Universität Zürich
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Influence of Corporate Diversification on the Value of Swiss Companies

(Einfluss der Corporate Diversification auf den Unternehmenswert von Schweizer Unternehmen)

Bachelor Essay

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Executive Summary

I Problem definition

Almost all the economic models handle the companies as homogeneous producers of single goods. The firm must, according to these theories, operate just in one core business in order to efficiently utilize all the resources because of the high know-how in this production field. This because it is easier and more efficient for an investor to diversify away his portfolio risk by buying many unrelated assets. This is the theory of CAPM. The question is now? Why do the biggest and most important companies all around the world diversify their operating businesses without following the economic theories?
The research of Villalonga (2004) will be in this work replicated in order to understand whether the Swiss companies trade with a diversification premium or a discount, in other words if it's optimal or not for a firm relating to the performance to attempt a diversification strategy. The topic of corporate diversification has already been in detail researched and the results are not unambiguous.
The researchers are divided: on the one hand found Rhoades (1974), Utton (1977), Montgomery (1985), Palepu (1985) and others that the firms following a diversification strategy perform worse or at same level than firm which focalize the resources on the core business and therefore operate in just one business segment.
On the other hand found Rumelt (1982) that between all the diversification strategies (he classifies firms into 7 diversification categories ranging from single business to unrelated diversifier) the related constrained diversifier, that is diversification built around core skills, capabilities and resources, perform on average better than single business or high diversified firms. Villalonga (2004) found in his study that, if the diversification is measured with the new establishment-level database called BITS, the diversified firms trade at a large and statistically significant premium relative to the single business firm. Oppositely if diversification is constructed with Compustat data (with SIC-codes, used by all other previous studies), which are less objective and fine-grained data, the premium turns into a discount.

This last study of Villalonga (2004) seems to make clear that corporate diversification is a good thing that improves the performance of the companies. However these findings are just for the American industry and give no information for other markets and economies.

The goal of this work is to research whether the Swiss companies also trade to a diversification premium such as the American firms and which diversification strategy gives the highest performance.

II Research

The study focuses on the Swiss firms that are quoted on the SIX Swiss Exchange, the 31st. December 2009. The first part of this work illustrates the theoretical basis of corporate diversification listing the most important authors and theories, such as Ansoff (1958), Gort (1962), Rumelt (1974), Pitts and Hopkins (1982). The differences between the theories and the fact that there is any general accepted definition of corporate diversification will be accentuate.

The following section discuss the three motives that lead a company manager to follow a diversification strategy instead to stay on the single business way. These diversification explanations are for Montgomery (1994) the market power motive, the agency motive and the resource motive. After the concept of corporate diversification is explained and the motive that lead to this management decision are illustrated, the last section of the theoretical part of the work expound the effective methods a company dispose to enlarge his businesses. The concepts of organic and inorganic growth are explained focusing on the merger and acquisition activity and history especially for Swiss companies in order to understand the different motive for each merger wave of the last decades.

In the second part of the work will be empirically defined what are the best diversification strategy analyzing 100 Swiss companies. The sample is built choosing random 100 firms of the SIX Swiss Exchange. The firms operate in the industrial sector, therefore there is no financial institution such as banks or assurance companies according to Rumelt (1974). Each analyzed company is assigned to one of the seven diversification categories according to Rumelt (1982) and its Tobin's Q (Capital market value of the firm divided by the replacement

value of its assets) is calculated. The average Swiss market Tobin's Q is calculated in two different ways, namely an arithmetic average of all companies q's and a market weighted average. These two market q's are used to calculate the excess value for each diversification category in order to find out what is the best performing strategy.
The third and last section of the work is a discussion of the obtained results.

III Results

The results show that the companies are not homogeneous distributed into the seven diversification categories. The detailed distribution is the following: Single Business 22, Related Constrained 32, Related Linked 25, Dominant Constrained 12, Dominant Linked-Unrelated 3, Dominant Vertical 3, Unrelated Business 3.
This diversification strategy distribution say that the firms tent to follow the two big schools of thought described above. Namely 22 decided to operate in just one core business according to Montgomery (1985) and the big part of them follows a related diversification strategy according to Rumelt (1974).
The values for the categories' excess values are following: Single Business 0.4596 (0.0417), Related Constrained 0.0617 (-0.3561), Related Linked -0.4895 (-0.9074), Dominant Constrained 0.0739 (-0.3440), Dominant Linked-Unrelated 0.0131 (-0.4047), Dominant Vertical -0.7310 (-1.1489), Unrelated Business 0.4732 (0.0553). The excess value calculation with market weighted average q's are in parentheses.
The last three categories contain an insufficient number of firms. Therefore the results are not statistically robust. The results support the early theories about diversification, namely that the single business firm perform better than diversified ones, namely the excess values for this category is in both cases higher and statistically robust. Between the "losers" both constrained categories (Related Constrained and Dominant Constrained) perform better than the other diversification strategies, because of the diversification built around a core organizational capability (Rumelt, 1974). The Tobin's q has been calculated as market capitalization (number of shares times the course) divided by the book value of the assets. In year 2009 the subprime crisis was still present and this

reflected on the share courses that were almost at the lowest value since the beginning of the crisis. Thus the single business companies are more resistant to adverse market periods than diversified ones.