EXECUTIVE SUMMARY

Background
The conglomerates are regarded as ‘dinosaurs’ in the developed countries. The stock investors in the advanced nations prefer focused companies over the conglomerates because the latter trade at 6 to 12 percent discount in such markets. On the contrary, the diversified organizations are a predominant feature in the emerging economies, including India. The remarkable contribution of the diversified business houses to the country’s GNP has stimulated academic research interest in the domain of corporate diversification. The valuation effect of the corporate diversification has long been a part of strategy and finance research literature in the developed nations, whereas the diversified business groups have been subject to relatively recent investigation in the emerging economies. Furthermore, the empirical literature on the impact of diversification on company’s cost of capital is more or less absent in emerging economies, hence necessitating research in this domain.

The primary focus of the study is to evaluate corporate diversification from the cost and value perspectives in the Indian context. For this purpose, all the companies listed on the Bombay Stock Exchange have been put to empirical analysis over a period of 16 financial years, i.e., from the FY 1998-99 to FY 2013-14. In specific, the objectives of the study are:

1. To examine the relationship between diversification and company’s cost of capital.
2. To examine the relationship between diversification and corporate value.
3. To examine the relationship between diversification strategy (related or unrelated) and corporate value.
4. To explore the potential sources of value gains or losses from corporate diversification.

For the purpose of conducting analysis, the final sample drawn (after applying sample selection conditions and deleting companies with missing data observations) from the population of BSE listed companies has been broadly classified into unaffiliated standalone companies and diversified business groups (related and unrelated).
Theoretical Framework

Diversification is the dominant growth option for enterprises in both advanced and emerging economies. The concept of diversification can be defined as the process of adding new businesses to the company, whether related or unrelated, that are distinct from its established operations. The emphasis in unrelated diversification lies upon the financial considerations or risk reduction, as opposed to the product-market synergy in related diversification. A diversified organization can be structured in various ways. Diversified enterprises in the developed economies typically assume a multidivisional organization structure, whereas, the business group model is predominantly found in the emerging economies, such as India.

Cost of capital is the cost of procuring long-term funds for the purpose of financing the firm’s fixed assets. The corporations raise finance from both lenders and equity investors in order to fund their investment projects. The cost of equity capital can be computed by employing either of the two approaches, namely, the dividend valuation model and the Capital Asset Pricing Model (CAPM). The CAPM is practically the most frequently used technique for estimating the cost of equity capital. The overall cost of capital – referred to as WACC – is determined as the weighted average of the cost of each specific source of finance. While calculating the cost of capital for diversified organizations, the cost of individual capital components is estimated for each of the businesses to determine their respective WACC.

Corporate valuation refers to the task of estimating the value or worth of a business. The basic and the most popular approach to determine the corporate value is the Discounted Cash Flow (DCF) approach. In practice, the corporate value is determined as the sum total of market value of equity and book value of (long-term) debt. The fundamental criterion for evaluating corporate diversification decisions is to examine the value added by such diversification activity to the corporate whole. The separate valuations of the independent business units, as opposed to overall company valuation, provides deeper understanding into the key value drivers. Fundamentally, there is no difference between valuing a single-business company and valuing a diversified company. However, valuation of diversified organization is complex in the sense that each business unit has its own stream of cash flows, capital structure, and cost of capital.
The ‘institutional perspective’ and ‘resource-based perspective’ provide a coherent theoretical rationale to explain the value (or performance) implications of business group diversification in emerging economies, such as India. According to the institutional perspective, the presence of the weak market institutions inhibit the firm’s growth through market relationships, whereas simultaneously provides opportunities to create value through network-based growth strategies. The idea underlying the institutional perspective is that the lack or inefficiency of supportive market mechanisms and ineffectual legal framework, especially in the emerging markets, justifies the formation of a diversified organization in order to internalize the functions typically provided by the external market institutions in the advanced economies. The resource-based perspective provides theoretical underpinnings of the relationship between diversification strategies, i.e., related and unrelated and the firm performance. The resource-based view suggests that the unutilized or excess resources possessed by the firm offer potential to exploit scale and scope benefits by diversifying into related and unrelated industries, respectively. According to this perspective, the firms in the developed economies can obtain sustainable competitive advantage by concentrating their resources across limited number of related industries. Whereas, the diversification in the emerging economies can provide sustained competitive advantage if it is based on generic resources rather than specific resources, hence creating incentives for the firms to diversify into unrelated avenues.

**Review of Literature and Hypotheses Development**

Numerous studies in the past suggested that the systematic risk differs among firms with different types of diversification strategies, with majority of them reporting lower levels of systematic risk for diversified firms, particularly for related diversified firms. However, there is minimal evidence with regards to the effect of corporate diversification on cost of capital, which suggests that the diversified firms have lower cost of capital than the comparable portfolios of stand-alone firms. Borrowing from the limited evidence, the hypothesis, $H_1$: *Cost of capital of diversified business groups is lower than the cost of capital of unaffiliated standalone companies*, in the alternate form has been tested.
Although there is substantial empirical literature in the fields of corporate finance and strategic management that studies the relationship between diversification and corporate value in the developed economies, but little research efforts have been undertaken in this direction in India. Numerous U.S. based studies rendered strong empirical evidence to conclude that diversified firms trade at a significant discount compared to standalone firms. On the contrary, the studies pertaining to emerging or less-developed economies including India provide conclusive evidence in favor of corporate diversification and that the diversified companies or groups have high relative corporate valuations. Drawing on past empirical evidence with respect to emerging economies in general and Indian market in particular, the hypothesis, \( H_2: \) Diversified business groups have significantly higher corporate value than unaffiliated standalone companies, in alternate form has been tested. The literature examining the relationship between diversification strategy and corporate value is complex and inconclusive. The diverse results from studies across the globe made it difficult to establish the superiority of one diversification strategy over another. On the basis of the existing empirical evidence, the hypothesis, \( H_3: \) There is a significant difference in the corporate values of related and unrelated diversified business groups, in alternate form has been tested.

The literature identified overinvestment, cross-subsidization of failing segments, inability of diversified firms to efficiently exploit the financial economies of scope, etc. as the primary sources of value losses from diversification in developed economies. A large number of studies anchored in advanced economies have also ascribed the presence of diversification discount to numerous other factors, such as endogenous diversifying behaviour of firms, poor performance of diversifying firms, selection biases, high leverage, and measurement error, rather than to diversification activity. On the contrary, corporate diversification is expected to be a valuable growth strategy in emerging economies. Such value gains may arise from numerous sources, such as tax benefits, high market power, large sizes and diversity of business groups, privileged access to foreign capital and technology, monitoring by concentrated owners, inexpensive access to internal factor markets. A large number of Indian studies presented justifications in favour of ‘institutional perspective’ for the higher valuations of diversified business groups in India.
Research Design

From the research design perspective, the present study is related to the research work on corporate diversification done by Berger and Ofek (1995) and Hann et al. (2013). The important variables for studying the association of diversification with corporate value and cost of capital are diversification, excess value, and excess cost of capital. In addition to this, the impact of relatedness in business operations of diversified group companies on value was captured through the variables such as the number of group companies and related segments. However, the impact of certain company specific characteristics, namely, size, profitability, growth opportunities, book-to-market, and leverage needs to be controlled to get a realistic view. Following the past literature, two measures of diversification were used depending upon the objective to be achieved. Asset-based Herfindahl Index and diversification dummy have been used as measures of diversification for the purposes of Objective 1 and 2, respectively. Following the ‘Industry Multiplier Approach’ pioneered by Berger and Ofek (1995), the excess cost of capital (or value) has been computed as the natural logarithm of the ratio of the company’s actual cost of capital (or value) to its imputed cost of capital (or value).

The required data was primarily collected from the Prowess database, and the collected data was analyzed using two statistical softwares, viz., Stata and IBM SPSS Statistics. The descriptive statistics for the study variables, along with the univariate analysis of mean and median differences in excess cost of capital and excess value across group and non-group categories was attempted in order to provide with initial evidence on the effect of diversification on cost of capital and corporate value. Panel data regressions with random-effects model have been used to analyze the relationships hypothesized in the study. Prior to multivariate regression analysis, regression diagnostics were performed in order to test the presence or absence of normality, homoscedasticity, multicollinearity, and autocorrelation. In order to deal with the issue of non-normality and heteroscedasticity, robust regressions were employed.

Relationship between Diversification and Company’s Cost of Capital

In order to study the association between diversification and company’s cost of capital, the present study adopted descriptive, univariate, as well as multivariate
techniques. The descriptive statistics highlighted that the diversified groups have larger sizes, higher leverage levels, lower book-to-market ratios, and higher excess cost of capital relative to unaffiliated standalone companies.

As a prelude to the main analysis, the beta differences between diversifiers and non-diversifiers were examined. Contrary to the propositions of modern portfolio theory, the findings revealed higher betas of diversified groups (both related and unrelated) over unaffiliated standalone companies. The panel regressions of excess cost of capital on asset-based Herfindahl Index with firm-specific controls revealed a negative relationship between diversification and cost of capital. Contrary to the established evidence, the results revealed a significantly higher cost of capital for diversified groups over unaffiliated standalone companies. It was further observed that the unrelated diversifiers possessed highest excess cost of capital, followed by related diversifiers and unaffiliated standalone companies. The findings were found to be robust to alternative diversification measures. Such findings, although failed to extend support to the hypothesis formulated, were possibly due to the high leverage levels and consequently high betas observed for diversified Indian business groups in relation to unaffiliated standalone companies.

**Relationship between Diversification and Corporate Value**

With a major focus on examining the effect of diversification on corporate value in the Indian setting, the present study assessed the excess value differences between diversified groups and unaffiliated standalone companies. The descriptive information highlighted larger sizes, lower growth opportunities, and higher profitability for diversified groups over unaffiliated standalone companies. Besides this, considerably higher mean and median excess values of diversified groups over unaffiliated standalone companies, along with the significantly positive differences in mean and median excess values between diversified groups and unaffiliated standalone companies portrayed value gains from diversification. The panel data regressions of excess value on diversification dummy with firm-specific controls affirmed 14 to 18 percent value gain from diversification. Rendering support to the hypothesis formulated, the findings were found to be in line with the evidence from the previous literature with regards to the emerging economies in general and Indian market in particular. The market imperfections and weak regulation ingrained in the framework
of emerging economies, privileged access of diversified business groups to foreign investment and their inexpensive access to factor markets, and political connections and high market power of Indian business groups were identified as the most important sources of value gains arising from diversification.

Further, an extensive analysis of the impact of diversification strategy on corporate value was conducted. An initial observation of the descriptive statistics brought forth higher excess values of unrelated diversified groups relative to related diversified groups, highlighting the superiority of unrelated diversification strategy in the Indian context. The results (although insignificant) from panel data regression of excess value on related segments and number of group companies with firm-specific controls reported higher corporate values for unrelated diversified groups. The re-estimated regressions by taking an alternative measure of diversification strategy, i.e., dummy for diversification strategy confirmed that the unrelated diversified groups have significantly higher corporate value relative to related diversified groups. Extending support to the hypothesis formulated, the findings can be attributed to the high market power and profitability enjoyed by unrelated diversifiers.

**Implications, Suggestions, and Directions for Future Research**

The research findings have long-term implications for the conceptual knowledge base. In the wake of increasing number and importance of diversified business groups in emerging economies, particularly India, the findings will be helpful for theorists and academicians in building a comprehensive theory of corporate diversification and business groups. With the multidisciplinary impact, the research holds practical relevance for the set of corporate managers, investors, and public policy makers. The research findings have implications for the corporate managers in selecting an appropriate corporate strategy for growth that can be profitably practiced in the prevailing institutional setting. Similarly, the investors of stock and businesses can take their investment decisions by assessing the efficacy of corporate diversification in the light of current study findings. Further, the present study findings hold significant importance to the practitioners and policy makers in defining the future of diversified business groups in India.

The present research is paramount in providing valuable suggestions to the corporate management, investors, academicians, and financial analysts. First, drawing
upon the ‘institution-based view of strategy’, the conclusions derived for one country during a particular period may not apply to another country or period. Thus, the results of the present study may not hold for the corporate landscape in other countries. Second, the findings from the studies examining the relationship between diversification and value require justification in the light of sources of value gains (or losses) from diversification in order to enable their rational interpretation. Third, the findings present suggestions for the practicing strategic managers to reorient their growth strategies with changing institutional arrangements.

In order to establish the generalizability of the current study findings, the research needs to be conducted in other emerging economies. Future research would be constructive to strengthen the results obtained by altering the measurements of diversification, cost of capital, and corporate value. An exploration of the institutional differences between developed and emerging economies that influence the appropriateness of diversification as a growth strategy for firms is also worthy of research. Lastly, an industry-wise analysis of the relationship between diversification and value or cost of capital can also be conducted to assess any intra-industry and inter-industry variations in the impact which are not considered when studies are conducted at an aggregate level. On the whole, owing to the ongoing progressive changes in the market institutions and business organizations, the examination of the appropriateness of diversification as a growth strategy of firms and its resultant effects on the corporate accounting and market financials will remain an open empirical research issue.