

CORPORATE GOVERNANCE AND DIVERSIFICATION IN A SCENARIO OF WEAK SHAREHOLDER PROTECTION¹.

Elida Maia Ramires, eli.lmr@usal.es, Universidad de Salamanca.

Alberto De Miguel, amiguel@usal.es, Universidad de Salamanca.

Esther B. Del Brio, ebrio@usal.es, Universidad de Salamanca.

Resumen: El presente trabajo analiza la influencia de los mecanismos de gobierno de la empresa, expresamente la concentración de propiedad y la propiedad directiva, en el proceso de elección de estrategia corporativas basadas en la diversificación. Elegimos para ello un entorno, como es el español, caracterizado por una baja protección legal del accionista. Nuestros resultados arrojan evidencia de una relación cuadrática entre la concentración de propiedad y la diversificación y cúbica entre la diversificación y la participación directiva en el capital. Adicionalmente detectamos que mecanismos de control como la deuda, el cumplimiento de las recomendaciones contenidas en los códigos de buen gobierno o la remuneración directiva afectan negativamente a la diversificación, si bien con distinto nivel de significación.

Abstract: We examine the influence of governance mechanisms, namely ownership structure and insider ownership, on the selection of corporate strategies of diversification in a scenario characterized by poor protection of shareholders' interests. We find evidence of a quadratic relationship between ownership concentration and diversification and a cubic relationship between diversification and insider ownership. Additionally, our results show that control mechanisms such as debt, directors' remuneration and the compliance with codes of good practices are negatively related to the level of diversification.

Key Words: Diversification, Corporate governance, Ownership Structure, Panel Data.

JEL: G30, C23, C33

¹ Financial support was obtained from the DGI (Project SEJ2007-65789) and the Junta de Castilla y Leon (Project SA079A05). The authors also thanks the Agencia de Investigación and Banco Santander Central Hispano for the pre-doctoral grant that allows the realization of the PhD dissertation on which this paper is based. Correspondence: Alberto de Miguel.

1. Introduction.

Over the last decades, the relationship between the principal-agent conflict and corporate strategy has been a fundamental concern on both academic and practical grounds. Managerial and financial theories² have advanced research on the topic under the assumption that managers who are less aligned with outside investors tend to design corporate strategies which pursue growth and personal perquisites (i.e., diversification and internationalization) rather than value maximization (i.e., innovation).

Concerning diversification, most of the available evidence support that because diversified firms trade at a discount relative to their single-segment counterparts, diversification strategies represent a manifestation of a conflict of interests between managers and stockholders (Denis, Denis and Sarin, 1999) and a form of managers perquisite. Not in vain, Shleifer and Vishny (1989) report that one of the main motivations behind diversification strategies for entrenched managers is to make themselves valuable to shareholders and costly to replace. Amihud and Lev (1981, 1999) also report that through diversification strategies managers also diversify their own employment risk, reduce firm risk (at the expense of lower shareholders' returns) and increase firm size, thus, producing several personal gains, such as a concomitant increase in their compensation schemes (Stulz, 1990).

Nevertheless, the true effects of diversification on firm's value are still an empirical question. Recently, Villalonga (2004) has fuelled more debate on the issue by uncovering the existence of a diversification premium, which indicates that managers pursue shareholders' interests when diversifying.

But still the evidence found in several countries suggests that companies which exhibit less agency problems are less diversified, and, more specifically, that firms with greater ownership concentration are less diversified, highlighting the correlation between agency problems and ownership structure. For instance, Hill and Snell (1988) found that for research-intensive industries where managers dominate, diversification strategies are exacerbated, while innovation strategies are favored for owner-controlled firms. Amihud and Lev (1999) and Chkir and Cosset (2001) also report that for diffuse ownership, firms are not stimulated to pursue corporate value-maximizing strategies.

Therefore, when control mechanisms are effective, we may talk of an ownership moderator effect, both in terms of ownership concentration and the level of insider ownership³ (Jensen and Meckling, 1986), which also affects diversification. Denis, Denis and Sarin (1997, 1999) report that the level of diversification is negatively related to managerial equity ownership, and to the equity ownership of outside blockholders.

² Lane, Canella y Lubtakin (1998) and Arthus y Busenitz (2003), among others, discuss the limitations of the agency theory so as to describe the relationship between corporate strategy and the value of the firm. This relationship has also been analysed from other competing theories, such as the stewardship theory (Donaldson and Davis, 1991; Fox and Hamilton, 1994) and managerial approaches. Denis, Denis and Sarin (1999) and Amihud and Lev (1999) support the agency theory approach as the most relevant to analyse this issue.

³ Graves (1988), Graves and Wasddock (1990), Bethel and Liebeskind (1993) analyse the role played by different kinds of equity owners (blockholders, institutional owners) in strategic decision-making and corporate restructurations.

Carpenter, Pollock and Leary (2003) go further and point out the need of integrating agency and behavioral perspectives to analyze corporate strategy. From their point of view, the choice of corporate strategy and the nature of risks undertaken is a consequence of the interaction of governance mechanisms and stakeholder characteristics. The agency theory, in fact, suggests that governance mechanisms can encourage managerial risk-taking and thus exacerbate corporate diversification. If so, governance mechanisms beyond equity ownership structure should be also taken into account.

In this sense, the current investigation, apart from focusing on the effects of insider ownership and ownership concentration on diversification, also examines whether other governance mechanisms, such as leverage, directors' remuneration and the compliance with codes of good practices, have a direct influence upon diversification. Our main proposition being that for lower levels of shareholder protection, higher diversification is expected.

In fact, no much evidence exists on these issues for countries depicted by low levels of shareholder protection. Most of the available evidence on the relationship between governance mechanisms and diversification comes from the U.S. and common-law countries. However, La Porta, Lopez-de-Silanes and Vishny (1999) state that in civil law countries, ownership concentration becomes a substitute for legal investor protection, which gives great relevance to the study of ownership structure in these countries.

For this reason, we explore the relationship between ownership structures and diversification for Spanish firms. Spain provides a particularly well suited scenario for the analysis since it is an example of a civil law country in which the protection of investors is weaker than that in the U.S. and other European markets (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1998; Miguel, Pindado and De la Torre, 2004) and where the level of information asymmetries is very high (Del Brio, Miguel and Perote, 2002), which enhances the divorce between managers and outside investors.

Furthermore, according to Miguel, Pindado and De la Torre (2004), a non-linear relationship exists between ownership concentration and firms' value for Spanish companies which implies that rent expropriation is likely for the very high levels of ownership concentration, as compared to other countries. They also uncover that Spanish insiders get entrenched at higher ownership levels than their U.K. and U.S. counterparts⁴, while Pindado and De la Torre (2006) find that concentrated ownership requires high levels of insider ownership in order to ensure value maximization. All in all, the functioning of corporate governance mechanisms in Spain are at variance from U.S. and U.K. firms, which can also lead to different conclusions regarding the adoption of diversification strategies.

Therefore, the current paper attempts to analyze for the first time the influence of corporate governance mechanisms on the decision of diversification in a civil-law country, thus providing the first comparison for US and common-law countries' results. When analyzing the relationship between diversification and ownership structures under the agency theory framework, we should explore how the effects of the expropriation and entrenchment phenomena affect corporate strategy. Since diversification is expected to be negatively related to firm's value, we expect to get a convex function (rather than the concave

⁴ Spanish insiders get entrenched when ownership ranges from 35% to 70% rather than in the range 5% to 25% reported for US firms or the 12% and 41% for U.K. managers.

relationship identified for ownership concentration and firm's value) between ownership concentration and diversification and a cubic function for insider ownership.

Our results corroborate both expectations: a quadratic relationship between ownership concentration and diversification (in the opposite sign than the relationship between ownership and firm value), and a cubic relationship between insider ownership and diversification (also with the opposite sign). We also find that debt and the compliance with codes of good practices are negatively related to the level of diversification, as predicted by the agency theory. The relationship between directors' remuneration and diversification, however, is not conclusive.

This paper is organized as follows: Section 2 describes the hypotheses and reviews the literature on diversification and corporate governance issues, placing special emphasis on insider ownership and ownership concentration. Section 3 describes the sample and the methodology employed. Sections 4 and 5 contain the results and the main conclusions, respectively.

2. Hypotheses.

2.1. Ownership concentration and insider ownership.

Due to the monitoring effects of ownership concentration (Shleifer and Vishny, 1986; 1997), high levels of ownership concentration are expected to motivate the adoption of value-maximizing corporate strategies and prevent diversification. However, when the entrenchment effect dominates we find that for very high levels of ownership concentration, controlling owners are not willing to take on too much risk and thus pursue diversification strategies which usually drive to rent expropriation from minority shareholders and worsen companies' returns.

If we focus on a context of weak shareholder protection, this situation is exacerbated since the likelihood of expropriation is greater in countries with weaker investor protection (La Porta, Lopez-de-Silanes and Shleifer, 1999). Actually, La Porta, Lopez-de-Silanes, Vishny and Shleifer (1998) state that companies in countries with poor investor protection have more concentrated ownership of their shares, since dominant shareholders who monitor the managers might need to own more capital, *ceteris paribus*, to exercise their control rights and thus to avoid being expropriated by the managers.

The picture emerging for the Spanish companies accurately agrees with the situation described above: (i) their level of ownership concentration is higher than that of their US or Japanese counterparts (Fernández Rodríguez, Gómez-Ansón and Cuervo-García, 2004) and (2) a non-linear relationship between firm's value and ownership concentration has been uncovered by Miguel, Pindado and De la Torre (2004).

Given these arguments, for low protection scenarios we expect a quadratic U-shaped function to depict the relationship between ownership concentration and diversification. If so, the monitoring function of ownership concentration will only work at low levels of ownership concentration, driving to expropriation effects at very high levels. Thus, we propose the following hypothesis:

Hypothesis 1: In a scenario of weaker shareholder protection, a non-linear relationship is expected between corporate diversification and ownership concentration

As stated above, the likeliness of entrenchment in scenarios characterized by low levels of investor protection is very high. Although the agency theory suggests that managerial share ownership helps to closely align the interests of managers and owners and to enhance shareholder values, an excessive managerial equity may distort the monitoring effects of insider ownership. Thus, from a particular threshold on, managers may have incentives to increasing their personal wealth rather than firm value, which also favors the adoption of diversification strategies.

Thus, a non-linear relationship should be also expected between insider ownership and corporate diversification. According to recent results by Miguel, Pindado and De la Torre (2004) for the Spanish context, firm value decreases with insider ownership at intermediate levels (when ownership ranges from 35% to 70%) and increases with insider ownership at low and high levels (outside the abovementioned interval), giving place to a cubic relationship which has also been suggested by Mudambia and Nicosia (1998) and Hermalin and Weisbach (1991) for UK and US firms, respectively.

Therefore, since managers are entrenched between 35% and 75% of equity ownership, we may also expect a cubic relationship between insider ownership and diversification, which should be, however, of the opposite sign. That is, for intermediate levels of insider ownership where managers are likely to be entrenched, a positive relationship should be expected between managerial ownership and diversification. On the contrary, the relationship is expected to turn to negative for any percentage of insider ownership outside this interval, since managers interests shall be then aligned with those of shareholders.

Hypothesis 2: managers exhibiting either low or high ownership stakes within their own firm, will not select diversification strategies, while managers exhibiting moderate levels of equity ownership are more likely to set diversification strategies pursuing firm growth.

2.2. Control variables

The monitoring effect of debt on the conflict of interests has been widely documented in the literature since Jensen (1986). Concerning ownership structure, debt financing, as noted by Pindado and De la Torre (2006), succeeds in monitoring managers by limiting their profits through the misuse of their dominant position and, consequently, the incentives to entrench through share ownership diminish. Therefore, the inclusion of debt as control variable in our model is highly recommended.

Concerning corporate strategy, debt is found to reduce the risk of managers adopting unrelated diversification strategies which fail to create value from a shareholder viewpoint, since managers are exposed to the monitoring role of debt markets (Barton and Gordon, 1987; 1988). However, the only study which analyses the relationship between debt and diversification in the Spanish market, Menéndez-Alonso (2003), did not find a significant relationship between both variables, despite he used different debt ratios and different measures of diversification. According to the agency theory, we formulate hypothesis 3:

Hypothesis 3: a negative relationship is expected between debt ratio and the degree of corporate diversification.

Also the moderating role of the codes of good practices on the managers' choice of diversification strategies should be considered. Codes of good practices are deemed a key to more effective corporate governance and value maximization, since they may curb managerial discretion and increase minority shareholders protection. Mallin, Mullineux and Wihlborg (2005) consider that only through codes of good practice is it possible to increase confidence in managers, which, in conjunction with a favorable economic panorama, creates a very attractive atmosphere for shareholders. Actually, corporate governance codes encourage public firms to provide more information on the ethics of the business and the transparency of the management. In low protection scenarios, the codes of good practices are extremely useful as substitutes of the inefficient legal protection of the shareholders.

The Olivencia Code⁵ contained 23 recommendations which were mainly devoted to enhance a proper functioning of the ownership structure, the board of directors, the level of shareholders' rights and the transparency of a firm. As salient features of the Spanish companies regarding their compliance with the code, we may highlight (i) low percentage of shares held by the State, (ii) correct size, composition and number of annual meetings of the Boards of Directors, (iii) existence of audit and nominees and remuneration committees, (iv) low degree of usage of anti-takeover devices, (v) high degree of accountings' transparency of information, and (vi) high degree of transparency of information on the web page (Gomez-Anson, 2005).

Thus, concerning diversification, the codes of good practices, by aligning managers and outside investors' interests and enhancing value maximization, are expected to discourage diversification and other growth-pursuing strategies which managers adopt regardless of the shareholders' best interests. Thus, firms complying with the Olivencia code are less likely to adopt diversification strategies (Lehmann and Weigand, 2002; Fernández Rodríguez, Gómez-Ansón y Cuervo-García, 2004). Thus, our next hypothesis is as follows:

Hypothesis 4: The compliance with codes of good practices is negatively related to the level of product diversification.

Another outstanding feature that influences firm's value by way of monitoring managers behavior is directors' remuneration. Although there is a lack of consensus⁶, most of the available evidence supports that directors' remuneration works as an efficient incentive for managers to maximize firm value. Mehran (1995) finds that firm performance is positively related to the percentage of their compensation that is equity-based and to the percentage of equity held by managers. Denis, Denis and Sarin (1999) report that by tying managers compensation to shareholder wealth, the alignment of interests between ownership and

⁵ The current Spanish Code of Good Practice is the Aldama Code, however for the period of study, the Olivencia code was applying.

⁶ Rose and Shepard (1997) find higher executive remuneration in diversified firms since they are more difficult to run and thus managers expect a higher premium. Denis, Denis and Sarin (1999) also state that the payment of excessive salaries to managers is also an action that runs counter to shareholders' interests.

control is guaranteed, even when managerial equity ownership is low, thus discouraging diversification. Accordingly, we can expect a negative relationship between directors' remuneration and diversification, since managers are more likely to pursue value-maximizing strategies. Therefore, we formulate hypothesis 4:

Hypothesis 5: Directors' remuneration schemes are negatively related to the level of product diversification.

3. Sample and Methodology.

To evaluate these hypotheses, we have assembled a database of 50 non-financial firms quoting in the Spanish Continuous Market for the period 1996 to 2002. Combining the 50 firms for 7 years we thus constructed a complete, balanced panel of 350 observations which is estimated by using a GMM panel data estimator. Data on diversification measures, debt and directors' remuneration were obtained from Compustad database. Data on the compliance with the Spanish code of good practices were provided by the Spanish Stock Market Supervisory Commission (Comisión Nacional de Mercados de Valores, hereafter, CNMV).

The GMM estimation method (Arellano, 2003) controls for individual effects motivated by any variation on a firm-specific level and for the endogeneity problem, thus, allowing to properly consider the role played by corporate ownership in depicting corporate strategy. This methodology assumes that there is no autocorrelation in ε_{it} , which is tested through the m1 and m2 statistics of Arellano and Bond (1991) for first and second order autocorrelation in the first difference residuals. Moreover, the Sargan test of over-identifying restrictions for the dynamic panel data model must also be implemented to check the validity of the instruments on which the GMM estimator is based.

We tested two different models which examine the relationship between ownership concentration and diversification (Model 1), and insider ownership and diversification (Model 2). In both cases, the selected control variables (debt, compliance with codes of good practices and compensation schemes) are expected to capture any constraining influence in the selection of corporate strategy by upper echelons.

In Model 1, diversification is regressed on ownership concentration and its square, so as to test hypothesis 1. Following Miguel, Pindado and De la Torre (2004) we identify the break-point of the quadratic function (which is a minimum in our case), by computing the first partial derivative of diversification on ownership concentration⁷. Model 1 is expressed as in equation 1.

⁷ As in Miguel, Pindado and De la Torre (2004), we let this partial derivative equal zero, and thus the breakpoint is $OWNCON = -(\beta_1/2\beta_2)$. $OWNCON$ is negative and, consequently, β_1 and β_2 have opposite signs. Additionally, Hypothesis 1 implies that $OWNCON$ is a minimum and thus $\beta_2 > 0$ and $\beta_1 < 0$.

$$DIVER_{it} = \beta_0 + \beta_1 OWCON_{it} + \beta_2 OWCON_{it}^2 + \beta_3 DEBT_{it} + \beta_4 COMPGP_{it} + \beta_5 DIRCOMP_{it} + u_{it} \quad (\text{Eq. 1})$$

$$\forall i = 1, \dots, N \text{ y } \forall t = 1, \dots, T$$

where $u_{it} = \eta_i + \varepsilon_{it}$, and η_i captures the unobserved cross-sectional heterogeneity, and ε_{it} denotes the error term. $DIVER_{it}$ represents the Jacquemin-Berry (1979) entropy index which bases the diversification of the firm in the number of segments and the relative weight of each segment with respect to the total firm sales, as shown in equation 2.

$$DT = \sum_{i=1}^N P_i \ln\left(\frac{1}{P_i}\right) \quad (\text{Eq. 2})$$

where P_i is the share of the i th segment in the total sales of the firm. N is the number of industry segments (four digits) in which a firm operates, as provided by the Compustad database. $OWCON_{it}$ denotes ownership concentration and is measured as the Herfindalh index (ownership percentage of the five largest shareholders), and $OWCON_{it}^2$ is its square. $DEBT_{it}$ denotes leverage and is measured by the debt ratio to total assets (as extracted from the Compustad database). $DIRCOMP_{it}$ denotes the level of directors remuneration, and is measured as the ratio of director remuneration to earnings before interests and taxes. It was also obtained from the Compustat database. Finally, $COMPGP_{it}$ denotes the level of compliance with the recommendations of the Olivencia code of good practice for the i th firm in period t .

Data on compliance with the Olivencia code by all Spanish firms quoting in the Spanish Continuous Market were obtained from the CNMV. The CNMV sent a questionnaire to all Spanish quoted firms demanding information of their compliance with each of the 23 recommendations contained in the Olivencia code. The answers to this questionnaire were obtained from the CNMV website. To construct the variable COMPLCG, we assigned a value of 0, 1 or 2 to each of the first 22 recommendations⁸, considering whether the firm has total compliance (2), partial compliance (1) or non compliance (0) with each recommendation. We finally computed the sum of the weights obtained for the whole group of recommendations by each firm in a particular year.

Model 2, in turn, is expressed as in equation 3. To test hypothesis 2, diversification is regressed on insider ownership, its square and its cubic. In this case, we may identify whether the breakpoints are a minimum or a maximum by calculating the second partial derivative.

$$DIVER_{it} = \beta_0 + \beta_1 IOW_{it} + \beta_2 IOW_{it}^2 + \beta_3 IOW_{it}^3 + \beta_4 DEBT_{it} + \beta_5 COMPGP_{it} + \beta_6 DIRCOMP_{it} + u_{it} \quad (\text{Eq. 3})$$

⁸ We do not include recommendation 23 into the analysis since it refers to the obligation of the firm to report its compliance with the CGC to the CNMV. All the firms in our sample have so reported to the CNMV at least one year in our sample period.

where IOW_{it} denotes insider ownership and is measured as the percentage of outstanding shares possessed by a firm's managers. IOW_{it}^2 stands for its square, and IOW_{it}^3 represents its cubic. The rest of the variables are defined as in Model 1.

4. Results.

4.1. Ownership concentration and diversification.

Concerning ownership concentration, our results (as shown in Table 1) show a quadratic (U-shaped) relationship between diversification and ownership concentration with a breakpoint, which is a minimum, located at 91% level of ownership concentration (Figure 1).

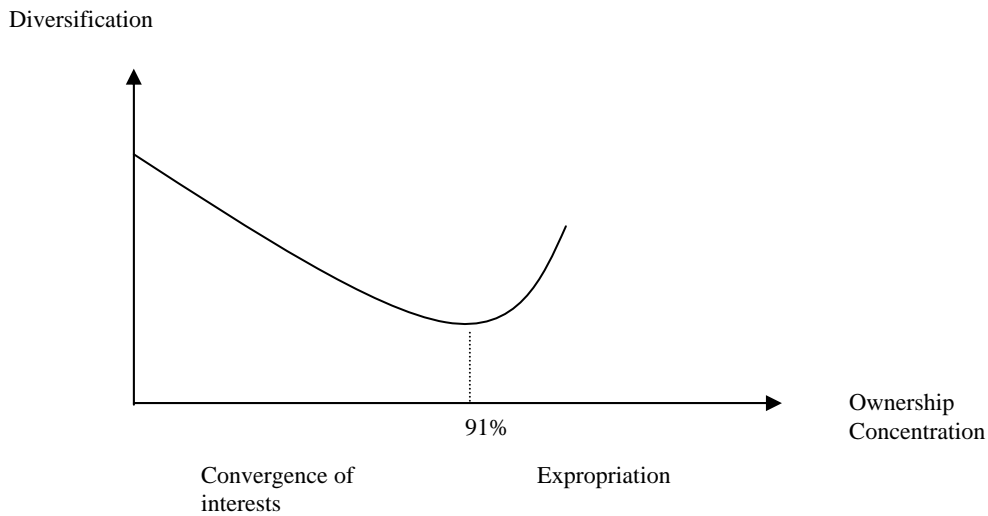
Table 1: Results for the panel data estimation of Model 1: diversification and ownership concentration.

This table reports the values of the coefficients, t-statistics and p-value for the estimation of Model 1.

	COEFFICIENT	STD. ERR.	Z	P > [Z]
DIVERS (-1)	5,69E-01	6,75E-02	8.43	0.000
OWNCONC	-6,24E-03	2,22E-03	-2.81	0.005
OWNCONC ²	3,42E-05	2,07E-05	1.65	0.098
DEBT	-1,03E-04	5,19E-05	-1.99	0.047
COMPGP	-1,04E-03	5,03E-04	-2.08	0.038
DIRCOM	-3,05E-04	2,92E-04	-1.05	0.296
INTERCEPT	5,94E-03	7,46E-03	0.80	0.426
M 1			-2.27	0.0231
M 2			-1.03	0.3017
SARGAN			12.33	0.5799

Thus, as the ownership concentration increases till 91%, diversification strategies are less likely to be adopted since managers are properly monitored by blockholders. However, since the sign of the function changes from 91% on, we find that for very highly concentrated firms, the expropriation hypothesis applies and managers' interests do not converge with those of the shareholders, thus exacerbating diversified structures.

FIGURE 1: QUADRATIC RELATIONSHIP FOR DIVERSIFICATION AND OWNERSHIP CONCENTRATION



Thus, our results corroborate those of Miguel, Pindado and De la Torre (2004) which identify a concave relationship between value and ownership concentration, which confirmed the monitoring and the expropriation effect hypothesis for the very highest concentration values in Spanish firms. We have advanced researched by providing the first evidence on the non-linear relationship between ownership concentration and diversification rather than focusing on firm value.

As to the control variables, concerning the compliance with the codes of good practices, the expected degree of compliance shows a negative coefficient ($\beta_4 = -0.0010449$). As expected, good governance practices mediate the relationship between diversification and ownership concentration. Those firms that observe good governance are less likely to diversify and, in turn, are more likely to pursue strategies which ensure shareholders' interests. As to the moderating role of debt, previously documented in the literature, we get a significant negative relationship, thus concluding that firms which diversify usually prefer equity to debt for financing the firm ($\beta_3 = -0.0001032$). Our results are at variance to those of Menendez-Alonso (2003) for the Spanish market, since he did not find a significant relationship between leverage and diversification. Finally, regarding directors remuneration, we identify a non-significant negative relationship, which questions the role of directors' compensation schemes as an efficient monitoring mechanism. It could be explained in the light of the lack of consensus mentioned above. In short, we may conclude that corporate governance palliates diversification, although its role as control mechanism should be enhanced for Spanish firms.

4.2. Insider Ownership and diversification

Concerning insider ownership (Model 2), results are shown in Table 2.

Table 2: GMM estimation of Model 2: diversification and insider ownership.

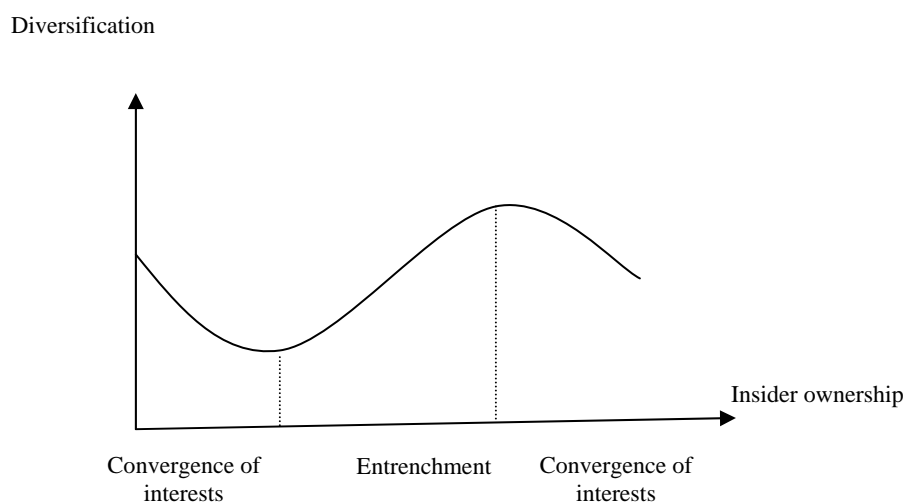
This table reports the values of the coefficients, t-statistics and p-value for the estimation of Model 2.

	COEFFICIENT	Z	P-value
DIVERS (-1)	6,35E-01	6.91	0.000
IOWN	-9,78E-03	-1.99	0.046
IOWN ²	4,93E-04	1.84	0.066
IOWN ³	-5,33E-06	-1.57	0.166
DEBT	-2,52E-06	-0.92	0.360
COMPGP	-6,03E-04	-1.29	0.198
DIRCOM	-4,15E-04	-2.18	0.029
INTERCEPT	-4,43E-03	-0.70	0.487
M 1		-2.30	0.0213
M 2		-1.13	0.2604
SARGAN		17.10	0.2509

They confirm a cubic relationship between insider ownership and diversification, as expected. It means that for low and high levels of ownership concentration, managers are able to expropriate shareholders' wealth and diversification strategies are more likely to be adopted. We find that in a first moment, insider ownership is negatively and significantly related to diversification (at a 5% level). However, its square is positively related to diversification ($\beta_2= 0.000493$), thus reflecting a direct relationship between insider ownership and diversification for entrenched managers. Finally, for upper levels of insider ownership, the convergence of interest is restored ($\beta_3= -0.000533$) and the level of diversification of the firm decreases (See Figure 2).

Additionally, for the control variables, we report similar results to those obtained upon the ownership concentration framework. The three variables are negatively related to diversification when insider ownership moderates the relationship, but the level of significance of these relationships are lower than those obtained when ownership concentration moderates its relationship with diversification.

FIGURE 2: CUBIC RELATIONSHIP BETWEEN DIVERSIFICATION AND INSIDER OWNERSHIP



5. Conclusions.

We analyze the relationship between ownership structure and corporate strategy for the first time in a civil-law country. By applying a GMM estimator on a complete and balanced panel, our results show that it exists a non-linear relationship between diversification and ownership concentration, which is a quadratic U-shaped function, and between diversification and insider ownership, which is cubic. Thus we provide the first evidence on a non-linear relationship between concentration structures and diversification, which has been usually found to be linear for US, and UK companies.

This papers shows that for low and moderate levels of ownership concentration, their benefits overpass their costs, but for higher levels, the conflict of interests between managers and shareholders arises, which indicates that sometimes the costs of the conflict between blockholders and minority shareholders are more severe than the managers-shareholders conflict. This problem could be exacerbated in countries with poor shareholder protection.

Therefore, the emerging picture is that of a company whose managers increase the level of diversification when they are entrenched, thus pursuing their personal goals rather than value maximization, and whose level of ownership concentration should be very high so as to compensate the lack of legal protection of the outside investors. Furthermore, concentrated ownership requires of very high levels of insider ownership to prevent expropriation.

We also find that debt and the compliance with codes of good practices are negatively related to the level of diversification, as predicted by the agency theory. The relationship between directors' remuneration and diversification, however, is not conclusive.

All in all, our results confirm the theoretical relevance of the agency theory in explaining the managerial attitudes towards corporate strategy, i.e., diversification. These results also corroborate the relevance of corporate governance mechanisms to promote firm value maximizing strategies. This is especially important in scenarios characterized by weak shareholder protection, such as civil-law countries. Due to their deficiencies in legal shareholder protection, their concentrated ownership structures and the higher likelihood of managers being entrenched, companies located in these countries should place their emphasis on enhancing the correct functioning of corporate governance mechanisms. These mechanisms are deemed effective to reduce agency costs and align the interests of managers and outside investors, which may guarantee both to the maximization of firm value and the stability and welfare of top managers.

REFERENCES

AMIHUD, Y. and LEV, B. (1981): Risk Reduction as a Managerial Motive for Conglomerate Mergers, *Bell Journal of Economics*, 12 (2): 605 – 618.

AMIHUD, Y. and LEV, B. (1999): Does corporate ownership structure affect its strategy towards diversification? *Strategic Management Journal*, 20 (11): 1063-1069

ARELLANO, M. and BOND, S. R. (1991): “Some Tests of Specification for Panel Data: Monte Carlo Evidence and Application to Employment Equations”, *Review of Economic Studies*, 58: 277-297.

ARELLANO, M. (2003): *Panel Data Econometrics*. Advanced Texts in Econometrics. Oxford University Press Inc., New York.

ARTHUS, J. D. and BUSENITZ, L. W. (2003): “The Boundaries and Limitations of Agency Theory and Stewardship Theory in the Venture Capitalist/Entrepreneur Relationship”, *Entrepreneurship: Theory & Practice*, 28 (2): 145-163.

BARTON, S. and GORDON, P. (1987): “Corporate Strategy: Useful Perspective for the Study of Capital Structure?”, *Academy of Management*, 12 (1): 67-76.

BARTON, S. L. and GORDON, P. J. (1988): “Corporate Strategy and Capital Structure”, *Strategic Management Journal*, 9 (6): 623-632

BERGER, P. and OFEK, E. (1995): “Diversification’s Effect on Firm Value”, *Journal of Financial Economics*, 37: 39-65.

BETHEL, J. E. and LIEBESKIND, J (1993): “The effects of ownership structure on Corporate Restructuring”, *Strategic Management Journal*, 14: 13-31.

CARPENTER, M. A., POLLOCK, T. G. and LEARY, M. M. (2003): “Testing A Model Of Reasoned Risk-Taking: Governance, The Experience Of Principals And Agents, And Global Strategy In High-Technology IPO Firms”, *Strategic Management Journal*, 24 (9), 802-820.

- CHKIR, I. E. and COSSET, J. C. (2001): “Diversification strategy and capital structure of Multinational Corporations”, *Journal of Multinational Financial Management*, 11:17-37.
- COOL, K., DIERICKX, I. and JEMISON, D. (1989): “Business Strategy, Market Structure and Risk-Return Relationships: A Structural Approach”, *Strategic Management Journal*, 10 (6): 507-523.
- DENIS, D., DENIS, D. and SARIN, A. (1997): “Agency problems, Equity Ownership, and Corporate Diversification”, *The Journal of Finance*, 52 (1), 135-160.
- DENIS, D. J., DENIS, D. K. and SARIN, A. S. (1999): “Agency theory and the influence of equity ownership structure on corporate diversification strategies”, *Strategic Management Journal*, 20,(11) : 1071-1076.
- DONALDSON, L. and DAVIS, J. H. (1991):”Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns”, *Australian Journal of Management*, 16 (1): 49 – 66.
- FERNÁNDEZ RODRÍGUEZ , E., GÓMEZ-ANSÓN, S. and CUERVO-GARCÍA, A. (2004): “The Stock Market Reaction to the Introduction of Best Practices Codes by Spanish Firms”, *Corporate Governance*, 12 (1): 29-46.
- FOX, M. A. and HAMILTON, R. T. (1994): “Ownership and Diversification: Agency Theory or Stewardship Theory”, *Journal of Management Studies*, 31 (1): 69 – 83.
- GÓMEZ-ANSON, S. (2005): “Corporate Governance Developments in Spain”, *UNECE Roundtable on Corporate Governance*. Geneve, 9 February 2005.
- GRAVES, S. B. (1988): “Institutional Ownership and Corporate R&D In The Computer Industry”, *Academy of Management Journal*, 31 (2): 417-429
- GRAVES, S. B. and WADDOCK, S. A. (1990): “Institutional ownership and control: implications for long-term corporate strategy”, *Academy of Management Executive*, 4 (1):75-84.
- HILL, C. and SNELL, S. (1988): “External Control, Corporate Strategy, and Firm Performance in Research-Intensive Industries”, *Strategic Management Journal*, 9, 577-590.
- JACQUEMIN, A.P. and BERRY, C. H. (1979): “Entropy Measure of Diversification and Corporate Growth”, *The Journal of Industrial Economics*, 27 (4) : 359
- JENSEN, M. C. (1986): “Agency costs of free cash flow, corporate finance, and takeovers”, *AEA Papers and Proceedings*, 76: 323-329.
- JENSEN, M. and MECKLING, W. (1976): “Theory of the firm: Managerial Behaviour Agency Costs and Ownership Structure”, *Journal of Financial Economics*, 3 (4), 305-360.

- LANE, P. J., CANELLA, A. A., and LUBTAKIN, M. H. (1998): "Agency problems as antecedents to unrelated diversification: Amihud and Lev reconsidered", *Strategic Management Journal*, 19 (6): 555-578.
- LANE, P. J., CANELLA, A. A., and LUBTAKIN, M. H. (1999): "Ownership structure and Corporate Strategy: One question viewed from Two Different Worlds", *Strategic Management Journal*, 20 (11), 1077-1086.
- LEHMANN, E. and WEIGAND, J. (2000): "Does the Governed Corporations Perform Better?" Governance Structures and Corporate Performance in Germany", *European Finance Review*, 4 (2), 157-195.
- MEHRAN, H. (1995): "Executive Compensation Structure, Ownership, and Firm Performance"; *Journal of Financial Economics*, 38, 163-184.
- MENÉNDEZ-ALONSO, E. J. (2003): "Does diversification strategy matter in explaining capital structure? Some evidence from Spain", *Applied Financial Economics*, 13, 427-430.
- MIGUEL, A., J. PINDADO and C. DE LA TORRE (2004): "Ownership Structure and Firm Value: New Evidence from Spain." *Strategic Management Journal*, 25: 1199-1207.
- MUDAMBI, R. and NICOSIA, C. (1998): "Ownership Structure and Firm Performance: Evidence from the UK Financial Services Industry", *Applied Financial Economics*, 8, 175-180.
- PINDADO, J., and DE LA TORRE, C., (2006): "The Role of Financing, Investment and Dividend Decisions in Explaining Corporate Ownership Structure: Evidence from Spain", *European Financial Management*, 12(5): 661-687.
- ROSE, N. L. and SHEPARD, A. "Firm diversification and CEO compensation: Managerial ability or executive entrenchment?", *The Rand Journal of Economics*, 28 (3); 489-515.
- SHLEIFER, A. and VISHNY, R.W. (1986): "Large shareholders and corporate control", *Journal of Political Economy*, 95: 461-488.
- SHLEIFER, A. and VISHNY, R. W. (1989): "Management Entrenchment", *Journal of Financial Economics*, 25 (1), 123- 140.
- SHLEIFER, A. and VISHNY, R. W. (1997): "A Survey of Corporate Governance", *Journal of Finance*, 52 (1): 35-55.
- STULZ, R. M. (1988): "Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control", *Journal of Financial Economics*, 20: 25-55
- STULZ, R. M. (1990): "Managerial discretion and optimal financing policies", *Journal of Financial Economics*, 26 (1): 3 - 28.