Joshua D. Shackman

Corporate Diversification, Vertical Integration, and Internal Capital Markets: A Cross-Country Study

Abstract and Key Results

- In this paper I test the theory that internal capital markets are a motivation for both corporate diversification and vertical integration. I use a sample of 1560 firms from 39 countries.
- Using this data I also test theories about vertical integration and capital market development. I also test agency cost and taxation theories of diversification and vertical integration.
- I find a significant and negative relationship between corporate diversification and capital market development.
- I find a significant and positive relationship between vertical integration and capital market development.

Key Words

Diversification, Vertical Integration, Shareholder Protection, Capital Market Development

Author

Joshua D. Shackman, Associate Professor of Business Administration, Touro University International, Cypress, CA, USA.
Manuscript received October 2005, revised March 2006, final version received November 2006.
Introduction

Vertical integration has been described as a strategy that “puts more of one’s eggs in one basket” (Chatterjee/Lubatkin/Schoenecker 1992, p. 154) since it involves a firm further committing itself to one specific industry rather than spreading itself across several industries. Conversely, corporate diversification may be described as putting eggs in several baskets as it involves a firm spreading its interests out into multiple industries. Little research has been done comparing the determinants of these opposing strategies: vertical integration and diversification. What research has been done on the determinants of these strategies focused primarily on data from U.S. firms. This study compares the determinants of diversification and vertical integration using a sample of firms from 39 developed and lesser-developed countries.

By using firm-level data from 39 countries, we are able to test the impact of capital market development on corporate diversification and vertical integration through the wide range of relevant data among the countries in this sample. Empirical tests asserting that corporate diversification is a more attractive strategy in countries with weaker capital market development have so far produced mixed results (Lins/Servaes 2002, Fauver/Houston/Naranjo 2003). One reason for these mixed results is in the basis for the studies, which examine observed valuation effects of diversification across countries rather than the actual degree and extent of the diversification itself. The method used in these estimated valuation effects studies has also been criticized for ignoring possible sample selection bias problems (Villalonga 2004b, Caves/Kedia 2002). Furthermore, the impact of capital market development on vertical integration has not been widely explored. Therefore, the approach of analyzing both the extent and degree of diversification and vertical integration in a sample of firms from 39 different countries allows us to address the following research questions:

Research Question 1: What is the relationship between capital market development and corporate diversification?

Research Question 2: What is the relationship between capital market development and vertical integration?

Using U.S. data, previous researchers have compared the impact of ownership concentration on vertical and diversifying mergers (Ahimud/Lev 1982, Lane/Cannella/Lubatkin 1998), with the argument that high ownership concentration reduces agency costs as large blocks of shareholders are able to more effectively monitor management. Firms outside of the U.S. often have much greater ownership concentration patterns than those in the U.S. (La Porta/Lopez-de-Silanes/Schleifer/Vishny 1998) thus allowing for richer tests of agency theory explanations for the strategies in question. Additionally, Ahimud and Lev (1982) and Lane, Cannella