ABSTRACT

Diversified firms trade at a discount relatively to similar single-segment firms. We argue in this paper that this observed discount is not per se evidence that diversification destroys value. Firms choose to diversify. Firm characteristics, which make firms diversify, might also cause them to be discounted. Not taking into account these firm characteristics might wrongly attribute the observed discount to diversification. Data from the Compustat Industry Segment File from 1978 to 1996 is used to select a sample of single segment and diversifying firms. We use three alternative econometric techniques to control for the endogeneity of the diversification decision. All three methods suggest the presence of self-selection in the decision to diversify and that a negative correlation exists between firm's choice to diversify and firm value. We do a similar analysis in a sample of refocusing firms. Again, some evidence of self-selection by firms exists and we now find a positive correlation between firm's choice to refocus and firm value. These results consistently suggest the importance of taking the endogeneity of the diversification status into account in analyzing its effect on firm value.