What I Teach My Students about the Diversification Discount: A Brief Summary
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Students in my Advanced Corporate Finance course address the diversification discount during the segment on mergers and corporate control. My goal is to develop their understanding of both the theoretical and the practical issues surrounding diversifying mergers. First, we discuss the irrelevance of a diversifying merger to firm value under the Modigliani-Miller assumptions. We recall that if shareholders seek diversification of unsystematic risk, they can diversify within their own portfolio directly by buying other stocks, rather than diversifying at the firm level. Discussion then turns to how diversification is different from other motivations for mergers that create value by reducing costs or enhancing revenues. We introduce the idea that diversification provides cash flow coinsurance: the assets of the segments generate partially offsetting cash flows which make them less variable overall. This directly benefits the bondholders by reducing their risk. Shareholders may actually be made worse off by this coinsurance, however, because as holders of a call option on the firm's assets they are hurt when cash flow variance is reduced. The class then discusses the tax and informational consequences of these mergers.

Next, we discuss the wave of conglomerate mergers, in 1967-1969, when many companies in unrelated business lines joined together for diversification. We observe that many of the conglomerates created during this period were subsequently broken apart in the 1980s, and we consider the implications for value creation and destruction.

I then present empirical evidence regarding the diversification discount. Much of this evidence addresses the average discount, and many theories have been offered to explain this average. We discuss how measurement issues, such as difficulties in matching comparable firms, affect our interpretation of the evidence.

Finally, since the variation across firms and over time in the diversification discount (or premium) is under-examined but important, I present my students with the theoretical predictions that emerge from my model with Paolo Fulghieri.[1] We predict the magnitude of the diversification discount (or premium) for each merger by considering the nature of the merging firms' assets. We define asset specificity as the difference in value between an asset in its best use and in its next best alternative use. Asset specificity measures how firm-specific or specialized assets are. Our theory predicts a small number of diversifying mergers in industries characterized by limited asset specificity, and a diversification discount when these firms do choose to merge. We also predict that for diversifying mergers, post-merger performance should be increasing in the degree of asset specificity.

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[1] See Fulghieri and Hodrick (2003), "Synergies and Internal Agency Conflicts: The Double-Edged Sword of Mergers."