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The determinants of firm diversification in UK quoted companies

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Abstract

This paper examines the role of resource-based and governance factors in determining the boundaries of UK quoted companies, measured by both the probability and intensity of market diversification. Using a panel of over 2000 firms for the period 1988 to 2001 it is found that firm-level heterogeneity and industry characteristics account for the variability in diversification behaviour and that resource-based and governance factors interact in a complex manner not necessarily fully explained by the theoretical literature. The results also indicate that the degree of data aggregation has significant implications for the empirical modelling of market diversification.

Notes

Time series analysis of firm diversification activity is sensitive to the level of aggregation. For example, Whittington et al. (1999) find for a sample of 84 UK public firms that the proportion who diversified had increased consistently between 1950 and 1993. In contrast, Haynes et al. (2000) show that for a sample of 121 large UK public firms that entropy measures of diversification intensity have fallen over the period 1985 to 1993 as a consequence of divestment in secondary industries.

Recent surveys that provide detailed and succinct summaries of the theoretical and empirical literature are Montgomery (1994), Whittingham and Mayer (2000, Chapter 3) and Lipczynski and Wilson (2001, Chapter 10).

As noted by Denis et al. (1999) the findings of these empirical studies do not necessarily support the risk-reduction aspects of agency theory because the private benefits from risk reduction brought about by greater firm diversification are likely to increase with the manager's equity stake since the manager's equity stake is likely to be negatively correlated with the level of diversification in his/her portfolio.

Diversification is likely to incur sunk costs (for example, marketing) which less efficient firms may not find worth paying.

As noted by Kochhar and Hitt (1998), debt financing is more typical than equity financing if diversification involves entry into unrelated activities, because the low-specificity of proprietary assets implies that potential lenders have less expected loss compared to related diversification that involves an increase in specific assets.