two countries. Various authors suggest that agency problems may be less severe in Germany (e.g., see Lins and Servaes, 1999). Lins and Servaes (1999), considering a sample of listed firms in Japan, UK and Germany, find a diversification discount for British and Japanese firms and insignificant results for German firms. These results suggest that institutional environment is relevant for examining corporate diversification.

The paper is organized as follows: It describes theories that seek to justify the diversification decisions, followed by a discussion on the data used in the study. Subsequently, the methodology and results are presented, and finally, the conclusion is offered with suggestions for future research.

Determinants of Diversification and the Diversification-Performance Relationship

Agency theory predicts that managers choose to diversify firms' activities based on risk reduction explanation. In this case, managers derive utility from reducing the idiosyncratic risk that they face. If managers have higher equity ownership in their firms, they face higher idiosyncratic risk from incentives and therefore diversify their firms more to lower that risk (Amihud and Lev, 1981; and May, 1995). In contrast, Denis *et al*. (1997) find a negative relation between the level of diversification and managerial equity ownership. They interpret this as: higher equity ownership, implying a greater fraction of the costs

[1] Research work explaining why firms diversify, in the management, financial and economic literature, has been synthesized by Montgomery (1994).

associated with value-reducing actions, outweighs the private benefits that managers derive by diversifying. Managers may pursue diversification to increase private benefits. According to the agency costs of free cash flow argument, discretionary power pushes toward diversification as a result of opportunistic behaviors and inefficiency in the firm. Jensen's (1986) managerial discretion hypothesis provides an explanation of problems of overinvestment due to free cash flow. With excess free cash flow, after valuable investments are carried out, managers have greater discretion to increase firm size through diversification (over-diversification) because it increases manager's compensation, power and control. Jensen (1986) concludes that managers of firms with abundant cash flow are more likely to undertake low-benefit or even value-destroying decisions in terms of diversification strategies, especially in industries distant from the core business. Harford (1999), considering firms that realize diversifying acquisitions, finds that cash-rich firms are more likely to make value-destroying acquisitions than firms that are not cash-rich.

The agency costs of free cash flow perspective (Jensen, 1986) pointed out the disciplining role of debt on managerial behavior, in that it reduces managerial discretion. Empire-building preferences will cause managers to spend available financial funds excessively on unprofitable investment projects. Debt exerts pressure in favor of efficient behaviors, because the manager of a highly levered firm will have less cash available for diversification. Moreover, debt acts as a disciplinary mechanism and firms with more debt are more likely to be monitored by their debt holders. It follows that monitored firms are less likely to diversify as a consequence of opportunistic behaviors. Thus, the Jensen perspective supports the positive role of debt in reducing the ability of a manager to realize detrimental diversification strategies.

According to the financial synergies hypothesis, corporate diversification is expected to result in efficiency gains arising from the development of an internal capital market. When the external capital market fails to allocate resources in an efficient manner, managers may attempt to create an internal capital market in order to solve problems of asymmetric information (Khanna and Palepu, 1997 and 2000; Stein, 1997; and Peyer and Shivdasani, 2001). Firms that are able to generate higher cash flow are also able to have easier access to credit, cheaper cost of capital and more available finance, especially with the diffusion of the rating culture. Firms with low financial performance (low cash flow), operating in an inefficient external capital market, try to realize an internal capital market that is able to combine the cash flows of many divisions through diversification. As a consequence, firms with higher capacity to generate cash flow are less interested in the benefits of an internal capital market through diversification. Therefore, a negative link between cash flow and diversification is assumed.

The internal capital market can provide benefits with the intent of maintaining control over firms' financial needs (Lewellen, 1971; and Kim and McConnell, 1977). An important benefit associated with the decision to diversify is the reduction in the firm's operating risk because of mutual financial support among the different business units (coinsurance effect). The use of debt requires the firm to make interest and principal payments according to a

schedule stipulated in the contract. As a consequence, the firm will prefer to become diversified because diversification makes it more comfortable in being able to face all the payment deadlines, essentially the reduction in operating risk which occurs when a firm runs businesses with cash flows which are less than perfectly correlated. Consistently with the coinsurance effect, a firm, especially if financially constrained, can increase its debt capacity by diversifying its business, thus reducing the magnitude of its financial constraint through this extra debt capacity. Low and Chen (2004) show that product diversification is positively related to leverage. However, Comment and Jarrell (1995) find little evidence that diversified firms use substantially more debt than focused firms.

Data

The empirical analysis offers a test of existing theories, primarily originating from the US experience, by providing a comparative picture of two major European economies. Our sample countries (UK and Germany) also represent two distinct legal and financial traditions. The sample includes non-financial firms that were unlisted during the year 2005. Data are obtained from AMADEUS, that is a product of Bureau van Dijk Electronic Publishing and provides standardized annual accounts for European firms.

Table 1 shows that 21% of the firms are diversified in the UK, while the mean diversified firms in Germany is 84%. Standard deviation is higher in the UK than in Germany.

We also report information on ownership concentration *OWN* (percentage of ownership), cash flow to asset ratio *CASHFLOW* (cash and equivalents on total assets), leverage *LEV* (total debt on total assets), tangibility *TANGIBILITY* (property, plant and equipment on total assets), and firm size *SIZE* (natural logarithm of total assets).

We include the variable *OWN* and OWN^2 to assess the role of agency theories. According to the risk reduction motive for diversification (Amihud and Lev, 1981), managers with higher equity ownership are expected to diversify in order to reduce their idiosyncratic risk. At the same time, managers diversify because they derive private benefits from managing a more diversified firm (Jensen, 1986).

CASHFLOW and *LEV* are two financial variables that differently support the agency costs of free cash flow argument and the internal capital market perspective. According to the agency costs of free cash flow argument, a positive effect of *CASHFLOW* and a negative effect of *LEV* on diversification decisions are expected. On the contrary, according to the internal capital market perspective, a negative effect of *CASHFLOW* and a positive effect of *DEBT* on diversification decisions are expected. *TANGIBILITY* and *SIZE* are included as additional control variables.

On an average, ownership concentration is higher in Germany (80%) than in the UK (51%). The leverage is also higher in Germany (0.35) than in the UK (0.13). A perusal of other variables in Table 1 also shows cross-country differences, implying substantial variations in the tradition and practices of corporate financial systems in the two countries.

Table 1: Descriptive Statistics				
Variables	**Mean**	**Median**	**Std. Dev.**	**No. of Observations**
Panel A: The UK				
D_DIV	0.210	0	0.407	742
OWN	51.482	50	32.342	742
LEV	0.130	0.069	0.167	742
CASHFLOW	0.082	0.034	0.110	742
TANGIBILITY	0.288	0.239	0.224	741
SIZE	9.184	9.077	0.813	742
Panel B: Germany				
D_DIV	0.840	1	0.365	2,723
OWN	80.142	100	25.239	2,723
LEV	0.351	0.292	0.270	2,723
CASHFLOW	0.091	0.038	0.131	2,723
TANGIBILITY	0.297	0.232	0.254	2,719
SIZE	9.172	9.103	0.903	2,723

Table 2 shows the correlation matrix of all the continuous variables analyzed. The results exhibit marginality of all correlation parameters, which does not bias the statistical significance of results obtained by using the sample.

Table 2: Correlation Matrix					
Variables	***OWN***	***CASHFLOW***	***LEV***	***TANGIBILITY***	***SIZE***
OWN	1	–	–	–	–
CASHFLOW	–0.016 (–0.334)	1	–	–	–
LEV	0.143 (0)	–0.118 (0)	1	–	–
TANGIBILITY	–0.040 (–0.016)	–0.227 (0)	0.080 (0)	1	
SIZE	0.045 (–0.007)	–0.103 (0)	–0.007 (–0.649)	0.327 (0)	1
Note: *p*-values are given in parentheses.					

Methodology and Results

To identify differences between diversified and focused firms, we examine firm specific-characteristics that predict whether a firm is diversified or focused, using probit models. As Campa and Kedia (2002) suggest, a dummy variable (*D_DIV*) is used that takes the value of 1, when the firm operates in more than one segment (diversified firm) and 0 otherwise (focused firm). The diversification activity is a function of *OWN*, OWN^2, *CASHFLOW*, *LEV*, *TANGIBILITY* and *SIZE*. We use a dummy variable (*UK_DUMMY*) that takes the value of 1 for UK firms and 0 for German firms. Furthermore, we include industry dummies, based on one-digit SIC codes, to correct for possible differences across industries.

In Model 1, we find a positive relation between *OWN* and *D_DIV* for low level of ownership concentration and a negative relation for high level of ownership concentration (Table 3). This result does not support the risk reduction and private benefits motives for diversification. We find a negative relation between *CASHFLOW* and *D_DIV*. This result is coherent with the financial synergies perspective. We also find a significant coefficient of

Table 3: Diversification Determinants: Probit Analysis

Variables	MODEL (1) (Full Sample) *D_DIV*	MODEL (2) (Only UK Sample) *D_DIV*	MODEL (3) (Only Germany Sample) *D_DIV*
OWN	0.0025* (0.001)	0.0016 (0.002)	0.0037* (0.002)
OWN^2	–0.0000* (0.000)	–0.0000 (0.000)	–0.0000* (0.000)
LEV	0.0477 (0.035)	–0.2189* (0.117)	0.0408* (0.021)
CASHFLOW	–0.1048* (0.060)	–0.0447 (0.134)	–0.0927* (0.056)
TANGIBILITY	–0.0637 (0.041)	–0.0312 (0.080)	–0.0427 (0.033)
SIZE	0.0152 (0.011)	0.0508** (0.020)	0.0031 (0.009)
UK_DUMMY	–0.6231*** (0.020)		
Industry Dummies (1-Digit SIC Code)	Yes	Yes	Yes
No. of Observations	3,460	741	2,719
Log Likelihood	–1,560	–371.3	–1,174
Pseudo-R^2	0.255	0.226	0.242

Note: *, ** and *** indicate that coefficients are significant at 10%, 5% and 1% levels, respectively. Clustered robust standard errors are given in parentheses.

the *UK_DUMMY* in the model that implies the presence of country-specific factors in determination of diversification decisions. To verify this possibility, we split the sample into two subsamples. Specifically, in Model 2, we examine the determinants of diversification for British firms, and in Model 3 for German firms. In Model 2, we do not find evidence of more diversification for firms with higher equity ownership as predicted by the risk reduction and private benefits motives for diversification. The sign of *LEV* is negative and significant coherent with the view that debt serves as a monitoring mechanism. *CASHFLOW* is insignificant. In Model 3, the negative sign of OWN^2 contradicts the risk reduction and private benefits motives for diversification. The positive sign of *LEV* and the negative sign of *CASHFLOW* are coherent with financial synergies perspective.

To sum up, the evidences from UK partially support the agency arguments of diversification decision, while evidences from Germany support the financial synergies perspective of diversification decision. These results suggest that diversification may be value-destroying in UK due to agency problems and value-enhancing in Germany due to financial synergies and increased debt capacity.

In Table 4, we present the results obtained on the relation between performance and diversification decision, using OLS technique.

Since we have considered only unlisted firms, we take into consideration an accounting-based measure of performance (Palich *et al*., 2000; Singh *et al*., 2007; and Jiraporn *et al*., 2008). More specifically, we measure operating performance (ROA) as the ratio of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) to total assets (Denis and Kruse, 2000). We include industry dummies based on one-digit SIC codes. The results of our analysis of the impact of diversification on performance, in Table 4, suggest that diversification affects performance significantly. In the first regression model where we have considered the full sample, the results indicate that diversified firms outperform focused firms. To identify differences between British and German firms, we divide the

Table 4: Performance and Diversification

Country	Constant	*D_DIV*	Industry Dummies (1-Digit SIC Code)	No. of Observations	$\overline{R}^2$
Full Sample	0.1412*** (0.014)	0.0211*** (0.004)	Yes	5,803	0.15
UK	0.1052*** (0.018)	–0.0088* (0.005)	Yes	3,013	0.09
Germany	0.1968*** (0.022)	0.0143* (0.009)	Yes	2,790	0.08

Note: * and *** indicate that coefficients are significant at 10% and 1% levels, respectively. Clustered robust standard errors are given in parentheses.

sample into two subsamples. The results suggest that diversification affects performance significantly and negatively in the case of UK, and significantly and positively in the case of Germany.

Conclusion

This paper examines empirically the effects of diversification on firm value and its determinants in UK and Germany. From a theoretical point of view, financial studies offer two competing theoretical perspectives providing motivations for diversification. The agency perspective and financial synergies perspective are the two competing arguments that, although based on managerial discretion, consider diversification decisions differently as an output of opportunistic behaviors and as a means to foster efficiency in firms respectively. Taking into account the institutional environment in which the firms operate, we find that different motivations to diversify can exist.

The results showed different effects of ownership concentration and financial variables on the decision to diversify for UK and Germany. In particular, we find that the variables *OWN* and OWN^2 are not significant in the UK probit regression. In contrast, we find significant coefficients for German firms that contradict the risk reduction and private benefits motives for diversification. Interestingly, *LEV* was found to have a negative impact on diversification probability for British firms coherent with the view that debt serves as a monitoring mechanism. Again, we find a positive impact of *LEV* and a negative impact of *CASHFLOW* on diversification decision for German firms. These results appear to be consistent with the financial synergies arguments.

The results of regression of performance on diversification suggests that in the UK diversification reduces firm performance, while in Germany diversification improves firm performance.

Overall, the results find significant country heterogeneity with respect to the effects of firm-level characteristics on the probability of diversification and also the effect of diversification on performance. The results are consistent with that of Lins and Servaes (1999), who found differences across countries and emphasized the importance of exploring institutional differences.

Although studies were interested in the general (net) effect of diversification on firm value (Do benefits overweigh the costs?), controversial results can be due to the fact that the roles of the theoretical arguments considered are not mutually exclusive. Both the theories can work concurrently. Therefore, future studies need to analyze subgroups of firms according to factors related to higher probability of opportunistic problems, or with regard to relevant financial constraint problems. This could be a direction to understand which factors allow more for opportunism in diversification decisions or for seeking financial benefits. By considering both the effects of these factors, as a direction for future research, a firm can work to optimize its diversification strategy and maximize its value.

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