Corporate Diversification and Financial Policy Consequences: 
A Literature Survey

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Abstract: This review paper analyses the financial policy consequence of mergers and acquisitions. The investment and capital structure policies changes in the corporate set up, following mergers and acquisitions are analyzed from literature (empirical and conceptual) for the period 1971 to 2013. To make the task manageable, only the pivotal papers in the field, published by corporate finance journals in the relevant period were considered. The analysis of the literature showed that mergers and acquisition decisions do influence the investment and capital structure policies of organizations significantly. Hence, the need to synchronize these financial policy changes with mergers and acquisition decisions is appreciated.

Keywords: financial policy; merger and acquisition; internal capital markets; managerial bias

I. Introduction

Globalization coupled with factors such as exposure to global capital markets, understanding of international markets, cultural synergies, focus on quality, geographic diversification etc. have made India Inc. active in mergers & acquisitions. M&A targeting India totalled US$20.8 bn in 2013, of which inbound deals accounted for US$14.3 bn while outbound bids totalled US$7.7 bn. The Pharma, Medical & Biotech continued to be the dominant sector for M&A, followed by Construction, Consumer goods, Industrials & Chemicals, and Telecommunications etc. (India M&A Trend Report:2013, MERGER MARKET).

Firms analyse rigorously, the revenue and cost synergies that are likely to happen as a result of M & A before deciding on the deals. Yet, very few firms are found to be successful in experiencing these synergies. The reasons could be many such as selection of targets, poor estimation of synergy benefits, overpricing of the deal, etc. One such possible reason is incompatibility between corporate strategy and functional policies. Diversified firms need to follow financial policies that are complementing the corporate strategy and not contradicting it. Since corporate strategy provides the blueprint for success in the market, it is to be given topmost priority in any business concern. Gordon Donaldson (1985) pointed out in his paper that as a rule, market priorities were crucial to any corporate strategy and will tend to dominate the financial goals system in organizations. Failure to integrate financial policies with corporate strategy would result in managers ignoring to analyse the strategic consequences of their financial policies. In such organizations, financial policies become arbitrarily imposed corporate goals, become sacrosanct, which may even restrict the company’s potential value (Richard Ellsworth, 1983). Corporate strategic decisions need to be given priority over capital market imposed financial goals. This was insisted by Alfred Rappaport (2006). He recommended for organizations to make value maximizing strategic decisions even at the expense of lowering near term earnings. To do this, operating units which have sufficient value creation potential and require infusion of capital, should be identified and nurtured by the corporate headquarters. This may require suitable investment policies to regulate the internal capital markets within conglomerates. The reason why there exists a conflict between corporate strategy and financial policies can be attributed to the origin of the two. While the origin of the corporate strategy is the product market, the origin of the financial policies is the capital market. Corporate strategies have a long term focus, whereas capital market is moved by short term results. Richard A. Bettis (1983) clarified on the role of the two. While financial theory assumes normative wealth and utility maximizing framework, strategic management utilized a much broader framework encompassing multiple descriptive goals and non-maximizing behaviour of various forms. Hence, he suggested for research efforts to focus on problems that lie at the interface of the two disciplines.

Firms indulge in M & A to grow rapidly, to gain economies of scale, to increase market share, to spread the risk, to invest the idle capital, to obtain tax advantages, to gain better control over supply sources, to acquire technical knowledge and expertise etc. (H. Kent Baker, Thomas O. Miller and Brian J.Ramsperger, 1981) Further, to attain
financial self-sufficiency through internal capital markets, to stabilize corporate income, to reduce cost of capital are the other motives of M & A. These benefits are broadly classified into operating and financial synergies. Related diversification generates operating synergies for the merging firms whereas unrelated diversification provides financial synergies. Acquirers may select targets with different risk profiles, cash flows, and their products in different stages of the life cycle. A “resource fit” analysis is needed to understand which businesses are ‘cash hogs’ and which businesses are ‘cash cows’. The financial policies need to be tuned to the new corporate environment to ensure that the businesses add value to the firm ultimately. The type of diversification that a firm has adopted determines the kind of assets that the firm has to invest upon. For example, a horizontal merger aimed at increasing the capacity will require investment on technology and equipment that aid in increasing the production. The investment policy of a firm therefore has to consider this reality. Vikas Mehrotra (2005) showed that the tangibility of assets along with other factors such as operating profitability, variability of industry operating profits and tax status will alter the capital structure of spinoff units. An increasing number of M & A involves either the acquirer or the target having good growth opportunities. This shows the firms’ inherent intent to grow bigger. Big organizations are able to mobilize capital through capital market easily and at a reduced cost. Therefore, the firm will have to alter the capital structure policy after completing their M & A initiative. The aim of this review is to find out the financial policy consequences of mergers and acquisitions. This review focuses on two broad financial policy issues: Investment and Capital Structure Policies. The literature on mergers and acquisitions has focused on many aspects such as motivations for M & A, medium of exchange, integration issues, firm value consequences etc. We restricted our attention on papers that were relevant for studying financial policy impact. Specifically, we have not attempted to review the literature on business level strategies and financial policies other than investment and capital structure. The reasons how diversified firms destroy value can be many such as failure to experience the potential synergies, poor integration etc. There is substantive body of research evidence to show that investment policies followed by conglomerates are faulty. The internal capital markets operating within the conglomerates are not found to allocate capital to various business segments judiciously. Managers in conglomerates are found to make investment decisions which are self-serving. Many moves to prevent such behaviour on the part of the managers have not been very successful. There is also research evidence to show that investment behaviour of conglomerates improve significantly when they become more focused. Tobin’s q, a measure used by researchers to study the investment opportunities of firms effectively show the investment lapses of diversified conglomerates. Also, the excess cash possessed by conglomerates is used to make value destroying mergers and acquisitions and ultimately increases the agency conflicts in organizations. Diversification is found to affect the capital structure of firms significantly. Firms experience change in cash and debt capacity after the mergers and acquisitions. These changes are found to affect the capital structure of the conglomerates. Capital structure also changes when firms become bigger after the mergers and acquisitions. Firms are motivated for mergers and acquisitions since risk reduction is possible by bringing down the earnings volatility of conglomerate firms. Reductions in earnings volatility may push the firms towards higher financial leverage. Firms indulge in mergers and acquisitions as a way to grow bigger. Acquirers are found to buy growing targets. Research evidence shows that firms with good growth opportunities may not use stock to finance acquisitions. Therefore there is a need for organizations to review their financial policies relating to investment and capital structure after mergers & acquisitions.

This paper is organized as follows: Section II discusses the methodology, section III provides a synthesis of investment policies of conglomerate firms and section IV a synthesis of capital structure changes post mergers and acquisitions, followed by conclusion in section V.

Objectives of the study
The core objectives of the study are:

i. To find out the financial policy consequences of mergers and acquisitions at the firm level,

ii. To examine various finance theories and how they relate to mergers and acquisitions and ultimately determine the financial policies of firms,

iii. To understand how the financial policies of organizations post M & A have influenced the success or failure of merged companies.

II. Methodology
To understand the above, the reviewers focused on examining existing financial theories and hypotheses and suggest how the financial polices of organizations undergo changes following mergers and acquisitions. The researchers were determined to find out how wrong choices on financial policies would be detrimental for the welfare of the organizations. With the aforesaid objectives, papers on mergers and acquisitions which shape the financial policies of organizations were selected from leading finance journals such as Journal of Finance, Journal of Financial Economics, Journal of Corporate Finance, American Economic Review, Academy of Management Review, Journal of Applied Corporate Finance, Journal of Financial & Quantitative Analysis, Harvard Business Review, Strategic Management Journal, Journal of Business & Finance, and Journal of Business etc. The papers were selected from...
1971 to 2013. The selection included both conceptual and empirical papers. The reviewers were careful in selecting papers which supported a viewpoint and also the papers which do not. Therefore, only those papers which are considered central in the field of mergers and acquisitions were selected. The references sections of the reviewed articles were used to identify major contributions in the area. The process was repeated until a point of saturation was reached. Hence, the reviewers were convinced that sufficient evidence was obtained for this review. The selected papers were reviewed carefully and integrated so as to generalize the conclusions. The discussion is organized conceptually by integrating groups of papers. The outcome of the review offers some financial policy choices following mergers and acquisitions to the conglomerate firms.

III. Diversification and Investment Policies
There is research evidence to show that diversified firms destroy value. The market also shows positive reactions to firms which focus on their core businesses. But the major question is what causes the poor performance of multidivisional firms? The answer could be inefficient allocation of internally generated funds, or poor allocation because of agency problems (John D. Martin and Akin Sayrak, 2003). Hence, a comprehensive examination of investment practices and policies of conglomerates is essential to identify the deficiencies, if any.
To understand the investment policies of diversified firms, it is essential to understand the workings of internal capital markets within conglomerates. Internal capital markets within conglomerates operate to allocate capital into the most productive uses among the competing divisions/projects. The internal capital markets differ from external capital markets due to differences in information, incentives, asset specificity, control rights or transaction cost. (Lamont, 1997)

Robert Gertner, David Scharfstein, and Jeremy Stein (1994) identified three important consequences of internal capital providers. They are increased monitoring incentives, decreased entrepreneurial incentives and better asset re-deplorability.

A. Internal Capital Markets
Whether the working of internal capital markets ensure that appropriate allocation of capital is done or not? In other words, what determines the efficiency of internal capital markets? Hyun-Han Shin and Rene M. Stulz (1998) defined an efficient internal capital market when it gives priority in the allocation of funds to the segment with the best investment opportunities, that segment’s investment less sensitive to its own cash flow, and its allocation of funds to a segment falls when other segments have better investment opportunities. Based on the above definition for efficient internal capital markets, empirical studies have supported the view that internal capital markets are efficient. For example, John A Doukas and Ozgur B Kan (2008) suggested that diversifying bidders tend to allocate financial resources from less profitable business segments to more profitable business segments. Hence, they concluded that diversification increases do not result in inefficient capital allocation. By shifting funds from one project to another, headquarters can create value to the organization, despite the credit constraints. Thus corporate headquarters engage in “winner-picking” (Jeremy C. Stein, 1997). Easing the financial constraints facing the firms is another motive for M & A.

Isil Erel et.al (2013) found answer for the question whether acquisitions relieve target firm’s financial constraints. On a sample of 5187 European acquisitions occurred between 2001 and 2008, the authors tested the financial policies of the targets, before and after the acquisitions. They found that the level of cash target firms hold, the sensitivity of cash to cash flow, and the sensitivity of investment to cash flow, all declined significantly, while investment significantly increased following the acquisition, thus supporting the view that internal capital markets are efficient. One major criticism on internal capital markets is that firms engage in a kind of “socialism” in allocating capital to different divisions/segments within the organization. That is, firms overinvest in and subsidize underperforming segments, which results in value destruction. (Hyun – Han Shin and Rene M.Stulz,1998, Owen Lamont,1997, Raghu Ram Rajan, Henry Servaes, and Leigui Zingales, 2000, David S. Scharfstein, 1998). Antonio Bernardo et.al (2005) argued in their paper that when division managers have private information about project quality and can enhance cash flows, will tilt the capital budget in favour of divisions with relatively poor investment opportunities. While such an action increases the competition for internal funds, but reduces the incentive for the managers of the strong divisions to shirk on effort by setting low targets. They further added that this socialistic behaviour is more severe when there is greater diversity in the quality of investment opportunities across divisions. Thus the above evidences suggest that internal capital markets do possess certain deficiencies in allocating funds among various divisions/projects.

B. Managerial Bias
Managerial behaviour is found to affect the working of internal capital markets and distort the investment decisions of firms. David S. Scharfstein (2000) showed how rent seeking behaviour on the part of division managers of multi-segment firms can subvert the workings of an internal capital market. By rent seeking, division managers can raise their bargaining power and extract greater overall compensation by way of preferential capital budget allocation. Managers may also engage in “entrenchment behaviour” by making specific investments to increase their value to shareholders. By making such investments, managers can reduce the probability of being replaced; extract higher
wages, and larger perquisites from shareholders. This “entrenchment” may be the motivation behind diversification strategies (Andrei Shleifer and Robert W. Vishny, 1989). Another managerial motive i.e. managers’ concern for building their reputation may distort firms’ investment policies in favour of relatively safe projects thus creating agency problems in organizations (David Hirchleifer and Anjan V. Thokor, 1992). George P. Baker et.al (1988) documented the relationship between CEO pay and firm size. They claimed that executive compensation has an elasticity of compensation with respect to firm sales of about 3 percent. This suggests that CEOs can increase their pay by increasing firm size, even when the increase in size reduces the firm’s market value. The authors further added that this could be the reason for vast amount of inefficient expenditures of corporate resources on diversification programs that have created large conglomerates. The “hubris hypothesis” propounded by Richard Roll (1986), states that executives of the acquiring firm are less competent than they think they are. These executives of acquiring firms pay too much for their target on average, which results in value reduction for the bidders. Sometimes, bad acquisitions are driven by managerial objectives. Managerial objectives such as buying growth or diversifying into unrelated businesses reduce the returns of firms. Poor performance may drive managers to buy something new which may turn out to be faulty (Randall Morch et.al, 1990). Many studies have found that investment behaviour of conglomerates improve significantly after initiatives such as spinoff. These studies used Tobin’s q as a measure to understand investment sensitivity of firms. For example Robert Gertner, Eric Powers and David Scharfstein (2002) found that firms’ investment after the spinoff was significantly more sensitive than it was before the spinoff. Spinoffs tend to cut investment in low q industries and increase investment in high q industries. These changes are observed primarily in spinoffs of firms unrelated to the parent’s industries and in spinoffs where the stock market reacts favourably to the spinoff announcement. Seoungpil Ahn and David J. Denis (2004) showed empirically that post spinoff, there is significant increase in measures of investment efficiency and the diversification discount is eliminated. Dittmar and Anil Shivdasani (2003) found that the efficiency of segment investment increased substantially following the divestiture and the improvement is associated with a decrease in diversification discount. They claimed that the results support the corporate focus hypothesis. Corporate focus hypothesis states that divestitures that increase focus lead to large improvement in investment policy. Shen - Syan Chen (2006) examined the role of “focus” versus diversification in explaining the economic impact of corporate capital investments. He found that the stock market’s responses to announcements of capital investment were more favourable for focused firms than for diversified firms. He also showed that focused firms exhibited significantly better post-investment operating performance than diversified firms. Thus we find conflicting evidences about the efficiency of diversification and separation, also about the efficiency of internal capital market.

IV. Conclusion

This review paper analysed the financial policy consequences of mergers and acquisition decisions. The analysis of empirical and conceptual papers on M & A for a period of 1971 to 2013 showed that M & A do influence the investment policies of organizations in significant ways. The investment decisions through internal capital market are found to have both positive and negative effects; hence it is necessary for organizations to have suitable investment policies following M & A.

References

